

# COVER SHEET

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S.E.C Registration Number

M A N I L A E L E C T R I C C O M P A N Y

(Company's Full Name)

L O P E Z B U I L D I N G , O R T I G A S A V E N U E ,  
B A R A N G A Y U G O N G , P A S I G C I T Y

(Business Address: No. Street City / Town / Province)

ATTY. WILLIAM S. PAMINTUAN

Contact Person

632-8014

Company Telephone Number

1 2 - 3 1

Month Day

Fiscal Year

SEC FORM

1 7 Q

FORM TYPE

0 5

Month

2 7

Day

Annual Meeting

Secondary License Type, if Applicable

Dept. Requiring this Doc.

Amended Articles Number/Section

Total No. of Stockholders

Total Amount of Borrowings

Domestic

Foreign

To be accomplished by SEC Personnel concerned

File Number

LCU

Document I.D.

Cashier

STAMPS

Remarks = pls. use black ink for scanning purposes

# **SECURITIES AND EXCHANGE COMMISSION**

## **SEC FORM 17-Q**

### **QUARTERLY REPORT PURSUANT TO SECTION 17 OF THE SECURITIES REGULATION CODE AND SRC RULE 17(2)(b) THEREUNDER**

1. For the quarterly period ended: *June 30, 2014*
2. Commission identification number: *PW-102*
3. BIR Tax Identification Code: *000-101-528-000*
4. Exact name of issuer as specified in its charter: *Manila Electric Company*
5. Country of Incorporation: *Philippines*
6. Industry Classification: (SEC use only)
7. Address of issuer's principal office: *Lopez Building, Ortigas Avenue,  
Barangay Ugong, Pasig City  
Postal Code: 1605*
8. Issuer's Telephone Numbers including area code: *16220*
9. Former name, former address and former fiscal year, if changed since last report: *N/A*
10. Securities registered pursuant to Sections 8 and 12 of the Code, or Sections 4 and 8 of RSA:

Number of Shares of  
Common Stock Outstanding

*1,127,271,117<sup>1</sup>*  
(As of June 30, 2014)

**Amount of Debt Outstanding:** *Php33, 173,650,679 as of June 30, 2014.*

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<sup>1</sup> Include 172,412 shares held in treasury

**11. Are any or all of these Securities listed on a Stock Exchange?**

Yes ☒ No ☐

If yes, the name of such Stock Exchange and the class/es of Securities:

*Philippine Stock Exchange*

**12. Indicate by check mark whether the registrant:**

- (a) has filed all reports required to be filed under Section 17 of the Code and SRC Rule 17 thereunder or Sections 11 of the RSA and RSA Rule 11(a)-1 thereunder, and Sections 26 and 141 of the Corporation Code of the Philippines, during the preceding twelve (12) months (or for such shorter period that the registrant was required to file such reports):

Yes ☒ No ☐

- (b) has been subject to such filing requirements for the past ninety (90) days:

Yes ☒ No ☐

## **PART I – FINANCIAL INFORMATION**

**Item 1. Financial Statements**

*The Second Quarter 2014 Financial Statements is hereto attached and made integral part of this report.*

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*Please refer to the attached Second Quarter 2014 Management's Discussion and Analysis of Financial Condition and Results of Operations.*

## **PART II – OTHER INFORMATION**

*Not applicable.*

**SIGNATURES**

Pursuant to the requirements of the Securities Regulation Code, the issuer has caused this report to be signed on its behalf by the undersigned duly authorized representatives.

**MANILA ELECTRIC COMPANY**  
Issuer



**WILLIAM S. PAMINTUAN**  
First Vice President,  
Assistant Corporate Secretary &  
Information Disclosure Officer



**BETTY C. SIY-YAP**  
Senior Vice President &  
Chief Finance Officer

**Date: August 14, 2014**

*Cc: Disclosure Department  
Listings and Disclosure Group  
Philippine Stock Exchange*

*Issuer Compliance and Disclosure Department  
Philippine Dealing & Exchange Corp.*

## **Management's Discussion and Analysis of Financial Position and Results of Operations**

The following discussion and analysis of financial position and results of operations of Manila Electric Company or *MERALCO* and its subsidiaries, collectively referred to as the "*MERALCO Group*" should be read in conjunction with the unaudited interim consolidated financial statements as at June 30, 2014 and December 31, 2013 and for the six months ended June 30, 2014 and 2013. The unaudited interim consolidated financial statements have been prepared in compliance with the Philippine Financial Reporting Standards or *PFRS*. *PFRS* includes statements named *PFRS* and Philippine Accounting Standards, including Interpretations issued by the *PFRS* Council.

The financial information appearing in this report and in the accompanying unaudited interim consolidated financial statements is presented in Philippine pesos, *MERALCO Group's* functional and presentation currency, as defined under *PFRS*. All values are rounded to the nearest million pesos, except when otherwise indicated. The exchange rate used to translate U.S. dollars to Philippine peso in this report and in the accompanying unaudited interim consolidated financial statements is US\$1.00 to ₱43.65, the closing rate as at June 30, 2014 (the last trading day in June 2014) quoted through the Philippine Dealing System.

## **Financial Highlights and Key Performance Indicators**

| <i>(Amounts in millions, except financial ratios, earnings per share, and operational data)</i> |                                 |                              | <b>Increase (Decrease)</b> |          |
|-------------------------------------------------------------------------------------------------|---------------------------------|------------------------------|----------------------------|----------|
|                                                                                                 | <b>June 30,<br/>2014</b>        | <b>December 31,<br/>2013</b> | <b>Amount</b>              | <b>%</b> |
|                                                                                                 | (Unaudited)                     | (Audited)                    |                            |          |
| <b>Condensed Statements of Financial Position</b>                                               |                                 |                              |                            |          |
| Total assets                                                                                    | ₱263,745                        | ₱264,004                     | (₱259)                     | -        |
| Current assets                                                                                  | 108,857                         | 107,486                      | 1,371                      | 1        |
| Cash and cash equivalents                                                                       | 67,053                          | 59,851                       | 7,202                      | 12       |
| Equity attributable to equity holders of the parent                                             | 77,409                          | 75,162                       | 2,247                      | 3        |
| Total debt                                                                                      | 30,174                          | 33,591                       | (3,417)                    | (10)     |
| Current liabilities                                                                             | 77,859                          | 94,626                       | (16,767)                   | (18)     |
| <b>Financial Ratios</b>                                                                         |                                 |                              |                            |          |
| Debt to equity                                                                                  | 0.39                            | 0.45                         | (0.06)                     | (13)     |
| Current ratio                                                                                   | 1.40                            | 1.14                         | 0.26                       | 23       |
| <b>Operational Data</b>                                                                         |                                 |                              |                            |          |
| Number of customers (in thousands):                                                             |                                 |                              |                            |          |
| Residential                                                                                     | 5,004                           | 4,901                        | 103                        | 2        |
| Commercial                                                                                      | 458                             | 453                          | 5                          | 1        |
| Industrial                                                                                      | 10                              | 10                           | -                          | -        |
| Streetlights                                                                                    | 4                               | 4                            | -                          | -        |
|                                                                                                 |                                 |                              |                            |          |
|                                                                                                 | <b>(Unaudited)</b>              |                              |                            |          |
|                                                                                                 | <b>Six Months ended June 30</b> |                              | <b>Increase (Decrease)</b> |          |
|                                                                                                 | <b>2014</b>                     | <b>2013</b>                  | <b>Amount</b>              | <b>%</b> |
| <b>Condensed Statements of Income</b>                                                           |                                 |                              |                            |          |
| Revenues                                                                                        | ₱132,168                        | ₱141,714                     | (₱9,546)                   | (7)      |
| Costs and expenses                                                                              | 117,964                         | 128,964                      | (11,000)                   | (9)      |
| Other expenses (income)                                                                         | 314                             | (532)                        | 846                        | 159      |
| Income before income tax                                                                        | 13,890                          | 13,282                       | 608                        | 5        |
| Net income                                                                                      | 9,676                           | 9,474                        | 202                        | 2        |
| Net income attributable to equity holders of the parent                                         | 9,637                           | 9,441                        | 196                        | 2        |
| Earnings per share attributable to equity holders of the parent                                 | 8.55                            | 8.38                         | 0.17                       | 2        |
| <b>Condensed Statements of Cash Flows</b>                                                       |                                 |                              |                            |          |
| Net cash from operating activities                                                              | 24,178                          | 22,990                       | 1,188                      | 5        |
| Net cash used in investing activities                                                           | (6,730)                         | (12,444)                     | 5,714                      | 46       |
| Net cash used in financing activities                                                           | (10,246)                        | (12,136)                     | 1,890                      | 16       |
| <b>Financial Ratios</b>                                                                         |                                 |                              |                            |          |
| Profit margin                                                                                   | 7%                              | 7%                           | -                          | -        |
| Return on equity                                                                                | 12%                             | 13%                          | (1%)                       | (8)      |
| Asset turnover                                                                                  | 0.50                            | 0.54                         | (0.04)                     | (7)      |
| <b>Operational Data</b>                                                                         |                                 |                              |                            |          |
| Electricity sales volume (in GWh)                                                               | 17,299                          | 16,863                       | 436                        | 3        |
| System loss (in percentage) <sup>1</sup> :                                                      |                                 |                              |                            |          |
| MERALCO                                                                                         | 6.68%                           | 6.85%                        | (0.17%)                    | (2)      |
| CEDC                                                                                            | 4.55%                           | 4.23%                        | 0.32%                      | 8        |

<sup>1</sup> Based on 12-month moving average

## OVERVIEW

*MERALCO* is the Philippines' largest electric power distribution company, with franchise service area covering 9,337 square kilometers. It provides power to over five million customers in 35 cities and 76 municipalities, which include Metro Manila, the provinces of Rizal, Cavite and Bulacan, and parts of the provinces of Pampanga, Batangas, Laguna and Quezon. Turnover of business establishments in the franchise area accounts for around 55% of the country's Gross Domestic Product or *GDP*.

Through Clark Electric Distribution Corporation or *CEDC*, a 65% owned subsidiary, it holds the power distribution franchise for the Clark Special Economic Zone or *CSEZ* in Clark, Pampanga. *CEDC* franchise area covers 44 square kilometers and services 1,849 customers. *CEDC* is registered with Clark Development Corporation or *CDC* under RA No. 9400, *Bases Conversion Development Act of 1992*, as a *CSEZ*-enterprise primarily engaged in owning, operating, and maintaining a power distribution system within the zone.

*MERALCO Group's* business is divided into two segments, namely, power and other services. The power segment, primarily power distribution, consists of operations of *MERALCO* and its subsidiary, *CEDC*.

- Power

The Power segment consists of (a) electricity distribution, (b) power generation and (c) Retail Electricity Supply or *RES*.

Electricity distribution – This is principally electricity distribution and supply of power on a pass-through basis covering the *MERALCO* franchise area and the *CEDC* franchise area in the Luzon Grid. Electricity distribution within the *MERALCO* franchise area accounts for approximately 55% of the power requirements of the country. *CEDC's* service area covers the *CSEZ*.

Power generation – The *MERALCO Group's* re-entry in the power generation business is through investment in operating companies or participation in the development of such power generation projects. *MGen*, the power generation arm of the *MERALCO Group* has a 22%-equity interest in Global Business Power Corporation or *GBPC*. *GBPC* operates a total of 627 MW gross capacity of coal and diesel-fired power plants. It has 232 MW of coal-fired power plants under construction in the Visayas.

In March 2013, *MGen* acquired an effective 28% equity in PacificLight Power Pte Ltd. or *PacificLight Power*, in Jurong Island, Singapore.

*MGen* is currently developing a 460 MW net capacity of supercritical coal-fired power plant in Mauban, Quezon. On the other hand, land development for its 2 x 300 MW Circulating Fluidized Bed or *CFB*, coal-fired power generation plant in the Subic Freeport Zone under Redondo Peninsula Energy, Inc. or *RP Energy* is ongoing.

Further, *MGen* is in various stages of pre-development of other power generation projects in the Philippines.

*RES* – This covers the sourcing and supply of electricity to qualified contestable customers. The *MERALCO Group* serves as a local *RES* within its franchise area only under the brand, *MPower*. Starting June 26, 2013, certain qualified contestable customers sourced their electricity supply from *MPower*.

- Other Services

The other services segment is involved principally in electricity-related services such as electro-mechanical engineering, construction, consulting and related manpower as well as light rail-related maintenance services, e-transaction and bills collection, insurance and e-business development and energy systems management. These services are provided by Meralco Industrial and Engineering Services Corporation or *MIESCOR*, Miescor Builders, Inc. or *MBI*, and Miescor Logistics, Inc. or *MLI* (collectively known as "*MIESCOR Group*"), Corporate Information Solutions, Inc. or *CIS*, Bayad Center, Inc. or *Bayad Center* and Customer Frontline Solutions, Inc. or *CFSI* (collectively referred to as "*CIS Group*"), Miescorrail, Inc. or *Miescorrail*, Republic Surety and Insurance Corporation or *RSIC*, Lighthouse Overseas Insurance Limited or *LOIL*, Meralco Financial Services, Inc. or *Finserve*, e-Meralco Ventures, Inc. or *e-MVI* and Meralco Energy, Inc. or *MEI*.

Below is the summary of *MERALCO Group*'s business segments:

| <b>BUSINESS SEGMENTS</b>                                                                                                                                                                                                                                                                                                                              |                                                                                                                                                                                                                                                                          |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Power</b>                                                                                                                                                                                                                                                                                                                                          | <b>Other Services</b>                                                                                                                                                                                                                                                    |
| Electricity distribution <ul style="list-style-type: none"> <li>• <i>MERALCO</i></li> <li>• <i>CEDC</i></li> </ul> Power generation <ul style="list-style-type: none"> <li>• <i>MGen</i> and subsidiaries</li> </ul> Retail electricity supply <ul style="list-style-type: none"> <li>• <i>MERALCO</i> through <i>MPower</i> business unit</li> </ul> | <ul style="list-style-type: none"> <li>• <i>MIESCOR Group</i></li> <li>• <i>Finserve</i></li> <li>• <i>LOIL</i></li> <li>• <i>RSIC</i></li> <li>• <i>CIS Group</i></li> <li>• <i>e-MVI and subsidiary</i></li> <li>• <i>MEI</i></li> <li>• <i>Miescorrail</i></li> </ul> |

## **RESULTS OF OPERATIONS**

The table below summarizes the consolidated results of operations and the contribution of each business segment to *MERALCO Group's* revenues, costs and expenses, and net income for the six months ended June 30, 2014 and 2013.

| <b>For the Six Months ended June 30, 2014</b>           |                              |                       |                                   |                     |
|---------------------------------------------------------|------------------------------|-----------------------|-----------------------------------|---------------------|
| <b>(Unaudited)</b>                                      |                              |                       |                                   |                     |
|                                                         | <b>Power<sup>2</sup></b>     | <b>Other Services</b> | <b>Inter-segment Transactions</b> | <b>Consolidated</b> |
|                                                         | <i>(Amounts in millions)</i> |                       |                                   |                     |
| Revenues                                                | ₱129,720                     | ₱2,984                | (₱536)                            | ₱132,168            |
| Costs and expenses                                      | 116,225                      | 2,275                 | (536)                             | 117,964             |
| Other expenses, net of income                           | 224                          | 90                    | -                                 | 314                 |
| Net income attributable to equity holders of the parent | 9,482                        | 194                   | (39)                              | 9,637               |

| <b>For the Six Months ended June 30, 2013</b>           |                              |                       |                                   |                     |
|---------------------------------------------------------|------------------------------|-----------------------|-----------------------------------|---------------------|
| <b>(Unaudited)</b>                                      |                              |                       |                                   |                     |
|                                                         | <b>Power<sup>3</sup></b>     | <b>Other Services</b> | <b>Inter-segment Transactions</b> | <b>Consolidated</b> |
|                                                         | <i>(Amounts in millions)</i> |                       |                                   |                     |
| Revenues                                                | ₱139,697                     | ₱2,702                | (₱685)                            | ₱141,714            |
| Costs and expenses                                      | 127,462                      | 2,187                 | (685)                             | 128,964             |
| Other income, net of expenses                           | (534)                        | 2                     | -                                 | (532)               |
| Net income attributable to equity holders of the parent | 9,133                        | 341                   | (33)                              | 9,441               |

## **2014 compared with 2013**

### **REVENUES**

The following table shows the composition of *MERALCO Group's* consolidated revenues for the six months period ended June 30, 2014 and 2013 by business segment:

| <b>Unaudited</b>           |                              |            |                      |            |                          |            |
|----------------------------|------------------------------|------------|----------------------|------------|--------------------------|------------|
|                            | <b>June 30, 2014</b>         | <b>%</b>   | <b>June 30, 2013</b> | <b>%</b>   | <b>Increase/Decrease</b> |            |
|                            |                              |            |                      |            | <b>Amount</b>            | <b>%</b>   |
|                            | <i>(Amounts in millions)</i> |            |                      |            |                          |            |
| Power <sup>4</sup>         | ₱129,720                     | 98         | ₱139,697             | 98         | (₱9,977)                 | (7)        |
| Other services             | 2,984                        | 2          | 2,702                | 2          | 282                      | 10         |
| Inter-segment transactions | (536)                        | -          | (685)                | -          | 149                      | 22         |
| <b>Total</b>               | <b>₱132,168</b>              | <b>100</b> | <b>₱141,714</b>      | <b>100</b> | <b>(₱9,546)</b>          | <b>(7)</b> |

Total revenues for the six months ended June 30, 2014 were lower by 7% at ₱132,168 million compared with ₱141,714 million during the same period last year. Electric revenues represent 98% or ₱129,720 million of the total revenues. The lower electric revenues in 2014 are attributable to the (a) billing adjustment by the Philippine Electricity Market Corporation or *PEMC* for power purchases from the Wholesale Electricity Spot Market or *WESM*, for the December 2013 supply month based on an order of the Energy Regulatory Commission or *ERC*, amounting to ₱9.3 billion (b) foregone revenues on the volume of contestable customers served by other retail electricity suppliers under Retail Competition and Open Access (“*RCOA*”), and (c) lower pass-through generation charges under competitively negotiated Power Supply Agreements (“*PSAs*”).

<sup>2</sup>Principally electricity distribution

<sup>3</sup>Ibid

<sup>4</sup>Ibid.

## Power

Revenues from the power segment represent *MERALCO* and *CEDC*'s sale of electricity, which include generation, transmission, distribution charges and subsidies, and *MPower*'s generation revenue as a retail electricity supplier beginning June 26, 2013. *MERALCO* and *CEDC* distribute electricity to industrial, commercial and residential customers, while *MPower* provides electricity supply to certain qualified contestable customers within *MERALCO*'s franchise area only.

The composition of revenues of the power segment for the six months ended June 30, 2014 and 2013 is summarized as follows:

| Unaudited                      |                 |            |                 |            |                             |            |
|--------------------------------|-----------------|------------|-----------------|------------|-----------------------------|------------|
|                                | June 30, 2014   | %          | June 30, 2013   | %          | Increase/Decrease<br>Amount | %          |
| <i>(Amounts in millions)</i>   |                 |            |                 |            |                             |            |
| Generation charge              | ₱77,287         | 59         | ₱89,118         | 64         | (₱11,831)                   | (13)       |
| Transmission charge            | 16,296          | 13         | 14,265          | 10         | 2,031                       | 14         |
| Distribution service charges   | 28,680          | 22         | 27,907          | 20         | 773                         | 3          |
| System loss charge             | 7,340           | 6          | 8,334           | 6          | (994)                       | (12)       |
| Subsidies and other charges    | 117             | -          | 80              | -          | 37                          | 46         |
| Power act reduction adjustment | -               | -          | (7)             | -          | 7                           | 100        |
| <b>Total</b>                   | <b>₱129,720</b> | <b>100</b> | <b>₱139,697</b> | <b>100</b> | <b>(₱9,977)</b>             | <b>(7)</b> |

## Electricity Revenues

Generation charge represents the largest component of electricity revenues, which is at 59% in 2014. Average generation charge to captive customers was at ₱5.54 per *kWh* in the first semester of 2014 against ₱5.38 per *kWh* in the same period of 2013. Transmission charge represents only 13% of the total power revenues or an equivalent to ₱0.94 per *kWh* in 2014 compared with ₱0.85 per *kWh* in 2013. *MERALCO*'s 12-month moving average system loss rate as at June 30, 2014 was at 6.68%, 0.17 percentage point lower compared with the 6.85% system loss rate as at June 30, 2013, and outperforming the *ERC*-imposed 8.5% cap by 1.82 percentage points as a result of its institutionalized system loss management programs. *CEDC*'s 12-month moving average system loss rate as at June 30, 2014 was at 4.55%. Subsidies and other charges include interclass and lifeline subsidies and universal charges.

Distribution revenues comprise 22% of the total electric revenues. Total distribution service charges for the six months ended June 30, 2014 amounted to ₱28,680 million, reflecting a 3% increase compared with the same period in 2013. The growth in distribution revenue is mainly attributable to 3% increase in sales volume from 16,863 *GWh* for the six months ended June 30, 2013 to 17,299 *GWh* for the same period in 2014. Increase in sales volume is driven by 4% growth in customer count and higher electricity consumption of existing customers. The growth in the industrial sector was driven by higher demand of food and beverage, rubber and plastics, and semiconductor industries. Commercial volume is driven by real estate and retail trade fuelled by the BPO industry expansion and higher consumer spending in entertainment, malls, hotels, and restaurants.

The following table summarizes the customer count as at June 30, 2014 and 2013 and the corresponding electric consumption per customer class for the six months ended June 30, 2014 and 2013:

| Customer Class | No. of Customers      |              | Electricity Sales |               | % Change            |                      |
|----------------|-----------------------|--------------|-------------------|---------------|---------------------|----------------------|
|                | <i>(in thousands)</i> |              | <i>(in GWh)</i>   |               | No. of<br>Customers | Electricity<br>Sales |
|                | 2014                  | 2013         | 2014              | 2013          |                     |                      |
| Residential    | 5,004                 | 4,823        | 5,147             | 5,174         | 4                   | (1)                  |
| Commercial     | 458                   | 447          | 6,753             | 6,557         | 2                   | 3                    |
| Industrial     | 10                    | 10           | 5,334             | 5,067         | -                   | 5                    |
| Streetlights   | 4                     | 4            | 65                | 65            | -                   | -                    |
| <b>Total</b>   | <b>5,476</b>          | <b>5,284</b> | <b>17,299</b>     | <b>16,863</b> | <b>4</b>            | <b>3</b>             |

The first phase of *RCOA* started commercial implementation on June 26, 2013. Contestable customers in the Luzon and Visayas grids whose connected load is at least one (1) MW over the past 12 months, commenced to source their power supply from Retail Electricity Suppliers ("RES"). Out of 811 qualified contestable customers in the Meralco franchise area, 327 customers have opted for contestability and switched their supply to eight (8) RESs, including *MERALCO*'s local RES, *MPower*. Total energy sourced from RESs was 3,340 *GWh* for the first half of year 2014. *MPower* accounted for 197 of the 327 customers.

## Other Services

Revenues from other services pertain mostly to non-electric revenues of *MERALCO* and revenues of subsidiaries excluding *CEDC*. Revenues generated from other services increased to ₱2,984 million in the first half of 2014 from ₱2,702 million in the same period of 2013. The 10% increase in revenues from other services is mainly attributable to *MET*'s new projects, which include installation of powerhouse, installation of *LED* and the photo voltaic system project. *MIESCOR*'s contract revenues also increased in 2014 which include construction of a substation, line installation and rationalization of electrical feeders, as well as new maintenance, janitorial and renovation activities. Also, *CIS* posted a growth in *Bayad Center*'s bills pay business, mobile phone loading and franchising revenue.

## **COSTS AND EXPENSES**

Consolidated costs and expenses for the six months ended June 30, 2014 amounted to ₱117,964 million, 9% lower compared with ₱128,964 million for the same period in 2013. The following table shows the breakdown of *MERALCO Group*'s consolidated costs and expenses for the six months ended June 30, 2014 and 2013 by business segment:

| Unaudited                    |                 |            |                 |            |                   |            |
|------------------------------|-----------------|------------|-----------------|------------|-------------------|------------|
|                              | June 30, 2014   | %          | June 30, 2013   | %          | Increase/Decrease |            |
|                              |                 |            |                 |            | Amount            | %          |
| <i>(Amounts in millions)</i> |                 |            |                 |            |                   |            |
| Power <sup>5</sup>           | ₱116,225        | 99         | ₱127,462        | 99         | (₱11,237)         | (9)        |
| Other services               | 2,275           | 2          | 2,187           | 2          | 88                | 4          |
| Inter-segment transactions   | (536)           | (1)        | (685)           | (1)        | 149               | 22         |
| <b>Total</b>                 | <b>₱117,964</b> | <b>100</b> | <b>₱128,964</b> | <b>100</b> | <b>(₱11,000)</b>  | <b>(9)</b> |

## Power

The details of costs and expenses are summarized in the following table:

| Unaudited                             |                 |            |                 |            |                   |            |
|---------------------------------------|-----------------|------------|-----------------|------------|-------------------|------------|
|                                       | June 30, 2014   | %          | June 30, 2013   | %          | Increase/Decrease |            |
|                                       |                 |            |                 |            | Amount            | %          |
| <i>(Amounts in millions)</i>          |                 |            |                 |            |                   |            |
| Purchased power                       | ₱100,273        | 86         | ₱111,575        | 88         | (₱11,302)         | (10)       |
| Salaries, wages and employee benefits | 4,437           | 4          | 4,562           | 4          | (125)             | (3)        |
| Depreciation and amortization         | 2,564           | 2          | 2,912           | 2          | (348)             | (12)       |
| Contracted services                   | 1,940           | 2          | 1,795           | 1          | 145               | 8          |
| Others                                | 7,011           | 6          | 6,618           | 5          | 393               | 6          |
| <b>Total</b>                          | <b>₱116,225</b> | <b>100</b> | <b>₱127,462</b> | <b>100</b> | <b>(₱11,237)</b>  | <b>(9)</b> |

Costs and expenses of the power segment for the six months ended June 30, 2014 amounted to ₱116,225 million, 9% lower compared with the ₱127,462 million in 2013.

Purchased power accounted for 86% of the total costs and expenses. *MERALCO*'s power segment does not operate its own generation capacity and purchases all of the electricity that it distributes from recently contracted *PSAs* with generators, National Power Corporation or *NPC* (up to June 25, 2013), long-term Power Purchase Agreements contracted with Independent Power Producers or *IPPs* and the *WESM*. Lower purchased power cost was primarily due to the billing adjustment by *PEMC* for power purchases for the December 2013 supply month. Moreover, with the implementation of *RCOA*, certain contestable customers sourced their generation from other retail electricity suppliers.

The volume of energy purchased under long-term power supply contracts with *IPPs*, First Gas Corporation or the *Sta. Rita Power Plant*, FGP Corp. or the *San Lorenzo Power Plant* and Quezon Power (Philippines) Limited Co. or *QPPL*, represent 33.7% of *MERALCO*'s Net Systems Input. Purchases from *SGCs* and *NPC*, and other special programs account for 63.1%, while the balance of 3.2% was sourced from the *WESM*.

<sup>5</sup>*Ibid.*

Contracted services increased by 8% from ₱1,795 million for the six months ended June 30, 2013 to ₱1,940 million for the same period in 2014. The increase was a result of IT system maintenance for new and existing hardware and software of the Company.

Depreciation and amortization decreased by 12% to ₱2,564 million in 2014 from ₱2,912 million in 2013 as some assets reached the end of their economic lives.

Other expenses consist of business taxes and permits, provision for probable charges and expenses from claims, provisions for doubtful accounts, costs of materials, transportation, and other corporate expenses.

### **Other Services**

The cost and expenses of other services business segment for the six months ended June 30, 2014 amounted to ₱2,275 million, 4% higher compared with ₱2,187 million in 2013. The details are as follows:

| <b>Unaudited</b>                      |                      |            |                      |            |                          |          |
|---------------------------------------|----------------------|------------|----------------------|------------|--------------------------|----------|
|                                       | <b>June 30, 2014</b> | <b>%</b>   | <b>June 30, 2013</b> | <b>%</b>   | <b>Increase/Decrease</b> |          |
|                                       |                      |            |                      |            | <b>Amount</b>            | <b>%</b> |
| <i>(Amounts in millions)</i>          |                      |            |                      |            |                          |          |
| Salaries, wages and employee benefits | ₱951                 | 42         | ₱1,014               | 46         | (₱63)                    | (6)      |
| Contracted services                   | 542                  | 24         | 391                  | 18         | 151                      | 39       |
| Depreciation and amortization         | 105                  | 5          | 110                  | 5          | (5)                      | (5)      |
| Others                                | 677                  | 29         | 672                  | 31         | 5                        | 1        |
| <b>Total</b>                          | <b>₱2,275</b>        | <b>100</b> | <b>₱2,187</b>        | <b>100</b> | <b>₱88</b>               | <b>4</b> |

The cost and expenses of other services segment increased by ₱88 million in 2014 as a result of higher contracted services. The increase is mainly due to the increase in number of projects and business expansion initiatives of subsidiaries.

Salaries, wages and employee benefits decreased by 6% from ₱1,014 million in 2013 to ₱951 million in 2014.

Other expenses, which accounted for 29% of the total costs and expenses, increased by 5% from ₱672 million in 2013 to ₱677 million in 2014. This is mainly due to increase in corporate expenses driven by business expansion activities.

### **OTHER EXPENSES (INCOME)**

The following table shows the breakdown of *MERALCO Group's* consolidated other income, net of expenses, for the three months ended June 30, 2014 and 2013 by business segment:

| <b>Unaudited</b>             |                      |            |                      |            |                          |            |
|------------------------------|----------------------|------------|----------------------|------------|--------------------------|------------|
|                              | <b>June 30, 2014</b> | <b>%</b>   | <b>June 30, 2013</b> | <b>%</b>   | <b>Increase/Decrease</b> |            |
|                              |                      |            |                      |            | <b>Amount</b>            | <b>%</b>   |
| <i>(Amounts in millions)</i> |                      |            |                      |            |                          |            |
| Power <sup>6</sup>           | ₱224                 | 71         | (₱534)               | 100        | ₱758                     | 142        |
| Other services               | 90                   | 29         | 2                    | -          | 88                       | 440        |
| <b>Total</b>                 | <b>₱314</b>          | <b>100</b> | <b>(₱532)</b>        | <b>100</b> | <b>₱846</b>              | <b>159</b> |

Consolidated net other expenses/income for the six months ended June 30, 2014 resulted in net expense of ₱314 million, compared with net other income of ₱532 for the same period last year. This is mainly due to decrease in interest and other financial income as interest rates on peso and dollar placements were lower in 2014. Associates and joint ventures incurred losses this period compared to net income contribution in the same period last year. Also, foreign exchange losses were incurred in 2014 while gains were recognized in 2013 mainly due to stronger peso to dollar in the first half of 2013 compared with the same period in 2014.

<sup>6</sup>*Ibid.*

### **Power**

Breakdown of other expenses (income) of power segment is summarized in the following table:

| Unaudited                                             |               |            |               |            |                   |            |
|-------------------------------------------------------|---------------|------------|---------------|------------|-------------------|------------|
|                                                       | June 30, 2014 | %          | June 30, 2013 | %          | Increase/Decrease |            |
|                                                       |               |            |               |            | Amount            | %          |
| (Amounts in millions)                                 |               |            |               |            |                   |            |
| Interest and other financial income                   | (P319)        | (142)      | (P731)        | 137        | P412              | 56         |
| Interest and other financial charges                  | 835           | 373        | 706           | (132)      | 129               | 18         |
| Equity in net losses of associates and joint ventures | 52            | 23         | 48            | (9)        | 4                 | 8          |
| Foreign exchange losses (gains)                       | 223           | 99         | (277)         | 52         | 500               | 181        |
| Others                                                | (567)         | (253)      | (280)         | 52         | (287)             | (103)      |
| <b>Total</b>                                          | <b>P224</b>   | <b>100</b> | <b>(P534)</b> | <b>100</b> | <b>P758</b>       | <b>142</b> |

Other income/expenses for the six months ended June 30, 2014 resulted in net other expense of P224 million, compared with other income of P534 million in the same period of 2013. Interest and other financial charges increased by 18% due to accelerated amortization of debt issue costs and payment of pre-termination penalty related to preterminated debt during the first half of 2014, and interest expense related to the P18.5 billion bonds issued in December 2013. In addition, interest income decreased due to lower interest rates for peso and dollar placements for the first half of 2014. Associates and joint ventures incurred losses in relation to its pre-operating and development activities.

### **NET INCOME ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT**

The following table shows the breakdown of MERALCO's net income attributable to the equity holders of the parent for the six months ended June 30, 2014 and 2013 by business segment:

| Unaudited                  |               |            |               |            |                   |          |
|----------------------------|---------------|------------|---------------|------------|-------------------|----------|
|                            | June 30, 2014 | %          | June 30, 2013 | %          | Increase/Decrease |          |
|                            |               |            |               |            | Amount            | %        |
| (Amounts in millions)      |               |            |               |            |                   |          |
| Power <sup>7</sup>         | ₱9,482        | 98         | ₱9,133        | 97         | ₱349              | 4        |
| Other services             | 194           | 2          | 341           | 3          | (147)             | (43)     |
| Inter-segment transactions | (39)          | -          | (33)          | (4)        | (6)               | (18)     |
| <b>Total</b>               | <b>₱9,637</b> | <b>100</b> | <b>₱9,441</b> | <b>100</b> | <b>₱196</b>       | <b>2</b> |

### **Power**

Net income attributable to equity holders of the parent is higher by 4% for the six months ended June 30, 2014 compared with the same period last year mainly due to increases in distribution rates and sales volume in 2014. The increase was partially offset by the decrease in interest income due to lower interest rates and foreign exchange losses in 2014.

### **Other Services**

Net income from other services business segment was 43% lower at P194 million in 2014 compared with P341 million in 2013. The decrease is mainly attributed to the higher expenses of subsidiaries due to business expansion initiatives.

<sup>7</sup>Ibid.

## **LIQUIDITY AND CAPITAL RESOURCES**

The following table shows *MERALCO*'s consolidated cash flows for the six months ended June 30, 2014 and 2013 as well as the consolidated capitalization and other selected consolidated financial data as at June 30, 2014:

|                                                         | <b>For the Six Months Ended June 30</b> |                          |
|---------------------------------------------------------|-----------------------------------------|--------------------------|
|                                                         | <b>2014</b>                             | <b>2013</b>              |
|                                                         | <i>(Amounts in millions)</i>            |                          |
| <b><u>Cash Flows</u></b>                                |                                         |                          |
| Net cash from operating activities                      | ₱24,178                                 | ₱22,990                  |
| Net cash used in investing activities                   | (6,730)                                 | (12,444)                 |
| Net cash used in financing activities                   | (10,246)                                | (12,136)                 |
| Net increase (decrease) in cash and cash equivalents    | 7,202                                   | (1,590)                  |
| <b><u>Capital Expenditures</u></b>                      | 4,865                                   | 3,970                    |
|                                                         | <b>June 30, 2014</b>                    | <b>December 31, 2013</b> |
|                                                         | <i>(Amounts in millions)</i>            |                          |
| <b><u>Capitalization</u></b>                            |                                         |                          |
| <b>Interest-bearing long-term financial liabilities</b> |                                         |                          |
| Current portion                                         | ₱2,227                                  | ₱11,021                  |
| Noncurrent portion                                      | 27,579                                  | 20,756                   |
| Notes payable                                           | 368                                     | 1,814                    |
| Equity attributable to equity holders of the parent     | 77,409                                  | 75,162                   |
| <b><u>Other Selected Financial Data</u></b>             |                                         |                          |
| Total assets                                            | 263,745                                 | 264,004                  |
| Utility plant and others                                | 116,721                                 | 112,586                  |
| Cash and cash equivalents                               | 67,053                                  | 59,851                   |

As at June 30, 2014, *MERALCO Group*'s consolidated cash and cash equivalents totalled ₱67,053 million, ₱7,202 million higher compared with ₱59,851 million as at December 31, 2013. Following are the significant sources and uses of consolidated cash and cash equivalents for the first six months of 2014; a) cash flows from operating activities of ₱24,178 million; b) proceeds from borrowings of ₱7,418 million; c) settlement of debt principal and interest of ₱11,893 million; d) capital expenditures of ₱4,685 million e) payment of dividends of ₱9,192 million and; f) additional investment in *GBPC* of ₱1,379 million.

### **Operating Activities**

Consolidated net cash provided by operating activities for the six months ended June 30, 2014 of ₱24,178 million is 5.17% higher compared with ₱22,990 million of the same period in 2013. In the first quarter of 2014, *MERALCO* settled the deferred amount of the purchased power cost for the December supply month, while the corresponding pass through charges remained unbilled to the customers as at June 30, 2014. Also, the short-term investment amounting to ₱4,841 million included in other current assets in the consolidated balance sheet as at December 31, 2013 and matured in June 2014, contributing to the increase in net cash flows from operating activities.

### **Investing Activities**

Consolidated net cash flows used in investing activities for the six months ended June 30, 2014 totalled ₱6,730 million, ₱5,714 million lower compared with ₱12,444 million used for the same period in 2013. This is mainly due to the investment and advances to *FPM Power* amounting to ₱9,340 million in 2013.

### **Financing Activities**

Consolidated net cash used in financing activities amounted to ₱10,246 million for the six months ended June 30, 2014, compared with ₱12,136 million cash used in 2013. This is mainly due to higher amount of interest and other financial charges paid in 2014 as a result of the refund of bill deposits and interest to customers, pre-termination of debt amounting ₱9,192 million and payment of short-term debt of ₱1,700 million. The availment of interest-bearing long term financial liabilities of ₱7,164 million reduced the cash used in financing activities.

## Debt Financing

On September 23, 2013, the *BOD* of *MERALCO* authorized the offer, sale and issuance by way of public offering in the Philippines, 7- and 12-year corporate bonds, putable in 5 and 10 years, respectively, with an aggregate principal amount of up to ₱15 billion with an overallotment option of up to ₱5.0 billion. The 12-year corporate bonds also include a call option, where *MERALCO* may redeem (in whole but not in part only) the outstanding bonds on the 7th year from issue date at the early redemption price at 101.0%. The put and call options are clearly and closely related to the host instruments, thus, were not recognized separately.

On December 12, 2013, the ₱11.5 Billion Fixed Rate Putable Bonds due in 2020 and ₱7.0 Billion Fixed Rate Putable Bonds due in 2025, were listed with the Philippine Dealing and Exchange Corporation.

The net proceeds from the bond issuance were and shall be utilized for refinancing certain loans including principal payments, accrued interest, prepayment penalties and other financing costs.

In March 2014, *MERALCO* entered into a 10-year fixed rate loan from a major domestic universal bank. The principal is payable in nominal annual amortizations with a balloon payment on final maturity in February 2024.

*MERALCO*'s loan agreements require compliance with debt service coverage of 1.2 times calculated at specific measurement dates. The agreements also contain restrictions with respect to the creation of liens or encumbrances on assets, issuance of guarantees, mergers or consolidations, disposition of a significant portion of its assets and related party transactions.

As at June 30, 2014, *MERALCO* is in compliance with all covenants of its loan agreements.

## Equity Financing

Consistent with the provisions of *PAS 32*, "Financial Instruments: Disclosure and Presentation", *MERALCO*'s preferred shares are presented as debt while the dividends declared are recorded as interest expense. Accumulated and unpaid dividends were accrued and classified as accrued interest payable. Coupon rate on such preferred share is fixed at 10%. The preferred shares were issued to service applications, which would require extension or new distribution facilities beyond a specific distance. Beginning April 8, 2005, such requirement was discontinued. Instead, as provided in the "Implementing Guidelines of the Magna Carta for Residential Electricity Consumers", customers were required to advance the costs of extension of lines and installation of additional facilities. All of the redeemable preferred shares have been called for redemption as at June 30, 2011, consistent with the terms of the Preferred Shares Subscription Agreement. The unclaimed dividends amounted to ₱250 million as at June 30, 2014 and December 31, 2013. Interest is no longer accrued on the preferred shares, which have been called for redemption.

As at June 30, 2014 and December 31, 2013, *MERALCO*'s capital stock consists of:

| <i>(Amounts in millions, except par value<br/>and number of shares)</i> | 2014    | 2013    |
|-------------------------------------------------------------------------|---------|---------|
| Common stock - ₱10 par value                                            |         |         |
| Authorized - 1,250,000,000 shares                                       | ₱12,500 | ₱12,500 |
| Issued - 1,127,271,117 shares                                           | 11,273  | 11,273  |
| Treasury - 172,412 shares                                               | (11)    | (11)    |

Treasury shares represent subscribed shares and the related rights of employees who have opted to withdraw from the *ESPP* in accordance with the provisions of the *ESPP* and which *MERALCO* purchased.

The table below summarizes the cash dividends declared in the second half of 2014 and 2013:

| Declaration Date     | Record Date    | Payment Date   | Dividend<br>Per Share | Amount |
|----------------------|----------------|----------------|-----------------------|--------|
| <i>(In millions)</i> |                |                |                       |        |
| March 17, 2014       | April 15, 2014 | May 8, 2014    | ₱6.45                 | ₱7,269 |
| February 25, 2013    | March 26, 2013 | April 24, 2013 | 6.10                  | 6,875  |

On July 28, 2014, the *BOD* declared a special cash dividend of ₱5.91 per share to all shareholders of record as of August 25, 2014, payable on September 18, 2014.

## RISK FACTORS

The major factors affecting *MERALCO*'s financial position and results of operations are:

- a. Regulated rates and cost recoveries
- b. Sales volume and Philippine economic conditions
- c. Electricity supply
- d. Industry restructuring

### *Regulated Rates and Cost Recoveries*

The most significant determinants of *MERALCO*'s and *CEDC*'s rate structure vis-à-vis operating results are “allowable returns” and “permitted cost recoveries”. Rates billed by *MERALCO* and *CEDC* are approved by the *ERC* and are set to allow a reasonable rate of return on investments. *MERALCO*'s and *CEDC*'s rate structure also allows pass-through of certain purchased power costs, system loss up to an annual cap enforced by the *ERC*, and taxes.

#### *Performance-Based Regulation*

*MERALCO* was among the Group A entrants to the *PBR*, together with two other private *DUs*.

Rate-setting under *PBR* is governed by the *RDWR*. The *PBR* scheme sets tariffs based on the regulated asset base of the *DUs*, and the required operating and capital expenditures once every regulatory period or *RP*, to meet operational performance and service level requirements responsive to the needs for adequate, reliable and quality power, efficient service, and growth of all customer classes in the franchise area as approved by the *ERC*. The *PBR* also employs a mechanism that penalizes or rewards a *DU* depending on its network and service performance.

As part of the *PBR*, *MERALCO* implements payouts to customers for instances when its performance is beyond the guaranteed service levels or *GSL*.

Rate filings and settings are done on a *RP* basis. One (1) *RP* consists of four (4) Regulatory Years or *RYs*. An *RY* for *MERALCO* begins on July 1 and ends on June 30 of the following year. As at June 30, 2014, *MERALCO* has ended the third *RY* of the third *RP*. The third *RP* is from July 1, 2011 to June 30, 2015.

#### *Pass-through of Allowable Costs*

The pass-through of allowable costs or costs that do not entail a revision of the rate base and/or rate of return of *MERALCO* is governed by various adjustment mechanisms promulgated by the *ERC*.

In approving *MERALCO*'s unbundled rate in May 2003, the *ERC* prescribed a generation charge that will be adjusted under the Generation Rate Adjustment Mechanism, or *GRAM*. This has since been superseded by the Guidelines for the Automatic Adjustment of Generation Rates and System Loss Rates by Distribution Utilities. The monthly automatic adjustment under the Automatic Generation Rate Adjustment or *AGRA* mechanism provides timely price signals to consumers. While the *GRAM* only provided for changes in the generation charge, the new mechanism also allows the monthly adjustment of the system loss charge. Implementation of the guidelines started with the November 2004 billing cycle.

The *ERC*'s approval of *MERALCO*'s second filing under *GRAM* was questioned before the Supreme Court or *SC*, for failure by *MERALCO* and the *ERC* to comply with Section 4 (e) Rule 3 of *EPIRA*'s Implementing Rules and Regulations or *IRR*, which required publication, notice, and hearing of an application prior to issuance of an Order. On August 16, 2006, the *SC* ruled with finality that strict compliance with the requirements under the *IRR* of the *EPIRA* is jurisdictional and applies to any adjustment to the retail rate, including those for pass-through costs. The *AGRA* was then suspended beginning September 2006 and *MERALCO* could adjust generation and other pass-through charges only after the filing and approval by the *ERC* of an appropriate application.

On June 7, 2007, the Joint Congressional Power Commission approved amendments to Section 4 (e), Rule 3 of the *EPIRA*'s *IRR* that exempt the adjustments of pass-through electric rate components from the jurisdictional and hearing requirements of the *IRR*. The amendments were subsequently promulgated by the Department of Energy on June 21, 2007. Thereafter, the *ERC* lifted the suspension of the *AGRA*, which allowed *MERALCO* to resume the monthly updating of generation and system loss charges beginning July 2007.

On August 12, 2009, the *ERC* issued its Resolution No. 16, Series of 2009, adopting the “Rules Governing the Automatic Cost Adjustment and True-up Mechanisms and Corresponding Confirmation Process for Distribution Utilities”. These rules govern

the recovery of pass-through costs, including over- or under-recoveries in the following bill components: Generation Charge, Transmission Charge, System Loss Charge, Lifeline rate subsidies, Local franchise and business taxes.

The rules will also synchronize the various confirmation processes for the foregoing charges, in which the *ERC* will verify whether the *DU* incurred over- or under-recoveries in the implementation of the said charges. Luzon *DUs*, such as *MERALCO*, were required to file not later than October 30, 2009 their consolidated applications to resolve over- or under-recoveries accumulated from the start of their rate unbundling until December 2008. Subsequent filings will be every three years thereafter.

On October 8, 2009, *MERALCO* filed a petition at the *ERC* seeking an amendment to the *ERC*'s Resolution No. 16, Series of 2009. In particular, *MERALCO* proposed a modification to the formula used in confirming the system loss charges of *DUs*, shifting the reckoning of the system loss cap from a monthly to an annual reckoning to more fairly reflect the actual system loss performance of *DUs*.

On October 18, 2010, the *ERC* ruled on *MERALCO*'s Petition and agreed that there is a need to address the mismatch between the billing periods of the *DUs* and of their suppliers in the confirmation of the system loss. However, the *ERC* did not adopt *MERALCO*'s proposed modification to the formula and instead prescribed a new formula. Resolution No. 21, Series of 2010 adopted the new formula and correspondingly amended the one prescribed in Resolution No. 16, Series of 2009. The Resolution also prescribed the period of filing for the *DUs*' consolidated applications, which for Luzon *DUs* will be by March 31, 2011 and setting March 31, 2011 (covering adjustments implemented from the rate unbundling until the billing month of December 2010) and March 31, 2014 (covering adjustments from January 2011 to December 2013) as the new deadlines for *DUs* in Luzon to file their respective applications. Subsequent filings shall likewise be every three years thereafter.

On April 23, 2014, *ERC* released its Proposed Resolution Amending Articles 2 and 3 of Resolution 16, Series of 2009, the Resolution Governing the Automatic Cost adjustment and True-Up Mechanisms and Corresponding Confirmation Process for *DUs*. The proposal will allow automatic inclusion of the monthly over/under recoveries in the monthly generation, transmission and system loss rate calculations. Public consultations were held for its first and second drafts but the final amendments have not yet been released.

#### *System Loss*

On December 8, 2008, the *ERC* promulgated a resolution providing for a lower maximum rate of *SL* (technical and non-technical) that a utility can pass on to its customers. The revised *SL* cap is 8.5% for private utilities, effective January 2010 billing. This is one percentage point lower than the *SL* cap of 9.5% provided under *RA No. 7832*. The actual volume of electricity used by *MERALCO* (administrative loss) is treated as part of the operation and maintenance expense beginning July 2011. The manner by which the utility is rewarded for its efforts in *SL* reduction is addressed by the *ERC* in the *PIS* under *PBR*.

On December 8, 2009, *MERALCO* filed a Petition to amend the said Resolution with an urgent prayer for the immediate suspension of the implementation of the new *SL* cap of 8.5% starting January 2010. The proposed amendment is aimed at making the Resolution consistent with the provisions of *RA No. 9136* and *RA No. 7832*, by increasing the *SL* cap to not less than 9%. The hearing on the Petition was conducted on November 18, 2010. Thereafter, *MERALCO* was directed to submit its *FOE*.

*MERALCO*'s 12 month average system loss of 6.68% as at June 30, 2014 improved by 17 basis points from the 6.85% registered in 2013. *CEDC*'s system loss of 4.55% in 2014 was well within the 8.5% cap set by the *ERC* for the private *DUs*.

#### ***Sales Volume and Philippine Economic Conditions***

The sale of electric energy is driven mainly by prevailing economic conditions and the number of customers being served by *MERALCO*. *MERALCO*'s franchise area accounts for an estimated 50% of the Philippines' Gross Domestic Product or *GDP*, with 37% from Metro Manila.

The favourable economic environment, supported by robust overseas Filipino workers, business process outsourcing and capital inflows, low interest rate and inflation rates, 'wealth creation' associated with significantly higher equity and property prices, and sustained confidence in the National Government, boosted strong domestic consumption and local and foreign investments. These affected per capital electricity consumption.

For the six months ended June 30, 2014, *MERALCO Group*'s energy sales volume was 17,299 *GWh*, 3% higher compared with 16,863 *GWh* in 2013. The growth in sales volume in 2014 was mainly due to increased demand of industrial and commercial sectors offset by reduced household consumption due to lower temperature for the first four months of 2014, *MERALCO* still managed to grow customers by 4% largely from the commercial and residential sectors. *MERALCO* has 5.476 million customers as at June 30, 2014.

Average temperature throughout the first half of 2014 is cooler by 0.6°C from 28.3°C in 2013 to 27.7°C in 2014.

### ***Electricity Supply***

*MERALCO* does not operate its own generation capacity and purchases all of the power it distributes from the privatized plants of the *NPC-SGCs*, *IPPs* and *WESM*. *WESM* is a venue where suppliers and buyers trade electricity as a commodity. For the six months ended June 30, 2014, *MERALCO* purchased 33.7% of its requirements from *IPPs*, 63.1% from the privatized plants of *NPC*, and 3.2% from the *WESM*.

Following are the Power Supply Agreements or *PSAs* entered into by *MERALCO*:

| <b>Date</b>       | <b>Power Supplier</b>                                 | <b>Plant/contracted capacity</b>                                                                                                             | <b>Terms of <i>PSA</i></b>                                                                                                                                                                                                   |
|-------------------|-------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| December 12, 2011 | South Premiere Power Corporation or <i>SPPC</i>       | Ilijan Power Plant in Batangas, for the full 1,180 <i>MW</i> net capacities                                                                  | Under the <i>PSA</i> , <i>MERALCO</i> will procure power from <i>SPPC</i> until December 25, 2019, with an option to extend the term for another three years.                                                                |
| December 21, 2011 | Masinloc Power Partners Co., Ltd. or <i>MPPCL</i>     | The initial contracted capacity is 330 <i>MW</i> , to increase to 430 <i>MW</i> by December 26, 2015                                         | The <i>PSA</i> has a term of seven years and can be extended by the parties for another three years. Under the agreement, the terms of the <i>NPC-MERALCO TSC</i> will govern the supply by <i>MPPCL</i> to <i>MERALCO</i> . |
| December 26, 2011 | SEM-Calaca Power Corporation                          | The initial contracted capacity is 210 <i>MW</i> and will be increased to 420 <i>MW</i> upon the commercial operation of the plant's Unit 1. | Term of seven years, which may be extended by the parties for another three years.                                                                                                                                           |
| February 29, 2012 | Therma Luzon, Inc. or <i>TLI</i>                      | Pagbilao coal-fired power plant with contracted capacity of 350 <i>MW</i> located in Quezon Province                                         | Term of seven years, which may be extended for three years upon agreement of parties.                                                                                                                                        |
| June 25, 2012     | San Miguel Energy Corporation, or <i>SMEC</i>         | Sual coal-fired power plant with initial contracted capacity of 200 <i>MW</i> to increase to 500 <i>MW</i> by December 26, 2012              | Term of seven years, which may be extended up to five years upon agreement of parties.                                                                                                                                       |
| April 26, 2012    | Pangea Green Energy Philippines, Inc., or <i>PGEP</i> | Biogas power plant methane gas with a total nominal generating capacity of 1 <i>MW</i> .                                                     | Term of two years from the delivery period commencement date, unless amended by the parties.                                                                                                                                 |

On January 30, 2012, the *ERC* indefinitely extended the provisional authority to the Contract of Supply of Electricity with Bacavalley Energy Inc., the owner/operator of a 4*MW* landfill gas-to-power plant.

In separate Decisions dated December 17, 2012, the *ERC* approved with modifications the *PSAs* of *MERALCO* with *MPPCL*, *SPPC*, *Sem-Calaca*, *TLI* and *SMEC*.

Motions for Reconsideration were filed regarding the *ERC* decisions on the *PSAs* with *SPPC*, *Sem-Calaca* and *SMEC*. On May 22, 2014, the *ERC* denied the motion for reconsideration on the *PSA* with *SMEC*.

On December 27, 2012, *MERALCO* executed the *PSAs* with *TLI* and *Aboitiz Power* to cover the volume needed by *MERALCO* during the six-month transition period before the start of the commercial operations of *RCOA*. Under the *PSAs* with *TLI* and *Aboitiz Power*, *MERALCO* will procure power from *TLI* and *Aboitiz Power* from the expiration of the *TSC* until June 25, 2013 conditioned upon *ERC* approval. The said *PSAs* had been submitted to the *ERC* for approval on January 2, 2013. *MERALCO* filed Motions to Withdraw the said *PSAs* considering that the *TSC* was extended up to June 25, 2013. The *ERC* granted said Motions in separate Orders.

On May 30, 2014, *MERALCO* signed long term *PSA* for a 455MW (net) capacity and electrical output with *SBPL*. *SBPL* will be constructing the first supercritical highly fuel efficient, reliable and environmental friendly pulverized coal-fired power plant in the country. The *PSA* will be subject to the approval of the *ERC*

Under the *PSAs*, fixed capacity fees and fixed operating maintenance fees are recognized monthly based on their contracted capacities. The annual projection of these payments is shown in the table below:

| Year | Contracted Capacity  | Fixed Payment Amount |
|------|----------------------|----------------------|
|      | <i>(In Megawatt)</i> | <i>(In Million)</i>  |
| 2014 | 3,000                | ₱35,593              |
| 2015 | 3,084                | 37,775               |
| 2016 | 3,114                | 39,865               |
| 2017 | 3,114                | 39,574               |
| 2018 | 2,880                | 39,198               |
| 2019 | 2,460                | 33,864               |

#### ***Interim Power Supply Agreement (IPSA)***

On April 2, 2014, *MERALCO* signed two separate *IPSAs* with the wholly owned subsidiaries of Global Business Power Corporation or *GBPC*, namely: (1) Panay Power Corp. for a 27 MW firm output from its 72-MW diesel-fired power plant in Brgy. Incore, La Paz, Iloilo City; and (2) Toledo Power Co. for a 28 MW firm and 9 MW non-firm output from its 40-MW diesel-fired power plant in Carmen, Toledo City. Both *IPSAs* became immediately effective upon execution and shall expire on June 30, 2014.

On July 10, 2014, *ERC* approved the extension of the *IPSA* with Panay Power Corp. and Toledo Power Co. until October 31, 2014.

On April 3, 2014, *MERALCO* signed an *IPSA* with *1590 Energy Corp.* for the 140 MW output from the Bauang power plant – a 225-MW diesel-fired power plant in Bauang, La Union. On April 8, 2014, *MERALCO* signed an *IPSA* with *PanAsia Energy Inc.* for the 270 MW output from the Limay Combined Cycle Power Plant – a 540-MW diesel power facility at Brgy. Luz, Limay, Bataan. Both *IPSAs* becomes effective upon the Final Approval of the *ERC* and shall expire on June 30, 2014.

On June 30, 2014, the *ERC* approved the extension of the *IPSA* with 1590 Energy Corp until October 31, 2014.

The *IPSAs* may also be extended upon mutual agreement of the parties.

#### ***Industry Restructuring***

Under the *EPIRA*, the Philippine power industry continues to undergo fundamental restructuring.

These restructuring measures include:

- The deregulation of, and introduction of competition in, power generation and supply activities and pricing;
- The privatization of the *NPC*'s power generating assets and *IPP* contracts;
- The unbundling of the relative costs of the various segments of the power supply chain and reflecting these in the bills to customers;
- Freedom of consumers to choose electricity suppliers;
- Open and non-discriminatory access in the networks of *DUs*, subject to the fulfillment of certain conditions precedent;
- The implementation of the *WESM*; and
- Removal of inter-grid, intra-grid, and inter-class cross-subsidies.

## ELECTRIC POWER INDUSTRY DEVELOPMENTS AND UPDATES

### 1. Implementation of Performance-Based Regulation or *PBR*

As *DUs*, *MERALCO* and *CEDC* are subject to the rate-making regulations and regulatory policies of the *ERC*. Billings to customers are itemized or “unbundled” into a number of bill components that reflect the various units incurred in providing electric service. The adjustment to each bill component is governed by mechanisms promulgated and enforced by the *ERC*, mainly: [i] the “Rules Governing the Automatic Cost Adjustment and True-up Mechanisms and Corresponding Confirmation Process for Distribution Utilities,” which govern the recovery of pass-through costs, including over- or under-recoveries of the bill components, namely, (a) generation charge, (b) transmission charge, (c) system loss charge, (d) lifeline rate subsidies, (e) local franchise and (f) business taxes; and [ii] the modified “Rules for the Setting of Distribution Wheeling Rates for Privately Owned Electricity Distribution Utilities Operating under Performance Based Regulation (First Entry Group: Third Regulatory Period) or *RDWR*”, which govern the determination of the *MERALCO*’s distribution, supply, and metering charges.

The rate-setting mechanism of *CEDC* is likewise in accordance with *ERC* regulations. The following is a discussion of matters related to rate-setting of *MERALCO* and *CEDC*:

#### *Rate Applications*

##### *Performance-Based Regulation or PBR*

###### *a. MERALCO*

*MERALCO* was among the Group A entrants to the *PBR*, together with two other private *DUs*.

Rate-setting under *PBR* is governed by the *RDWR*. The *PBR* scheme sets tariffs based on the regulated asset base of the *DUs*, and the required operating and capital expenditures once every regulatory period or *RP*, to meet operational performance and service level requirements responsive to the needs for adequate, reliable and quality power, efficient service, and growth of all customer classes in the franchise area as approved by the *ERC*. *PBR* also employs a mechanism that penalizes or rewards a *DU* depending on its network and service performance.

Rate filings and settings are done on an *RP* basis. One (1) *RP* consists of four (4) Regulatory Years or *RYs*. An *RY* for *MERALCO* begins on July 1 and ends on June 30 of the following year. As at June 30, 2014, *MERALCO* has ended the third *RY* of the third *RP*. The third *RP* is from July 1, 2011 to June 30, 2015.

##### *Maximum Average Price or MAP for RY 2008 and RY 2009*

On January 11 and April 1, 2008, *MERALCO* filed separate applications for the approval of its proposed translation of the *MAP* for *RY 2008* and *RY 2009*, respectively, into different rate schedules for its various customer segments. A portion of the distribution charge under-recoveries as a result of the delayed implementation of the *PBR* was incorporated in the proposed *MAP* for *RY 2009*.

In April 2009, the *ERC* approved the implementation of *MERALCO*’s average distribution rate of ₱1.2227 per *kWh* effective billing period of May 2009. This rate is inclusive of the under-recoveries for calendar year 2007 of ₱0.1285 per *kWh*.

On May 28, 2009, certain electricity consumer groups filed a Petition with the Court of Appeals, or *CA*, questioning the decision and Order of the *ERC* on *MERALCO*’s rate translation application for *RY 2008* and *RY 2009*. In a decision dated January 27, 2010, the *CA* denied the Petition. Consequently, the consumer groups brought the case to the Supreme Court of the Philippines or *SC*. Comments and responses were filed by both parties with a Manifestation filed by *MERALCO* on January 26, 2011. As at June 30, 2014, the *SC* has yet to render its decision on this case.

##### *MAP for RY 2012*

On June 21, 2011, *MERALCO* filed an application for the approval of its *MAP* for *RY 2012* and translation into rate tariffs by customer category. On October 6, 2011, the *ERC* provisionally approved the *MAP* for *RY 2012* of ₱1.6012 per *kWh* and the rate translation per customer class was reflected commencing with the October 2011 customer bills. Hearings for the final approval of the application have been completed and all parties have submitted their respective memoranda. As at June 30, 2014, the application is pending final approval by the *ERC*.

#### *MAP for RY 2013*

On June 11, 2012, the *ERC* provisionally approved the *MAP* for *RY* 2013 of ₱1.6303 per *kWh* which was reflected starting with the July 2012 customer bills. Hearings on this case have been completed. As at June 30, 2014, the application is pending final approval by the *ERC*.

#### *MAP for RY 2014*

On April 1, 2013, *MERALCO* filed its application for the approval of its *MAP* for *RY* 2014 of ₱1.6510 per *kWh* and the translation thereof into rate tariffs by customer category. On June 10, 2013, the *ERC* provisionally approved the *MAP* for *RY* 2014 of ₱1.6474 per *kWh* and the rate translation per customer class. As at June 30, 2014, the application is pending final approval by the *ERC*.

#### *MAP for RY 2015*

On March 31, 2014, *MERALCO* filed its application for the approval of its *MAP* for *RY* 2015 of ₱1.5562 per *kWh* and the translation thereof into rate tariffs by customer category. On May 5, 2014, the *ERC* provisionally approved *MERALCO*'s *MAP* for 2015 of ₱1.5562 per *kWh* and the rate translation per customer class.

#### *b. CEDC*

*CEDC* was among the four (4) Group D entrants to the *PBR*. Similar to *MERALCO*, it is subject to operational performance and service level requirements approved by the *ERC*. The *RP* of *CEDC* began on October 1, 2011 and ends on September 30, 2015.

#### *MAP for RY 2013*

On August 30, 2012, *CEDC* filed its application for the approval of its *MAP* for *RY* 2013. The *ERC*, on December 17, 2012, approved a *MAP* of ₱0.8953 per *kWh*. The revised rates based on the approved *MAP* 2013 were implemented by *CEDC* starting January 2013.

### **2. Application for Recoveries**

#### *Applications for the Recovery of Generation Costs and System Loss Charges*

*MERALCO* filed separate applications for the full recovery of generation costs, including value-added tax or VAT, incurred for the supply months of August 2006 to May 2007 or total under-recoveries of ₱12,679 million for generation charges and ₱1,295 million for *SL* charges.

The separate applications for the full recovery of generation charges have been approved by the *ERC* in its decisions released on January 18, 2008, September 3, 2008 and August 16, 2010.

As at June 30, 2014, the remaining balance of ₱137 million of generation costs were fully recovered.

With respect to the ₱1,295 million *SL* charge under-recoveries, the *ERC* ordered *MERALCO* to file a separate application for the recovery of *SL* adjustments after the *ERC* confirms the transmission rate to be used in the calculation of the *SL* rate in accordance with the *SL* rate formula of the Automatic Generation Rate Adjustments Guidelines or *AGRA*. *MERALCO* has filed the application for recovery of the ₱1,295 million *SL* charge under-recoveries with the *ERC*. This was included in the Consolidated Application of over- or under- recoveries in generation, transmission, *SL* and lifeline subsidies filed on March 31, 2011 with the *ERC*. Hearings were completed on October 25, 2011. On December 12, 2011, *MERALCO* filed for the admission of its Supplemental Application. An expository hearing was conducted on February 1, 2012. As at June 30, 2014, *MERALCO* has already filed its *FOE* and is awaiting the final resolution by the *ERC*.

#### *Consolidated Applications for the Confirmation of Over/Under-recoveries of Pass-through Charges*

On August 12, 2009, the *ERC* issued Resolution No. 16, Series of 2009, adopting the "Rules Governing the Automatic Cost Adjustment and True-up Mechanisms and Corresponding Confirmation Process for Distribution Utilities." These rules govern the recovery of pass-through costs, including over- or under-recoveries with respect to the following bill components: generation charge, transmission charge, *SL* charge, lifeline and interclass rate subsidies, *LFT* and business tax. On October 18, 2010, the *ERC* promulgated *ERC* Resolution No. 21, Series of 2010, amending certain formula contained in *ERC* Resolution No. 16, Series of 2009, and setting March 31, 2011 (covering adjustments implemented until the billing

month of December 2010) and March 31, 2014 (covering adjustments from January 2011 to December 2013) as the new deadlines for *DUs* in Luzon to file their respective applications. Subsequent filings shall be made every three years thereafter.

On March 31, 2011, *MERALCO* filed a consolidated application with the *ERC* to confirm its under- or over-recoveries accumulated from June 2003 to December 2010 in compliance with Resolution No. 16, Series of 2009, as subsequently amended by Resolution No. 21, Series of 2010. Hearings were completed on October 25, 2011. On December 8, 2011, *MERALCO* filed an Omnibus Motion praying, among other things, for the admission of the Supplemental Application. In an Order dated December 12, 2011, the *ERC* granted *MERALCO*'s Omnibus Motion and admitted its Supplemental Application. Accordingly, hearings on the Supplemental Application were conducted where *MERALCO* presented additional evidence. *MERALCO* filed its *FOE* on September 13, 2012. The consolidated filing includes net generation charge under-recoveries of ₱1,000 million, net transmission charge over-recoveries of ₱111 million, net lifeline subsidy under-recoveries of ₱9 million and net *SL* over-recoveries of ₱425 million, excluding any applicable carrying charges.

On July 6, 2012, *MERALCO* filed a consolidated application with the *ERC* to confirm its under- or over-recoveries for the calendar year 2011. The consolidated filing includes net generation charge under-recoveries of ₱1,826 million, transmission charge under-recoveries of ₱253 million, net lifeline subsidy under-recoveries of ₱39 million and *SL* over-recoveries of ₱445 million, excluding any applicable carrying charges. Hearings on the application have been terminated and *MERALCO* has submitted its *FOE* on January 25, 2013. As at June 30, 2014, the application is pending decision by the *ERC*.

On March 31, 2014, *MERALCO* filed a consolidated application with the *ERC* to confirm its under- or over recoveries from January 2012 to October 2013. The consolidated filing includes net generation charge under recoveries of ₱559 million, transmission charge over-recoveries of ₱639 million, net lifeline subsidy over recoveries of ₱75 million, *SL* over-recoveries of ₱502 million, and net Senior Citizen Discount over-recoveries of ₱0.4 million, excluding any applicable carrying charges. As at June 30, 2014, the application is yet to be set for initial hearing by the *ERC*.

#### *Application for the Recovery of Differential Generation Costs*

On February 14, 2014, *MERALCO* filed for the recovery of the unbilled generation cost for December 2013 supply month amounting to ₱11,075 million. A supplemental application was filed last March 20, 2014 to adjust the unbilled generation cost for recovery to ₱1,310 million following the receipt of *WESM* billing adjustments based on regulated Luzon *WESM* prices. First hearing was conducted last May 26, 2014 where *ERC* ruled for the suspension of further hearings indefinitely.

#### *Application for Recovery of Local Franchise Taxes or LFT*

On March 25, 2011, *MERALCO* filed with the *ERC* an Application for recovery of *LFT* paid but are not yet billed to customers for the period beginning first quarter of 1993 up to the second quarter of 2004 for five provinces, namely: Bulacan, Batangas, Cavite, Laguna and Rizal; and 14 cities, namely: San Jose Del Monte, Batangas, San Pablo, Tagaytay, Lucena, Mandaluyong, Marikina, Quezon, Caloocan, Pasay, Las Piñas, Manila, Pasig and Calamba. The *LFT* is recognized as a legitimate and reasonable *DU* expense in the *ERC*'s unbundling decision.

In a Decision dated February 27, 2012, the *ERC* released its Order approving with modifications *MERALCO*'s application. The *ERC* approved recovery of *LFT* amounting to ₱1,571 million plus carrying charges of ₱730 million. As directed by the *ERC*, the recovery was reflected as a separate item in the *MERALCO* billing statement to its customers beginning April 2012. As at June 30, 2014, a total of ₱1,016 million *LFT* and carrying charges have been billed to affected customers. The amount recoverable within 12 months is included in the "Trade and other receivables" account while the long-term portion is included in the "Other noncurrent assets" account.

### 3. Benefit Sharing Scheme to Lower System Loss

On January 26, 2011, *MERALCO*, together with Private Electric Power Operators Association Inc. or *PEPOA* and Philippine Rural Electric Cooperative Association or *PHILRECA*, filed a joint petition to the *ERC* to initiate rule-making praying that a Resolution be issued adopting the *Proposed Guidelines for the Implementation of an Incentive Scheme to Lower the System Losses of Private Distribution Utilities and Electric Cooperatives to Level Below the System Loss Cap, for the Benefit of End-Users*. This was aimed to encourage the *DUs* to reduce system loss levels below the cap set by the *ERC* and benefit the end-users through lower system loss charge rates. Public hearings were conducted and completed on June 15, 2011.

On December 11, 2012, the *ERC* posted on its website the second draft of the *Rules to Govern the Implementation of a Benefit Sharing to Lower the System Losses of Electric Distribution Utilities*. The salient points of the second draft rules include calculation of System Loss Charge using the prevailing system loss cap or the lowest consecutive five year average system loss, whichever is lower, and an equitable sharing (50-50) of incentives between the customer and the *DU* on the

savings which is the difference between the lower of this system loss level and the *DU*'s actual system loss. Any system loss reward from the *PIS* under the *RDWR* for private *DUs* shall be offset from the rewards the *DU* will receive from this Benefit-Sharing scheme, except when the net benefit from this scheme is less than the *PIS* rewards of the *DU*, in which case the *DU* will retain the rewards under the *PIS* and forego its share under this Benefit-Sharing Scheme. The foregone share of the *DU* shall be added to the End-user share correspondingly. As at June 30, 2014, *MERALCO* and *PEPOA* are awaiting the action of the *ERC* on this matter.

#### 4. Retail Competition

On September 27, 2012, the *DOE* and the *ERC* issued a joint statement setting the initial *RCOA* implementation on December 26, 2012. The joint statement clarified that the *RCOA* commencement is on a phase-in and partial implementation of the program, with the first six (6) months of *RCOA* implementation (December 26, 2012 – June 25, 2013) allotted as the Transition Period to allow all concerned parties to undertake their respective preparations to operationalize the mechanism for *RCOA*. An initial *RCOA* Commercial Operation using an interim IT system started on June 26, 2013.

On December 17, 2012, the *ERC* issued Resolution No. 16 series of 2012 adopting the Transitory Rules for the implementation of *RCOA*. The resolution provides the detailed responsibilities of industry participants during the *RCOA* transition period.

On January 9, 2013, the *DOE* issued Department Circular, "Promulgating the Retail Rules for the Integration of Retail Competition and Open Access in the Wholesale Electricity Spot Market", to provide rules for the integration of retail competition in the operations and governance processes of the WESM, the management of the transactions of Suppliers and Contestable Customers, and the operations of the Central Registration Body.

On March 26, 2013, the *PEMC* began the *RCOA* Trial Operations Program, a nine-week test period participated in by the various entities and service providers of *RCOA*.

On June 19, 2013, the *ERC* issued a resolution adopting the Supplemental Rules to the Transitory Rules for the implementation of *RCOA*. The resolution seeks to prevent contestable customers who have yet to execute a Retail Supply Contract or *RSC*, with a *RES* from being disconnected or transferred to *SOLR* service upon the commencement of initial commercial operations of *RCOA*. Qualified contestable customers who fail to enter into a *RSC* with a *RES* shall be deemed to stay with their current *DU* until December 26, 2013 or until such time that it is able to find a *RES* provided that they inform the *DU*.

In accordance with the *ERC*'s "Transitory Rules for the Initial Implementation of Open Access and Retail Competition", commercial operations of *RCOA* began on June 26, 2013. As at June 30, 2014, there are 327 customers within the *MERALCO* franchise which opted for contestability and are now being supplied by competitive retail suppliers.

#### 5. Philippine Economic Zone Authority or PEZA Registration – ERC Jurisdiction

On September 13, 2007, *PEZA* issued "Guidelines in the Registration of Electric Power Generation Facilities/Utilities/Entities Operating Inside the Ecozones" and "Guidelines for the Supply of Electric Power in Ecozones." Under these Guidelines, *PEZA* effectively bestowed upon itself franchising and regulatory powers in Ecozones operating within the legislative franchise areas of *DUs* which are under the legislatively-authorized regulatory jurisdiction of the *ERC*. The Guidelines are the subject of an injunction case filed by the *DUs* at the *RTC-Pasig*.

In support of the government's objective of providing lower cost to Ecozone locators, *MERALCO* entered into a *MOA* with *NPC* on September 17, 2007 for the provision of special Ecozone rates to high load factor *PEZA*-accredited industries. The *ERC* authorized the immediate implementation of the Ecozone Rate Program or *ERP*. The program expired in December 2012.

The *ERP* was initially scheduled to expire on December 25, 2011 but has been extended and was terminated on December 25, 2012.

In January 2013, *MERALCO* entered into a tripartite agreement with *PEZA* and Trans-Asia Oil and Energy Development Corporation for the sale of power to *CEZ* and its locators beginning January 26, 2013.

#### 6. Decision on the ₱0.167 per kWh Refund

Following the *SC*'s final ruling that directed *MERALCO* to refund affected customers ₱0.167 per kWh for billings made from February 1994 to April 2003, the *ERC* approved the release of the refund in four phases. The refund is still ongoing.

## 7. MERALCO's Peak/Off-Peak or POP Program

On November 15, 2012, *MERALCO* filed an application with the *ERC* for the approval of its revised Time of Use or *TOU* rates program, also known as the Peak Off-Peak or *POP* Program. The *POP* is a rate program being offered by *MERALCO* to customers whose load characteristics can benefit from *TOU* rates as well as to those that can shift their loads from peak to off-peak hours. The proposed revised *POP* Rate aims to provide better savings to avalees by providing them with a *TOU* program that has a wider pricing difference between peak and off-peak rates. In an Order dated December 17, 2012, the *ERC* provisionally approved the *POP* Program. *MERALCO* started implementing the program on February 1, 2013.

## 8. Purchase of Sub-transmission Assets or STAs

On November 25, 2009, *MERALCO* signed a Contract to Sell with the National Transmission Corporation or *TransCo* for the sale and purchase of certain sub transmission assets for ₱86 million. On February 25, 2010, the *ERC* provisionally approved this Contract to Sell. On June 1, 2012, the *ERC* rendered a Decision dated March 6, 2012, approving the sale of the said *STAs* in favor of *MERALCO* for ₱85 million.

On April 17, 2012, *MERALCO* and *TransCo* filed a joint application for the approval of the Batch 4 contract to sell with the *ERC*. On April 22, 2013, the *ERC* issued its Decision on *MERALCO*'s joint application for the acquisition of the Batch 4 contract to sell. On June 21, 2012, *MERALCO* filed a motion for partial reconsideration regarding the exclusion of certain facilities for acquisition, which has yet to be resolved by the *ERC*.

On December 12, 2011, *MERALCO* signed various agreements for the acquisition of certain sub-transmission assets of *TransCo* within the *MERALCO* franchise area for its sole account, as well as with a consortium with Batangas II Electric Cooperative, Inc., or *BATELEC II* and First Bay Power Corporation. On September 18, 2012, an amended consortium agreement was executed between *MERALCO* and *FBPC*. On October 17, 2012, *MERALCO* signed two separate amended consortium agreements with *BATELEC II*, and with *FBPC* and *BATELEC II*. These amended consortium agreements superseded the ones signed on December 12, 2011. On December 27 and 28, 2012, the Contract to Sell and Consortium Agreements, respectively, covering these sub-transmission assets were filed with the *ERC* for approval.

## 9. Feed-in-Tariff

Pursuant to Republic Act No. 9513, or the Renewable Energy Act of 2008 (RE Act), the *ERC* issued Resolution No. 16, Series of 2010, Adopting the Feed-in-Tariff or *FIT* Rules, on July 23, 2010. As defined under the *FIT* Rules, the *FIT* system is as a renewable energy policy that offers a guaranteed payment on a fixed rate per kilowatt-hour for electricity from wind, solar, ocean, hydropower and biomass energy sources.

On May 16, 2011, the National Renewable Energy Board or *NREB* filed its Petition to Initiate Rule Making for the Adoption of *FIT*. The Petition proposed a specific *FIT* Rate for each emerging renewable resource. On July 27, 2012, after undergoing several public consultations and public hearings, the *ERC* approved *FIT* Rates that are significantly lower than the rates applied by the *NREB*.

To fund the *FIT* payments to eligible *RE* developers, a *FIT*-Allowance charge will be imposed on all end-users. The *FIT*-Allowance will be established by the *ERC* upon petition by the National Transmission Corporation or *TransCo*, which had been designated as the *FIT* Fund Administrator. Similar to the *NREB*'s *FIT* Rate Petition, the *FIT*-Allowance Petition will go through the process of public hearings and consultations.

On February 5, 2014, the *ERC* released the *FIT*-Allowance Disbursement and Collection Guidelines to supplement the *FIT* rules. This set of guidelines will govern how the *FIT*-Allowance will be calculated using the formulae provided. It will also outline the process of billing and collecting the *FIT*-Allowance from the electricity consumers, the remittance to a specified fund, the disbursement from the *FIT*-Allowance fund and the payment to eligible *RE* developers. The draft is currently undergoing public consultations.

## 10. Net Metering Program

The *RE* Act mandates the *DUs* to provide the mechanism for the “physical connection and commercial arrangements necessary to ensure the success of the *RE* programs”, specifically the Net Metering Program. The *RE* Act defines Net Metering as “a system, appropriate for distributed generation, in which a distribution grid user has a two-way connection to the grid and is only charged for his net electricity consumption and is credited for any overall contribution to the electricity grid”. By their nature, net metering installations will be small (less than 100 kW) and will likely be adopted by the households and small business end-users of *DUs*.

On September 4, 2012, the *ERC* released the first draft of the Proposed Net Metering Rules. The proposed rules will govern the implementation of the Net Metering program for *RE* sources. On September 21, 2012, the *ERC* conducted the first public consultation on the proposed rules.

After consultations with stakeholders, the *ERC* issued on July 3, 2013 its Resolution No. 09, Series of 2013, entitled, “A Resolution Adopting the Rules enabling the Net Metering Program for Renewable Energy”. The rules will govern the *DUs*’ implementation of the Net Metering program. Included in the Rules are the Interconnection Standards that shall provide technical guidance to address engineering, electric system reliability, and safety concerns for net metering interconnections. The final pricing methodology, however, will be addressed in another set of rules and will be endorsed to the *ERC* in due course. In the meantime, the distribution utilities’ blended generation cost equivalent to the generation charge, shall be used as the preliminary reference price in the net metering agreement. The rules took effect on July 24, 2013. As at June 30, 2014, *MERALCO* has already energized 12 Net Metering customers, the country’s first participants to the net metering program.

## OTHER QUANTITATIVE AND QUALITATIVE DISCLOSURES

- (i) **Any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in *MERALCO*’s liquidity increasing or decreasing in any material way.**

Not applicable

- (ii) **Any events that will trigger direct or indirect contingent financial obligation that is material to *MERALCO*, including any default or acceleration of an obligation.**

### 1. Mediation with *NPC*

The *NPC* embarked on a Power Development Program or *PDP*, which consisted of contracting generating capacities and the construction of its own, as well as private sector, generating plants, following a crippling power supply crisis. To address the concerns of the creditors of *NPC*, namely, Asian Development Bank and the World Bank, the Department of Energy or *DOE* required that *MERALCO* enter into a long-term supply contract with *NPC*.

Accordingly, on November 21, 1994, *MERALCO* entered into a 10-year Contract for Sale of Electricity or *CSE*, with *NPC* to commence on January 1, 1995. The *CSE* and the rates and amounts charged to *MERALCO* therein were approved by the *BOD* of *NPC* and the then Energy Regulatory Board, respectively.

Separately, the *DOE* further asked *MERALCO* to provide a market for half of the output of the Camago-Malampaya gas field to enable its development and production of natural gas, which was to generate significant revenues for the Philippine Government and equally significant foreign exchange savings for the country to the extent of the fuel imports which the domestic volume of natural gas will displace.

*MERALCO*’s actual purchases from *NPC* exceeded the contract level in the first seven years of the *CSE*. However, the 1997 Asian crisis resulted in a significant curtailment of energy demand.

While the events were beyond the control of *MERALCO*, *NPC* did not honor *MERALCO*’s good faith notification of its offtake volumes. A dispute ensued and both parties agreed to enter into mediation.

The mediation resulted in the signing of a Settlement Agreement or *SA* between the parties on July 15, 2003. The *SA* was approved by the respective *BODs* of *NPC* and *MERALCO*. The net settlement amount of ₱14,320 million was agreed upon by *NPC* and *MERALCO* and manifested before the *ERC* through a Joint Compliance dated January 19, 2006. The implementation of the *SA* is subject to the approval of *ERC*.

Subsequently, the Office of the Solicitor General or *OSG* filed a “Motion for Leave to Intervene with Motion to Admit Attached Opposition to the Joint Application and Settlement Agreement between *NPC* and *MERALCO*.” As a result, *MERALCO* sought judicial clarification with the Regional Trial Court – Pasig Branch or *RTC-Pasig*. Pre-trials were set which *MERALCO* complied with and attended. However, the *OSG* refused to participate in the pre-trial and opted to seek a Temporary Restraining Order or *TRO* from the *CA*.

In a Resolution dated December 1, 2010, the *CA* issued a *TRO* against *RTC-Pasig*, *MERALCO* and *NPC* restraining the respondents from further proceeding with the case. Subsequently, in a Resolution dated February 3, 2011, the *CA* issued a writ of preliminary injunction enjoining the *RTC-Pasig* from conducting further proceedings pending resolution of the Petition. In a Decision dated October 14, 2011, the *CA* resolved to deny the Petition filed by the *OSG* and lifted the injunction previously issued. The said Decision likewise held that the *RTC-Pasig* committed no error in finding the *OSG* in default due to its failure to participate in the proceedings. The *RTC-Pasig* was thus ordered to proceed to hear the case *ex-parte*, as against the *OSG*, and with dispatch. The *OSG* has filed an *MR* which was denied by the *CA* in its Resolution

dated April 25, 2012. The *OSG* filed a Petition for Review of the Certiorari with the *SC*. In a Resolution dated July 25, 2012, the *SC* required *MERALCO* to file a Comment. *MERALCO*'s Comment was filed on October 29, 2012. The *SC* then issued a Resolution dated November 26, 2012 requiring the *OSG* to file a Reply. On February 19, 2013, the *OSG* filed a motion for extension to file a Consolidated Reply.

With the dismissal of the petition filed by the *OSG* with the *CA*, *MERALCO* filed a motion for the reception of its evidence ex-parte with the *RTC-Pasig* pursuant to the ruling of the *CA*. In a Decision dated May 29, 2012, the *RTC-Pasig* declared the *SA*, independent of the pass-through for the settlement amount which is reserved for the *ERC*, valid and binding. The *OSG* has filed a Notice of Appeal with the *RTC* on June 19, 2012. Both parties filed their respective appeal briefs. In a decision dated April 15, 2014, the *CA* denied the appeal filed by the *OSG* of the *RTC* decision dated May 29, 2012.

On January 22, 2014, *MERALCO* received a Notice of Judgment from the *SC* in stating that a Decision dated December 11, 2013 was rendered by the First Division of the *SC* denying the Petition for Review on Certiorari by the *OSG* and affirming the decision promulgated by the *CA* on October 14, 2011.

## 2. Sucat-Araneta-Balintawak Transmission Line

The Sucat-Araneta-Balintawak transmission line is a two-part transmission line, which completed the 230kV-line loop within Metro Manila. The two main parts are the Araneta to Balintawak leg and, the Sucat to Araneta leg, which cuts through Dasmariñas Village, Makati City.

On March 10, 2000, certain residents along Tamarind Road, Dasmariñas Village, Makati City or plaintiffs, filed a case with the Regional Trial Court – Makati Branch or *RTC-Makati* against *NPC*, enjoining *NPC* from further preparing and installing high voltage cables to the steel pylons erected near the plaintiffs' homes and from energizing and transmitting high voltage electric current through said cables because of the alleged health risks and danger posed by the same. Following its initial status quo Order issued on March 13, 2000, *RTC-Makati* granted on April 3, 2000 the preliminary injunction sought for by the plaintiffs. The decision was affirmed by the *SC* on March 23, 2006, which effectively reversing a decision of the *CA* to the contrary. The *RTC-Makati* subsequently issued a writ of execution based on the order of the *SC*. *MERALCO*, in its capacity as an intervenor, was constrained to file an Omnibus Motion to maintain status quo because of the significant effect of a de-energization of the Sucat-Araneta line to the public and economy. Shutdown of the 230-kV line will result in widespread and rotating brownouts within *MERALCO*'s franchise area with certain power plants unable to run at their full capacities.

On September 8, 2009, the *RTC-Makati* granted the motions for intervention filed by intervenors *MERALCO* and *NGCP* and dissolved the Writ of Preliminary Injunction issued, upon the posting of the respective counter bonds by defendant *NPC*, intervenors *MERALCO* and *NGCP*, subject to the condition that *NPC* and intervenors pay all damages, which the plaintiffs may incur as a result of the Writ of Preliminary Injunction.

Thereafter, the plaintiffs questioned the *RTC-Makati* order before the *CA*. As at June 30, 2014, this case remains pending for resolution in the *CA*.

Moreover, in its Order dated February 5, 2013, the *RTC-Makati* granted plaintiffs' motion and directed the re-affle of the case to another court after the judicial dispute resolution failed.

## 3. Real Property Tax Assessment

Several Local Government Units or *LGUs* assessed *MERALCO* for deficiency real property taxes on certain assets of *MERALCO*. The assets include any of electric poles, wires, insulators, and transformers, collectively referred to as *TWIP*. Of these *LGUs*, one has secured a favorable decision from the *CA*. Such decision was appealed by *MERALCO* to the *SC* where it is now submitted for resolution. The cases of the other *LGUs* are pending with their respective administrative bodies or government offices.

*MERALCO* also filed a case against the City of Manila before *RTC-Pasig* to enjoin the collection of real property taxes on the company's transformers and poles and nullify the *RPT* assessments made thereon based on the argument that these are not within the ambit of the definition of real property under the *LGC*. The case is set for mediation after the City of Manila filed its comment on *MERALCO*'s petition.

In the event that the assessments are sustained by the *SC* and payment is warranted or appropriate, *MERALCO* will file for the recovery of any resulting real estate tax payments from customers in the relevant *LGU* through separate application with the *ERC*.

#### 4. Local Franchise Tax

Certain municipalities have served assessment notices on *MERALCO* for local franchise taxes. As provided in the *LGC*, only cities and provincial governments may impose taxes on establishments doing business in their localities. On the basis of the foregoing, *MERALCO* and its legal counsel believe that *MERALCO* is not subject or liable for such assessments.

#### 5. Deferred Purchased Power Adjustment or *PPA*

On October 14, 2009, the *ERC* released its findings on *MERALCO*'s implementation of the collection of the approved pass-through cost under-recoveries in 2004. *ERC* directed *MERALCO* to refund ₱268 million of deferred *PPA* transmission line costs related to *QPPL* and deferred accounting adjustments or *DAA* incurred to customers, along with ₱184 million in carrying charges, or an equivalent of ₱0.0169 per *kWh*. *MERALCO* implemented the refund beginning November 2009 until September 2010. However, the *ERC* has yet to rule on *MERALCO*'s deferred *PPA* under-recoveries of ₱106 million, which does not represent the transmission line fee. As at June 30, 2014, *MERALCO* has filed a Motion for Reconsideration, which is pending decision by the *ERC*.

#### 6. *SC* Decision on Unbundling Rate Case

On May 30, 2003, the *ERC* issued an Order approving *MERALCO*'s unbundled tariffs that resulted in a total increase of ₱0.17 per *kWh* over the May 2003 tariff levels. However, on August 4, 2003, certain consumer and civil society groups filed a Petition for Review with the *CA* on the *ERC*'s ruling. On July 22, 2004, the *CA* set aside the *ERC*'s ruling on *MERALCO* rate unbundling and remanded the case to the *ERC*. Further, the *CA* opined that the *ERC* should have asked the Commission on Audit or *COA*, to audit the books of *MERALCO*. The *ERC* and *MERALCO* subsequently filed separate motions asking the *CA* to reconsider its decision. On January 24, 2005, as a result of the denial by the *CA* of the motions, the *ERC* and *MERALCO* elevated the case to the *SC*.

In an En Banc decision promulgated on December 6, 2006, the *SC* set aside and reversed the *CA* ruling saying that a *COA* audit was not a prerequisite in the determination of a utility's rates. However, while the *SC* affirmed *ERC*'s authority in rate-fixing, the *SC* directed the *ERC* to request *COA* to undertake a complete audit of the books, records and accounts of *MERALCO*. On January 15, 2007, in compliance with the directive of the *SC*, *ERC* requested *COA* to conduct an audit of the books, records and accounts of *MERALCO* using calendar year 2004 and 2007 as test years.

The *COA* audit, which began in September 2008, was completed in August 2009.

On February 17, 2010, the *ERC* issued its Order directing *MERALCO* and all intervenors in the case to submit within 15 days from receipt their respective comments on the *COA*'s "Report No. 2009-01 Rate Audit Unbundled Charges."

On July 1, 2011, the *ERC* maintained and affirmed its findings and conclusions in its Order dated March 20, 2003. The *ERC* stated that the *COA* recommendation to apply disallowances under *PBR* to rate unbundling violates the principle against retroactive rate-making. An intervenor group filed a motion for reconsideration of the said Order. On September 5, 2011, *MERALCO* filed its comment to the intervenor's motion for reconsideration. On February 4, 2013, the *ERC* denied the intervenor's motion for reconsideration. The intervenor filed a petition for review before the *CA*. *MERALCO* is awaiting further action of the *CA* on this matter.

**(iii) All material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of *MERALCO* with unconsolidated entities or other persons created during the reporting period.**

Not Applicable.

**(iv) Any material commitments for capital expenditures, the general purpose of such commitments, and the expected sources of funds for such expenditures should be described.**

#### **2014 Capital Expenditure Requirements (In millions)**

|                                                   |                |
|---------------------------------------------------|----------------|
| Electric capital projects                         | ₱10,667        |
| Non-electric projects and other capitalized items | 3,898          |
| <b>Total capital expenditures</b>                 | <b>₱14,565</b> |

As at June 30, 2014, *MERALCO* has met, and expects that it will continue to meet its capital expenditure requirements primarily from cash flow from operations, and working capital.

*MERALCO* is required by the *ERC* to take necessary steps, including making necessary capital expenditures, to build and maintain its network so as to meet minimum performance and service requirements and in any event to make capital expenditures in each quarter at least equal to the amount of depreciation taken in the prior years. Most expenditure on transmission and substation projects, supervisory control and distribution automation, and distribution line projects are non-discretionary. The remaining capital expenditure is discretionary, which encompasses allocation projects, telecommunications projects and other non-electrical capital expenditure. If the actual peak demand is lower than the forecasted demand, a portion of the non-discretionary capital expenditure may become discretionary.

*MERALCO* has an approved capital expenditure budget of ₱14,565 million for the year ended December 31, 2014, of which about 73% represents planned expenditures for the electric projects of the power distribution business. It has to prioritize its projects to only those deemed urgent in the 2014 project line up. Funding of capital expenditures will be sourced substantially from internally generated cash flow and borrowings from local and foreign financial institutions.

The ₱14,565 million approved capital expenditure budget is geared to support projects on areas with large concentration of core customers, give priority to correction of normal deficiencies in the system, stretch loading limits of *MERALCO* facilities and initiate practical and cost-effective projects to correct system deficiencies.

**Any known trends, events or uncertainties that have had or that are reasonably expected to have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations should be described.**

1. Retail Competition

See related preceding discussions under ELECTRIC POWER INDUSTRY DEVELOPMENTS AND UPDATES.

2. Petition for Dispute Resolution

On September 9, 2008, *MERALCO* filed a Petition for Dispute Resolution with the *ERC*, against *PEMC*, *TransCo*, *NPC* and *PSALM* as a result of the congestion in the transmission system of *TransCo* arising from the outages of the San Jose-Tayabas 500kV Line 2 on June 22, 2008, and the 500kV 600 MVA Transformer Bank No. 2 of *TransCo*'s San Jose, Bulacan substation on July 11, 2008. The Petition seeks to, among others, direct *PEMC* to adopt the *NPC-TOU* rate or the new price determined through the price substitution methodology of *PEMC* as approved by the *ERC*, as basis for its billing during the period of the congestion and direct *NPC* and *PSALM* to refund the transmission line loss components of the line rentals associated with *NPC/PSALM* bilateral transactions from the start of *WESM* operation on June 26, 2006.

In a Decision dated March 10, 2010, the *ERC* granted *MERALCO*'s petition and ruled that there is double charging of the Transmission Line Cost on *MERALCO* by *NPC* for the *TSC* quantities to the extent of 2.98% loss factor, since the start of the *TSC* in November 2006. Thus, *NPC* was directed to refund/collect line rental adjustment to/from *MERALCO*. In the meantime, the *ERC* issued an Order on May 4, 2011 directing *PEMC* to submit an alternative methodology for the segregation of line rental into congestion cost and line losses from the start of the *WESM*. *PEMC* has filed its compliance submitting its alternative methodology.

On September 8, 2011, *MERALCO* received a copy of *PEMC*'s compliance to *ERC*'s directive and on November 11, 2011, *MERALCO* filed a counter-proposal which effectively simplifies *PEMC*'s proposal.

On November 11, 2011, *MERALCO* filed its Motion to Implement the Decision Dated March 10, 2010 By Immediately Effecting the Refund/(Collection) of Line Rental Adjustments to Consumers. On December 21, 2011, *PSALM* filed its Comment on *MERALCO*'s said Motion. Then, in an Order of the *ERC* dated January 24, 2012, it directed *PEMC*, *TRANSCO* and *NPC* to submit their respective comments on *MERALCO*'s motion within five days from receipt.

In an Order of the *ERC* dated June 27, 2012, *MERALCO* was directed to submit its computation of the amount of the double charging of line loss on a per month basis from June 26, 2006 up to the present. On July 4, 2012, *MERALCO* filed its Compliance to the said Order. Thereafter, the *ERC* issued an Order directing the parties to comment on *MERALCO*'s submissions.

In an Order dated March 4, 2013, the *ERC* approved the methodology proposed by *MERALCO* and *PEMC* in computing the double charged amount on line losses by deducting 2.98% from the *NPC-TOU* amount. Accordingly, the *ERC* determined that the computed double charge amount to be collected from *NPC* is ₱5.2 billion, covering the period November 2006 to August 2012 until actual cessation of the collection of the 2.98% line loss charge in the *NPC-TOU* rates imposed on *MERALCO*, while the amount to be collected from the *SGCs* is ₱4.7 billion. Additionally, *MERALCO* was directed to file a petition against the following *SGCs*: *MPPCLAPRI*, *TLI*, *SMEC* and *SCPC*, within thirty (30) days from receipt thereof, to recover the line loss collected by them. *MERALCO* filed a motion for clarification with the *ERC* regarding the directives contained in the March 4, 2013 Order.

In an Order dated July 1, 2013, the *ERC* issued the following clarifications/resolutions: 1) *SPPC* should be included as one of the *SGCs* against whom a petition for dispute resolution should be filed by *MERALCO*; 2) Amount to be refunded by *NPC* is not only ₱5.2 billion but also the subsequent payments it received from *MERALCO* beyond August 2012 until the actual cessation of the collection of the 2.98% line loss charge in its *TOU* rates; 3) Petition to be filed by *MERALCO* against the *SGCs* should not only be for the recovery of the amount of ₱4.7 billion but also the subsequent payments beyond August 2012 until the actual cessation of the collection of the 2.98% line loss charge in its *TOU* rates. ; 4) “*SCPC Ilijan*” pertains to *SPPC* instead. Thus, the refundable amount of ₱706 million pertaining to “*SCPC Ilijan*” should be added to *SPPC*’s refundable amount of ₱1.1 billion; 6) Grant the “Motion for Extension” filed by *MERALCO* and was directed to file a petition against the following *SGCs*: *MPPCL*, *APRI*, *TLI*, *SMEC*, *SCPC* and *SPPC*, otherwise, it shall be the one liable to refund the subject amount to its customers; and 7) deny the respective “Motions for Reconsideration” filed by *NPC* and *PSALM*.

On September 12, 2013, *MERALCO* filed a Manifestation with Motion with the *ERC* seeking approval of its proposal to offset the amount of ₱74 million against some of its monthly remittances to *PSALM*. *PSALM* and *NPC* filed their comments *ad cautelam* on *MERALCO*’s Manifestation and Motion. *MERALCO* is awaiting the resolution of the *ERC* on its Manifestation and Motion. On November 4, 2013, *MERALCO* filed its Reply. *MERALCO* is awaiting the resolution of the *ERC* on its Manifestation and Motion.

On October 24, 2013, *MERALCO* received *PSALM*’s Petition for Certiorari with the *CA* (With Urgent *TRO* and/or Writ of Preliminary Mandatory Injunction Applications) to question the March 4, 2013 and July 1, 2013 Orders of the *ERC*. In a Resolution dated December 29, 2013, the *CA* gave *MERALCO* until December 26, 2013, within which to submit its Comment on the Petition for Certiorari and to show cause why the prayer for the Application for *TRO* and/or Preliminary Injunction should not be granted (“*Comment and Opposition*”). On December 23, 2013, January 5, 2014 and January 15, 2014, *MERALCO* requested for an additional period of ten (10) days each, within which to submit its *Comment and Opposition*.

On February 2, 2014, *MERALCO* filed its Comment to said Petition. The *CA* has yet to rule on the Petition.

#### *PSALM* versus *PEMC* and *MERALCO*

Due to the unusually large increases in *WESM* prices during the 3<sup>rd</sup> and 4<sup>th</sup> months of the *WESM* operations, *MERALCO* raised concerns with the *PEMC* to investigate whether *WESM* rules were breached or if anti-competitive behavior had occurred.

While resolutions were initially issued by the *PEMC* directing adjustments of *WESM* settlement amounts, a series of exchanges and appeals with the *ERC* ensued. *ERC*’s decision directing the *WESM* settlement price for the 3<sup>rd</sup> and 4<sup>th</sup> billing months to be *NPC-TOU* rates, prompted *PSALM* to file a Motion for Reconsideration with the *CA*, which was denied on November 6, 2009. In December 2009, *PSALM* filed a Petition for Review on Certiorari with the *SC*.

As at June 30, 2014, *PSALM*’s petition for review is pending resolution by the *SC*.

### 3. Petition for Dispute Resolution with *NPC* on Premium Charges

On June 2, 2009, *MERALCO* filed a Petition for Dispute Resolution against *NPC* and *PSALM* with respect to *NPC*’s imposition of premium charges for the alleged excess energy it supplied to *MERALCO* covering the billing periods May 2005 to June 2006. The premium charges amounted to ₱315 million during the May-June 2005 billing periods, which have been paid for by *MERALCO*, and ₱318 million during the November 2005, February 2006 and April-June 2006 billing periods, which is being disputed and withheld by *MERALCO*. *MERALCO* believes that there is no basis for the imposition of the premium charges. The hearings on this case have been completed and *MERALCO* is now awaiting the resolution of the *ERC* on the petition.

### 4. Recovery of Local Franchise Tax

On March 25, 2011, *MERALCO* filed with the *ERC* an Application for recovery of *LFT* paid but are not yet billed to customers for the period beginning first quarter of 1993 up to the second quarter of 2004 for five provinces, namely: Bulacan, Batangas, Cavite, Laguna and Rizal; and 14 cities, namely: San Jose Del Monte, Batangas, San Pablo, Tagaytay, Lucena, Mandaluyong, Marikina, Quezon, Caloocan, Pasay, Las Piñas, Manila, Pasig and Calamba. The *LFT* is recognized as a legitimate and reasonable *DU* expense in the *ERC*’s Unbundling decision.

In a Decision dated February 27, 2012, the *ERC* released its Order approving with modifications *MERALCO*’s application. The *ERC* approved recovery of *LFT* amounting to ₱1,571 million plus carrying charges of ₱730 million. As directed by the *ERC*, the recovery was reflected as a separate item in the *MERALCO* billing statement to its customers

beginning April 2012. As at June 30, 2014, a total of ₱1,016 million *LFT* and carrying charges have been billed to affected customers.

#### 5. Supreme Court Temporary Restraining Order on *MERALCO*'s December 2013 Billing Rate Increase

On December 9, 2013, the *ERC* gave clearance to the request of *MERALCO* to implement a staggered collection over three (3) months covering the December 2013 billing month for the increase in generation charge and other bill components such as *VAT*, *LFT*, transmission charge, and *SL* charge, which reflected a total increase of ₱4.15 per *kWh* for a 200-*kWh* residential consumer. The generation costs for the November 2013 supply month increased significantly because of the use of the more expensive liquid fuel or bio-diesel by the natural gas-fired power plants that were affected by the Malampaya Gas Field or *Malampaya*, shutdown from November 11 to December 10, 2013. This was compounded by the aberrant spike in the *WESM*, charges on account of the scheduled and extended shutdowns, and the forced outages, of several base load power plants, as well as the non-compliance with *WESM* Rules by certain plants resulting in significant power generation capacities not being offered and dispatched.

The Department of Justice commenced an investigation while the House of Representatives and the Senate conducted separate hearings to determine the underlying reasons for the price increase, including any possible collusion among the power firms. In the meantime, *MERALCO* proceeded with billing its captive customers with the *ERC* approval.

On December 19, 2013, several party-list representatives of the House of Representatives filed a Petition against *MERALCO*, *ERC* and the *DOE* before the *SC*, questioning the *ERC* clearance granted to *MERALCO* to charge the ₱4.15 per *kWh* price increase, alleging the lack of hearing and due process. It also sought for the declaration of the unconstitutionality of the *EPIRA*, which essentially declared the generation and supply sectors competitive and open, and not considered public utilities. A similar petition was filed by a consumer group and several private homeowners associations challenging also the legality of the *AGRA* that the *ERC* had promulgated. Both petitions prayed for the issuance of *TRO*, and a Writ of Preliminary Injunction.

On December 23, 2013, the *SC* consolidated the two (2) Petitions and granted the application for *TRO* effective immediately and for a period of sixty (60) days, which effectively enjoined the *ERC* and *MERALCO* from implementing the ₱4.15 per *kWh* price increase. The *SC* also ordered *MERALCO*, *ERC* and *DOE* to file their respective comments to the Petitions. Oral Arguments were conducted on January 21, 2014, February 4, 2014 and February 11, 2014. Thereafter, the *SC* ordered all the Parties to the consolidated Petitions to file their respective Memorandum on or before February 26, 2014 after which the Petitions will be deemed submitted for resolution of the *SC*. *MERALCO* complied with said directive and filed its Memorandum on said date.

On February 18, 2014, acting on the motion filed by the Petitioners, the *SC* extended for another 60 days or until April 22, 2014, the *TRO* that it originally issued against *MERALCO* and *ERC* last December 23, 2013. The *TRO* was also similarly applied to the generating companies, specifically *MPPCL*, *SMEC*, *SPPC*, *FGPC*, and the *NGCP*, and the *PEMC* (the administrator of *WESM* and market operator) who were all enjoined from collecting from *MERALCO* the deferred amounts representing the ₱4.15 per *kWh* price increase for the November 2013 supply month.

In the meantime, on January 30, 2014, *MERALCO* filed an Omnibus Motion with Manifestation with the *ERC* for the latter to direct *PEMC* to conduct a re-run or re-calculation of the *WESM* prices for the supply months of November to December 2013. Subsequently, on February 17, 2014, *MERALCO* filed with the *ERC* an Application for the recovery of deferred generation costs for the December 2013 supply month praying that it be allowed to recover the same over a six (6)-month period.

On March 3, 2014, the *ERC* issued an Order voiding the Luzon *WESM* prices during the November and December 2013 supply months on the basis of the preliminary findings of its Investigating Unit that these are not reasonable, rational and competitive and imposing the use of regulated rates for the said period. *PEMC* was given seven (7) days upon receipt of the Order to calculate these regulated prices and implement the same in the revised *WESM* bills of the concerned. *PEMC*'s recalculated power bills for the supply month of December 2013 resulted in a net reduction of the December 2013 supply month bill of the *WESM* by ₱9,274 million. Due to the pendency of the *TRO*, no adjustment was made to the *WESM* bill of *MERALCO* for the November 2013 supply month. The timing of amounts to be credited to *MERALCO* is dependent on the reimbursement of *PEMC* from associated generator companies. However, several generating companies, including *MPPCL*, *SN Aboitiz Power Corporation*, *Team* (Philippines) Energy Corporation, *Panasia Energy Holdings, Inc.*, and *SMEC*, have filed motions for reconsideration questioning the Order dated March 3, 2014. *Meralco* has filed a consolidated comment to these motions for reconsideration. The *ERC* has yet to resolve these motions.

In view of the pendency of the various submissions before the *ERC* and mindful of the complexities in the implementation of *ERC*'s Order dated March 3, 2014, the *ERC* directed *PEMC* to provide the market participants an additional period of 45 days to comply with the settlement of their respective adjusted *WESM* bills. In an Order dated May 9, 2014, the parties were then given an additional non-extendible period of 30 days from receipt of the Order within which to settle their *WESM* bills. However, in an Order dated June 6, 2014 and acting on an intervention filed by

Angeles Electric Corporation, the *ERC* deemed it appropriate to hold in abeyance the settlement of *PEMC*'s adjusted *WESM* bills by the market participants.

On April 22, 2014, the *SC* extended indefinitely the *TRO* issued on December 23, 2013 and February 18, 2014 and directed generating companies not to collect from *MERALCO*. The *SC* has yet to resolve the various petitions filed against *MERALCO*.

**(v) Any significant elements of income or loss that did not arise from the registrant's continuing operations.**

None

**(vi) Any seasonal aspects that had a material effect on the financial condition or results of operations.**

*Seasonality of Operations and Growth Drivers*

Approximately 98% of *MERALCO Group*'s operating revenues pertain to sale of electricity distributed by *MERALCO* and *CEDC*.

The electricity sales of *MERALCO* and *CEDC* exhibit a degree of quarterly seasonality. The *kWh* sales in the first quarter is lower than the average of the year as this period is characterized by cooler temperature and softer consumer demand following heightened consumer spending in the last quarter of the year. The second quarter is marked by higher than average *kWh* sales. This is due to a number of factors, including: increased consumption of households and commercial establishments due the summer season; increased production of industries to replenish stocks and in preparation for the opening of classes; and, heightened construction activity to take advantage of the sunny weather. Despite the onset of the rainy season which tapers cooling requirements of commercial establishments, *kWh* sales typically peaks on the third quarter of the year. Manufacturing industries that cater to the export market have their peak production schedule at this time as they rush to meet shipping deadlines to foreign markets. Industries catering to the domestic market are also now starting production in preparation for the Christmas season. Lastly, the fourth quarter performance is about the average of the year. Industrial production winds down while households and commercial establishments also cut down on their cooling loads. Given this perspective on the seasonality of *kWh* sales, a higher proportion of the *MERALCO*'s and *CEDC*'s revenues are earned on the second half of the year.

Aside from the quarterly seasonal pattern, *kWh* sales on a year-on-year basis adjust as a result of a number of factors. Sales of electricity normally increase in periods of economic growth, low inflation and electricity rates, and in periods of high temperatures over extended period of time, e.g. the El Niño episodes.

The following table sets forth *MERALCO Group*'s quarterly sales in GWh.

| <b>Period</b>  | <b>2014</b> | <b>2013</b> |
|----------------|-------------|-------------|
| First Quarter  | 7,908       | 7,777       |
| Second Quarter | 9,391       | 9,086       |
| Third Quarter  |             | 8,753       |
| Fourth Quarter |             | 8,468       |
| Total          | 17,299      | 34,084      |

The businesses of all other subsidiaries are not highly seasonal.

**(vii) Any known trends, demands, commitments, events or uncertainties that will have a material impact of the issuer's liquidity.**

The Management is not aware of any known trends, demands, commitments, events or uncertainties that may deem potentially have a material impact on *MERALCO Group*'s liquidity as at June 30, 2014.

**(viii) Discussion of *MERALCO*'s and its majority-owned subsidiaries top five (5) key performance indicators. It shall include a discussion of the manner by which *MERALCO* calculates or identifies the indicators presented on a comparable basis.**

Listed hereunder are *MERALCO*'s major subsidiaries namely *CEDC*, *MGen*, *MIESCOR*, *e-MVI*, *RSIC* and *CIS*. The following table summarizes their key financial performance and indicators as at June 30, 2014 and December 31, 2013 and for the six months ended June 30, 2014 and 2013.

Financial Highlights and Ratios<sup>7</sup> of Major Subsidiaries

As at and for the six months ended June 30, 2014 and 2013

| (Amounts in millions, except<br>financial ratios and % change) | CEDC             |        |         | MGen             |        |         | MIESCOR          |        |         | e-MVI            |        |         | RSIC             |        |         | CIS              |        |         |
|----------------------------------------------------------------|------------------|--------|---------|------------------|--------|---------|------------------|--------|---------|------------------|--------|---------|------------------|--------|---------|------------------|--------|---------|
|                                                                | 30-Jun           | 31-Dec | %       | 30-Jun           | 31-Dec | %       | 30-Jun           | 31-Dec | %       | 30-Jun           | 31-Dec | %       | 30-Jun           | 31-Dec | %       | 30-Jun           | 31-Dec | %       |
|                                                                | 2014             | 2013   | change  | 2014             | 2013   | change  | 2014             | 2013   | change  | 2014             | 2013   | change  | 2014             | 2013   | change  | 2014             | 2013   | change  |
| Percentage of ownership                                        | 65%              | 65%    |         | 100%             | 100%   |         | 99%              | 99%    |         | 100%             | 100%   |         | 100%             | 100%   |         | 51%              | 51%    |         |
| <b>Condensed Statements of Financial Position</b>              |                  |        |         |                  |        |         |                  |        |         |                  |        |         |                  |        |         |                  |        |         |
| Total assets                                                   | 1,533            | 1,414  | 8       | 18,303           | 17,921 | 2       | 2,779            | 2,259  | 23      | 1,088            | 993    | 10      | 953              | 1,281  | (26)    | 1,410            | 1,274  | 11      |
| Current assets                                                 | 977              | 876    | 12      | 5,036            | 5,639  | (11)    | 2,336            | 1,886  | 24      | 386              | 362    | 7       | 631              | 877    | (28)    | 1,337            | 1,202  | 11      |
| Cash and cash equivalents                                      | 639              | 594    | 8       | 158              | 270    | (41)    | 631              | 338    | 87      | 110              | 131    | (16)    | 195              | 208    | (6)     | 486              | 544    | (11)    |
| Equity                                                         | 889              | 469    | 90      | 18,264           | 17,870 | 2       | 874              | 914    | (4)     | 897              | 820    | 9       | 326              | 316    | 3       | 399              | 443    | (10)    |
| Total debt <sup>8</sup>                                        | -                | -      |         | -                | -      |         | 318              | 114    | 179     | -                | -      |         | -                | -      |         | -                | -      |         |
| Current liabilities                                            | 373              | 666    | (44)    | 27               | 38     | (29)    | 1,788            | 1,305  | 37      | 162              | 156    | 4       | 81               | 283    | (71)    | 999              | 825    | 21      |
| <b>Financial Ratios</b>                                        |                  |        |         |                  |        |         |                  |        |         |                  |        |         |                  |        |         |                  |        |         |
| Debt-to-equity ratio                                           | -                | -      | -       | -                | -      |         | 0.36             | 0.12   | -       | -                | -      | -       | -                | -      | -       | -                | -      | -       |
| Current ratio                                                  | 2.62             | 1.32   | 100     | 186.52           | 148.39 | 26      | 1.31             | 1.45   | (10)    | 2.38             | 2.32   | 3       | 7.79             | 3.10   | 151     | 1.34             | 1.46   | (8)     |
|                                                                | Six Months Ended |        |         | Six Months Ended |        |         | Six Months Ended |        |         | Six Months Ended |        |         | Six Months Ended |        |         | Six Months Ended |        |         |
|                                                                | 30-June          |        |         | 30-June          |        |         | 30-June          |        |         | 30-June          |        |         | 30-June          |        |         | 30-June          |        |         |
|                                                                | 2014             | 2013   | %change | 2014             | 2013   | %change | 2014             | 2013   | %change | 2014             | 2013   | %change | 2014             | 2013   | %change | 2014             | 2013   | %change |
| <b>Condensed Statements of Income</b>                          |                  |        |         |                  |        |         |                  |        |         |                  |        |         |                  |        |         |                  |        |         |
| Revenues                                                       | 1,411            | 1,188  | 19      | -                | -      | -       | 1,476            | 1,615  | (9)     | 272              | 218    | 25      | 89               | 74     | 20      | 498              | 417    | 19      |
| Costs and expenses                                             | 1,301            | 1,096  | 19      | 288              | 145    | 97      | 1,428            | 1,602  | (11)    | 171              | 136    | 26      | 71               | 78     | (9)     | 349              | 318    | 10      |
| Net income (loss)                                              | 112              | 94     | 19      | (535)            | (96)   | (457)   | (29)             | (3)    | 867     | 78               | 58     | 34      | 10               | 1      | 900     | 106              | 74     | 43      |
| <b>Financial Ratios</b>                                        |                  |        |         |                  |        |         |                  |        |         |                  |        |         |                  |        |         |                  |        |         |
| Profit margin                                                  | 7.9%             | 7.9%   | 0       | -                | -      |         | (2.0%)           | (0.2%) | 958     | 28.7%            | 26.6%  | 8       | 11.2%            | 1.9%   | 491     | 21.3%            | 17.7%  | 20      |
| Return on equity                                               | 12.6%            | 12.8%  | (2)     | (2.9%)           | -      | (100)   | (3.3%)           | (0.3%) | 1,006   | 8.7%             | 7.7%   | 13      | 3.1%             | 0.4%   | 667     | 26.6%            | 21.5%  | 24      |
| Asset turnover                                                 | 0.92             | 0.89   | 3       | -                | -      | -       | 0.53             | 0.89   | (40)    | 0.25             | 0.23   | 9       | 0.09             | 0.08   | 17      | 0.35             | 0.44   | (20)    |

<sup>11</sup> The manner of computing the financial ratios for subsidiaries is the same with computing for the financial ratios of MERALCO as presented in *Financial Highlights and Key Performance Indicators*.

<sup>8</sup> Total Debt is composed of notes payable and interest-bearing long-term financial liabilities, current and non-current portions.

# **ANNEX – Aging of Trade and Other Receivables**

As at June 30, 2014

*(Amounts in millions)*

|                                        | <u><b>T o t a l</b></u> | <u><b>1 - 30 days</b></u> | <u><b>31 - 60 days</b></u> | <u><b>61 - 90<br/>days</b></u> | <u><b>Over<br/>90 days</b></u> |
|----------------------------------------|-------------------------|---------------------------|----------------------------|--------------------------------|--------------------------------|
| Trade Receivables – Electricity        |                         |                           |                            |                                |                                |
| A) Billed Trade Receivables            |                         |                           |                            |                                |                                |
| Residential                            | ₱10,765                 | ₱7,288                    | ₱684                       | ₱180                           | ₱2,613                         |
| Commercial                             | 9,625                   | 6,643                     | 387                        | 123                            | 2,472                          |
| Industrial                             | 3,754                   | 2,609                     | 18                         | 7                              | 1,120                          |
| Flat Streetlights                      | 607                     | 84                        | 1                          | 29                             | 493                            |
| Total Billed Trade Receivables         | 24,751                  | 16,624                    | 1,090                      | 339                            | 6,698                          |
| B) Unbilled Trade Receivables          | 3,798                   | 3,798                     | -                          | -                              | -                              |
| Total Trade Receivables Electricity    | 28,549                  | 20,422                    | 1,090                      | 339                            | 6,698                          |
| Other Trade Receivables                | 2,659                   | 2,659                     | -                          | -                              | -                              |
| <b>Gross Trade Receivables</b>         | <b>31,208</b>           | <b>23,081</b>             | <b>1,090</b>               | <b>339</b>                     | <b>6,698</b>                   |
| Non-Trade Receivables                  | 3,393                   | 3,393                     | -                          | -                              | -                              |
| <b>Total Receivables</b>               | <b>34,601</b>           | <b>26,474</b>             | <b>1,090</b>               | <b>339</b>                     | <b>6,698</b>                   |
| <b>Allowance for Doubtful Accounts</b> | <b>(3,444)</b>          | <b>(3,444)</b>            | <b>-</b>                   | <b>-</b>                       | <b>-</b>                       |
| <b>Net Receivables</b>                 | <b>₱31,157</b>          | <b>₱23,030</b>            | <b>₱1,090</b>              | <b>₱339</b>                    | <b>₱6,698</b>                  |

## Manila Electric Company and Subsidiaries

Interim Consolidated Financial Statements As at June 30, 2014 (Unaudited),  
December 31, 2013 (Audited)  
and For the Six Months and Three Months Ended June 30, 2014 and 2013 (Unaudited)

**MANILA ELECTRIC COMPANY AND SUBSIDIARIES**  
**UNAUDITED INTERIM CONSOLIDATED STATEMENTS**  
**OF FINANCIAL POSITION**

|                                                                                     | Note                     | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|-------------------------------------------------------------------------------------|--------------------------|---------------------------------|-----------------------------------|
| <i>(Amounts in millions)</i>                                                        |                          |                                 |                                   |
| <b>ASSETS</b>                                                                       |                          |                                 |                                   |
| <b>Noncurrent Assets</b>                                                            |                          |                                 |                                   |
| Utility plant and others                                                            | 7 and 15                 | ₱116,721                        | ₱112,586                          |
| Investments in associates and joint ventures                                        | 8                        | 14,457                          | 13,422                            |
| Investment properties                                                               | 9 and 15                 | 1,528                           | 1,526                             |
| Deferred tax assets - net                                                           | 28                       | 7,220                           | 5,381                             |
| Other noncurrent assets - net                                                       | 7, 10, 12, 27, 29 and 30 | 14,962                          | 23,603                            |
| <b>Total Noncurrent Assets</b>                                                      |                          | <b>154,888</b>                  | <b>156,518</b>                    |
| <b>Current Assets</b>                                                               |                          |                                 |                                   |
| Cash and cash equivalents                                                           | 11 and 27                | 67,053                          | 59,851                            |
| Trade and other receivables                                                         | 10, 12, 18, 23 and 27    | 31,157                          | 32,718                            |
| Inventories                                                                         | 13                       | 2,238                           | 2,750                             |
| Other current assets                                                                | 14 and 27                | 8,409                           | 12,167                            |
| <b>Total Current Assets</b>                                                         |                          | <b>108,857</b>                  | <b>107,486</b>                    |
| <b>Total Assets</b>                                                                 |                          | <b>₱263,745</b>                 | <b>₱264,004</b>                   |
| <b>EQUITY AND LIABILITIES</b>                                                       |                          |                                 |                                   |
| <b>Equity Attributable to Equity Holders of the Parent</b>                          |                          |                                 |                                   |
| Common stock                                                                        | 15                       | ₱11,273                         | ₱11,273                           |
| Subscriptions receivable                                                            |                          | (39)                            | (69)                              |
| Additional paid-in capital                                                          |                          | 4,111                           | 4,111                             |
| Excess of acquisition cost over carrying value of non-controlling interest acquired |                          | (328)                           | (328)                             |
| Employee stock purchase plan                                                        | 16                       | 1,049                           | 1,049                             |
| Unrealized fair value gains on available-for-sale, or AFS, financial assets         | 10                       | 108                             | 105                               |
| Share in cumulative translation adjustments of a subsidiary and associates          | 8                        | 247                             | 389                               |
| Cumulative actuarial gains                                                          |                          | 1,434                           | 1,446                             |
| Treasury shares                                                                     | 15                       | (11)                            | (11)                              |
| Retained earnings:                                                                  | 15                       |                                 |                                   |
| Appropriated                                                                        |                          | 11,000                          | 11,000                            |
| Unappropriated                                                                      |                          | 48,565                          | 46,197                            |
| <b>Equity Attributable to Equity Holders of the Parent</b>                          |                          | <b>77,409</b>                   | <b>75,162</b>                     |
| <b>Non-controlling Interests</b>                                                    |                          | <b>320</b>                      | <b>173</b>                        |
| <b>Total Equity</b>                                                                 |                          | <b>77,729</b>                   | <b>75,335</b>                     |

(Forward)

|                                                                              |                           | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|------------------------------------------------------------------------------|---------------------------|---------------------------------|-----------------------------------|
|                                                                              | Note                      |                                 |                                   |
| <i>(Amounts in millions)</i>                                                 |                           |                                 |                                   |
| <b>Noncurrent Liabilities</b>                                                |                           |                                 |                                   |
| Interest-bearing long-term financial liabilities -<br>net of current portion | 17, 25 and 27             | ₱27,579                         | ₱20,756                           |
| Customers' deposits - net of current portion                                 | 18, 22 and 27             | 20,275                          | 21,600                            |
| Long-term employee benefits                                                  | 26                        | 4,740                           | 4,183                             |
| Provisions                                                                   | 19 and 29                 | 26,932                          | 24,729                            |
| Refundable service extension costs -<br>net of current portion               | 22 and 27                 | 6,632                           | 5,782                             |
| Deferred tax liabilities - net                                               | 28                        | 5                               | 1                                 |
| Other noncurrent liabilities                                                 | 24 and 27                 | 21,994                          | 16,992                            |
| <b>Total Noncurrent Liabilities</b>                                          |                           | <b>108,157</b>                  | <b>94,043</b>                     |
| <b>Current Liabilities</b>                                                   |                           |                                 |                                   |
| Notes payable                                                                | 21, 25 and 27             | 368                             | 1,814                             |
| Trade payables and other current liabilities                                 | 15, 17, 18, 22, 23 and 27 | 66,042                          | 73,892                            |
| Customers' refund                                                            | 2, 20 and 27              | 5,971                           | 6,013                             |
| Income tax payable                                                           |                           | 3,251                           | 1,886                             |
| Current portion of interest-bearing long-term<br>financial liabilities       | 17, 25 and 27             | 2,227                           | 11,021                            |
| <b>Total Current Liabilities</b>                                             |                           | <b>77,859</b>                   | <b>94,626</b>                     |
| <b>Total Liabilities</b>                                                     |                           | <b>186,016</b>                  | <b>188,669</b>                    |
| <b>Total Liabilities and Equity</b>                                          |                           | <b>₱263,745</b>                 | <b>₱264,004</b>                   |

See accompanying Notes to Unaudited Interim Consolidated Financial Statements.

**MANILA ELECTRIC COMPANY AND SUBSIDIARIES**  
**UNAUDITED INTERIM CONSOLIDATED STATEMENTS OF INCOME**

|                                                                    |                         | Unaudited                           |          |                                       |         |
|--------------------------------------------------------------------|-------------------------|-------------------------------------|----------|---------------------------------------|---------|
|                                                                    |                         | For the Six Months<br>Ended June 30 |          | For the Three Months<br>Ended June 30 |         |
|                                                                    | Note                    | 2014                                | 2013     | 2014                                  | 2013    |
| (Amounts in millions, except per share data)                       |                         |                                     |          |                                       |         |
| REVENUES                                                           |                         |                                     |          |                                       |         |
| Sale of electricity                                                | 23, 24 and 32           | ₱129,720                            | ₱139,697 | ₱75,675                               | ₱75,536 |
| Sale of other services                                             | 9 and 23                | 2,448                               | 2,017    | 1,384                                 | 1,358   |
|                                                                    |                         | 132,168                             | 141,714  | 77,059                                | 76,894  |
| COSTS AND EXPENSES                                                 |                         |                                     |          |                                       |         |
| Purchased power                                                    | 24 and 30               | 100,273                             | 111,575  | 58,958                                | 59,986  |
| Salaries, wages and employee benefits                              | 16, 25 and 26           | 5,386                               | 5,577    | 2,721                                 | 2,977   |
| Provision for probable charges and expenses<br>from claims         | 19                      | 5,155                               | 5,199    | 3,257                                 | 3,083   |
| Depreciation and amortization                                      | 7, 9 and 10             | 2,669                               | 3,022    | 1,374                                 | 1,563   |
| Contracted services                                                |                         | 2,057                               | 1,521    | 1,239                                 | 905     |
| Provision for doubtful accounts                                    | 12                      | 230                                 | 230      | 138                                   | 134     |
| Taxes, fees and permits                                            |                         | 419                                 | 224      | 128                                   | 121     |
| Other expenses                                                     | 23 and 25               | 1,775                               | 1,616    | 959                                   | 935     |
|                                                                    |                         | 117,964                             | 128,964  | 68,774                                | 69,704  |
| OTHER EXPENSES (INCOME)                                            |                         |                                     |          |                                       |         |
| Interest and other financial income                                | 25                      | (329)                               | (732)    | (178)                                 | (321)   |
|                                                                    | 7, 17, 18, 21<br>and 25 | 839                                 | 708      | 404                                   | 335     |
| Interest and other financial charges                               |                         |                                     |          |                                       |         |
| Equity in net losses of associates and<br>joint ventures           | 8                       | 52                                  | 48       | 13                                    | 52      |
| Foreign exchange loss (gain)                                       |                         | 222                                 | (277)    | 163                                   | (277)   |
| Others                                                             | 2 and 30                | (470)                               | (279)    | (234)                                 | (208)   |
|                                                                    |                         | 314                                 | (532)    | 168                                   | (419)   |
| INCOME BEFORE INCOME TAX                                           |                         | 13,890                              | 13,282   | 8,117                                 | 7,609   |
| PROVISION FOR (BENEFIT FROM)<br>INCOME TAX                         |                         |                                     |          |                                       |         |
|                                                                    | 28                      |                                     |          |                                       |         |
| Current                                                            |                         | 6,012                               | 4,625    | 3,413                                 | 2,069   |
| Deferred                                                           |                         | (1,798)                             | (817)    | (945)                                 | 103     |
|                                                                    |                         | 4,214                               | 3,808    | 2,468                                 | 2,172   |
| NET INCOME                                                         |                         | ₱9,676                              | ₱9,474   | ₱5,649                                | ₱5,437  |
| Attributable To                                                    |                         |                                     |          |                                       |         |
| Equity holders of the Parent                                       | 31                      | ₱9,637                              | ₱9,441   | ₱5,629                                | ₱5,417  |
| Non-controlling interests                                          |                         | 39                                  | 33       | 20                                    | 20      |
|                                                                    |                         | ₱9,676                              | ₱9,474   | ₱5,649                                | ₱5,437  |
| Earnings Per Share Attributable to Equity<br>Holders of the Parent |                         |                                     |          |                                       |         |
|                                                                    | 31                      |                                     |          |                                       |         |
| Basic                                                              |                         | ₱8.55                               | ₱8.38    | ₱4.99                                 | ₱4.81   |
| Diluted                                                            |                         | 8.55                                | 8.38     | 4.99                                  | 4.81    |

*See accompanying Notes to Unaudited Interim Consolidated Financial Statements.*

**MANILA ELECTRIC COMPANY AND SUBSIDIARIES**  
**UNAUDITED INTERIM CONSOLIDATED STATEMENTS OF**  
**COMPREHENSIVE INCOME**

|                                                                                    | <i>Note</i> | Unaudited                           |               |                                       |               |
|------------------------------------------------------------------------------------|-------------|-------------------------------------|---------------|---------------------------------------|---------------|
|                                                                                    |             | For the Six Months<br>Ended June 30 |               | For the Three Months<br>Ended June 30 |               |
|                                                                                    |             | 2014                                | 2013          | 2014                                  | 2013          |
| <i>(Amounts in millions)</i>                                                       |             |                                     |               |                                       |               |
| <b>NET INCOME FOR THE PERIOD</b>                                                   |             | <b>₱9,676</b>                       | <b>₱9,474</b> | <b>₱5,649</b>                         | <b>₱5,437</b> |
| <b>OTHER COMPREHENSIVE INCOME</b>                                                  |             |                                     |               |                                       |               |
| Actuarial loss                                                                     |             | (17)                                | (384)         | (17)                                  | —             |
| Income tax effect                                                                  |             | 5                                   | 115           | 5                                     | —             |
|                                                                                    |             | (12)                                | (269)         | (12)                                  | —             |
| Items that will be reclassified to profit or<br>loss in subsequent periods:        |             |                                     |               |                                       |               |
| Unrealized fair value gain (loss) on<br>available-for-sale financial assets        | 10          | 4                                   | 7             | (6)                                   | 3             |
| Income tax effect                                                                  |             | (1)                                 | (2)           | 2                                     | (1)           |
|                                                                                    |             | 3                                   | 5             | (4)                                   | 2             |
| Share in cumulative translation adjustments<br>of a subsidiary and associates      | 8           | (142)                               | 265           | (125)                                 | 265           |
| <b>OTHER COMPREHENSIVE INCOME (LOSS)<br/>FOR THE PERIOD, NET OF INCOME<br/>TAX</b> |             | <b>(151)</b>                        | <b>1</b>      | <b>(141)</b>                          | <b>267</b>    |
| <b>TOTAL COMPREHENSIVE INCOME<br/>FOR THE PERIOD, NET OF INCOME<br/>TAX</b>        |             | <b>₱9,525</b>                       | <b>₱9,475</b> | <b>₱5,508</b>                         | <b>₱5,704</b> |
| <b>Total Comprehensive Income Attributable To</b>                                  |             |                                     |               |                                       |               |
| Equity holders of the Parent                                                       |             | <b>₱9,637</b>                       | <b>₱9,442</b> | <b>₱5,629</b>                         | <b>₱5,684</b> |
| Non-controlling interests                                                          |             | <b>39</b>                           | <b>33</b>     | <b>20</b>                             | <b>20</b>     |
|                                                                                    |             | <b>₱9,676</b>                       | <b>₱9,475</b> | <b>₱5,649</b>                         | <b>₱5,704</b> |

*See accompanying Notes to Unaudited Interim Unaudited Interim Consolidated Financial Statements.*

**MANILA ELECTRIC COMPANY AND SUBSIDIARIES**  
**UNAUDITED INTERIM CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY**  
**FOR THE SIX MONTHS ENDED JUNE 30, 2014 AND 2013**

|                                                 | Equity Attributable to Equity Holders of the Parent |                             |                                  |                                                                                                              |                                                 |                                                                                 |                                                                                                             |                                           |                                 |                                                   |                                                     |                                                                 |                                  |                 |
|-------------------------------------------------|-----------------------------------------------------|-----------------------------|----------------------------------|--------------------------------------------------------------------------------------------------------------|-------------------------------------------------|---------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------|-------------------------------------------|---------------------------------|---------------------------------------------------|-----------------------------------------------------|-----------------------------------------------------------------|----------------------------------|-----------------|
|                                                 | Common<br>Stock<br>(Note 15)                        | Subscriptions<br>Receivable | Additional<br>Paid-in<br>Capital | Excess of<br>Acquisition<br>Cost Over<br>Carrying<br>Value of<br>Non-<br>controlling<br>Interest<br>Acquired | Employee<br>Stock<br>Purchase Plan<br>(Note 16) | Unrealized<br>Fair Value<br>Gains on<br>AFS<br>Financial<br>Assets<br>(Note 10) | Share in<br>Cumulative<br>Translation<br>Adjustments<br>of<br>a Subsidiary<br>and<br>Associates<br>(Note 8) | Cumulative<br>Actuarial<br>Gains (Losses) | Treasury<br>Shares<br>(Note 15) | Appropriated<br>Retained<br>Earnings<br>(Note 15) | Unappropriated<br>Retained<br>Earnings<br>(Note 15) | Equity<br>Attributable<br>to Equity<br>Holders of<br>the Parent | Non-<br>controlling<br>Interests | Total<br>Equity |
| At January 1, 2014                              | ₱11,273                                             | (₱69)                       | ₱4,111                           | (₱328)                                                                                                       | ₱1,049                                          | ₱105                                                                            | ₱389                                                                                                        | ₱1,446                                    | (₱11)                           | ₱11,000                                           | ₱46,197                                             | ₱75,162                                                         | ₱173                             | ₱75,335         |
| Net income                                      | -                                                   | -                           | -                                | -                                                                                                            | -                                               | 3                                                                               | (142)                                                                                                       | (12)                                      | -                               | -                                                 | 9,637                                               | 9,637                                                           | 39                               | 9,676           |
| Other comprehensive income (loss)               | -                                                   | -                           | -                                | -                                                                                                            | -                                               | 3                                                                               | (142)                                                                                                       | (12)                                      | -                               | -                                                 | -                                                   | (151)                                                           | -                                | (151)           |
| Total comprehensive income (loss)               | -                                                   | -                           | -                                | -                                                                                                            | -                                               | 3                                                                               | (142)                                                                                                       | (12)                                      | -                               | -                                                 | 9,637                                               | 9,486                                                           | 39                               | 9,525           |
| Collection of subscriptions receivable          | -                                                   | 30                          | -                                | -                                                                                                            | -                                               | -                                                                               | -                                                                                                           | -                                         | -                               | -                                                 | (7,269)                                             | (7,269)                                                         | 30                               | (7,161)         |
| Dividends                                       | -                                                   | -                           | -                                | -                                                                                                            | -                                               | -                                                                               | -                                                                                                           | -                                         | -                               | -                                                 | (7,269)                                             | (7,239)                                                         | 108                              | (7,131)         |
|                                                 | -                                                   | 30                          | -                                | -                                                                                                            | -                                               | -                                                                               | -                                                                                                           | -                                         | -                               | -                                                 | (7,269)                                             | (7,239)                                                         | 108                              | (7,131)         |
| At June 30, 2014                                | ₱11,273                                             | (₱39)                       | ₱4,111                           | (₱328)                                                                                                       | ₱1,049                                          | ₱108                                                                            | ₱247                                                                                                        | ₱1,434                                    | (₱11)                           | ₱11,000                                           | ₱48,565                                             | ₱77,409                                                         | ₱320                             | ₱77,729         |
| At January 1, 2013                              | ₱11,273                                             | (₱211)                      | ₱4,111                           | (₱328)                                                                                                       | ₱1,049                                          | ₱120                                                                            | ₱3                                                                                                          | ₱289                                      | (₱11)                           | ₱6,000                                            | ₱45,607                                             | ₱67,902                                                         | ₱248                             | ₱68,150         |
| Net income                                      | -                                                   | -                           | -                                | -                                                                                                            | -                                               | -                                                                               | -                                                                                                           | -                                         | -                               | -                                                 | 9,441                                               | 9,441                                                           | 33                               | 9,474           |
| Other comprehensive income (loss)               | -                                                   | -                           | -                                | -                                                                                                            | -                                               | 5                                                                               | 265                                                                                                         | (269)                                     | -                               | -                                                 | -                                                   | 1                                                               | -                                | 1               |
| Total comprehensive income (loss)               | -                                                   | -                           | -                                | -                                                                                                            | -                                               | 5                                                                               | 265                                                                                                         | (269)                                     | -                               | -                                                 | 9,441                                               | 9,442                                                           | 33                               | 9,475           |
| Collection of subscriptions receivable          | -                                                   | 92                          | -                                | -                                                                                                            | -                                               | -                                                                               | -                                                                                                           | -                                         | -                               | -                                                 | (6,875)                                             | (6,875)                                                         | 92                               | (6,889)         |
| Dividends                                       | -                                                   | -                           | -                                | -                                                                                                            | -                                               | -                                                                               | -                                                                                                           | -                                         | -                               | -                                                 | -                                                   | -                                                               | (14)                             | (14)            |
| Appropriation of unrestricted retained earnings | -                                                   | -                           | -                                | -                                                                                                            | -                                               | -                                                                               | -                                                                                                           | -                                         | -                               | 5,000                                             | (5,000)                                             | -                                                               | -                                | -               |
|                                                 | -                                                   | 92                          | -                                | -                                                                                                            | -                                               | -                                                                               | -                                                                                                           | -                                         | -                               | 5,000                                             | (11,875)                                            | (6,783)                                                         | (14)                             | (6,797)         |
| At June 30, 2013                                | ₱11,273                                             | (₱119)                      | ₱4,111                           | (₱328)                                                                                                       | ₱1,049                                          | ₱125                                                                            | ₱268                                                                                                        | ₱20                                       | (₱11)                           | ₱11,000                                           | ₱43,173                                             | ₱70,561                                                         | ₱267                             | ₱70,828         |

See accompanying Notes to Unaudited Interim Consolidated Financial Statements.

**MANILA ELECTRIC COMPANY AND SUBSIDIARIES**  
**UNAUDITED INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS**

|                                                    |             | Unaudited                |          |
|----------------------------------------------------|-------------|--------------------------|----------|
|                                                    |             | For the Six Months Ended |          |
|                                                    |             | June 30                  |          |
|                                                    | Note        | 2014                     | 2013     |
| (Amounts in millions)                              |             |                          |          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>        |             |                          |          |
| Income before income tax                           |             | P13,890                  | P13,282  |
| Adjustments for:                                   |             |                          |          |
| Provision for probable charges and expenses from   |             |                          |          |
| claims - net                                       | 19          | 5,155                    | 5,199    |
| Depreciation and amortization                      | 7, 9 and 10 | 2,669                    | 3,022    |
| Interest and other financial charges               | 25          | 839                      | 708      |
| Interest and other financial income                | 25          | (329)                    | (732)    |
| Provision for doubtful accounts                    | 12          | 230                      | 230      |
| Unrealized foreign exchange loss (gain)            |             | 222                      | (277)    |
| Equity in net losses of associates                 |             |                          |          |
| and joint ventures                                 | 8           | 52                       | 48       |
| Gain on disposal of utility plant                  |             |                          |          |
| and others - net                                   |             | (93)                     | (60)     |
| Others                                             |             | —                        | 99       |
| Operating income before working capital changes    |             | 22,635                   | 21,519   |
| Decrease (increase) in:                            |             |                          |          |
| Trade and other receivables                        |             | 9,562                    | (295)    |
| Inventories                                        |             | (776)                    | (482)    |
| Other current assets                               |             | 3,929                    | 82       |
| Increase (decrease) in:                            |             |                          |          |
| Trade payables and other current liabilities       |             | (7,305)                  | 3,730    |
| Customers' refund                                  |             | (42)                     | (18)     |
| Customers' deposits                                |             | (1,287)                  | 3,609    |
| Long-term employee benefits                        |             | 549                      | (1,937)  |
| Cash generated from operations                     |             | 27,265                   | 26,208   |
| Income tax paid                                    |             | (3,087)                  | (3,218)  |
| Net cash flows from operating activities           |             | 24,178                   | 22,990   |
| <b>CASH FLOWS FROM INVESTING</b>                   |             |                          |          |
| <b>ACTIVITIES</b>                                  |             |                          |          |
| Additions to:                                      |             |                          |          |
| Utility plant and others                           | 7           | (4,710)                  | (3,616)  |
| Investments in associates and a joint venture      | 8 and 14    | (1,379)                  | (9,340)  |
| Intangible assets                                  | 10          | (140)                    | (177)    |
| Investment properties                              |             | (15)                     | —        |
| Acquisition of minority interest                   |             | 108                      | —        |
| Interest and other financial income received       |             | 320                      | 683      |
| Proceeds from disposal of utility plant and others |             | 93                       | 60       |
| Proceeds from disposal of investment properties    |             | —                        | 91       |
| Increase in other noncurrent assets                |             | (1,007)                  | (145)    |
| Net cash used in investing activities              |             | (6,730)                  | (12,444) |

(Forward)

|                                                                                   | Unaudited                |                       |
|-----------------------------------------------------------------------------------|--------------------------|-----------------------|
|                                                                                   | For the Six Months Ended |                       |
|                                                                                   | June 30                  |                       |
|                                                                                   | Note                     | 2014 2013             |
|                                                                                   |                          | (Amounts in millions) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                          |                       |
| Proceeds from:                                                                    |                          |                       |
| Availment of notes payable                                                        |                          | ₱254 ₱1,560           |
| Collection of subscriptions receivable                                            |                          | 30 92                 |
| Availment of interest-bearing long-term financial liabilities, net of issue costs |                          | 7,164 –               |
| Payments of:                                                                      |                          |                       |
| Dividends                                                                         |                          | (7,285) (6,620)       |
| Interest-bearing long-term financial liabilities                                  |                          | (9,192) (361)         |
| Notes payable                                                                     |                          | (1,700) (437)         |
| Interest and other financial charges                                              |                          | (1,001) (3,484)       |
| Decrease (increase) in other noncurrent liabilities                               |                          | 1,484 (2,886)         |
| Net cash used in financing activities                                             |                          | (10,246) (12,136)     |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>                       |                          | 7,202 (1,590)         |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>                           |                          | 59,851 60,500         |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>                                 | 11                       | ₱67,053 ₱58,910       |

See accompanying Notes to Unaudited Interim Consolidated Financial Statements.

# MANILA ELECTRIC COMPANY AND SUBSIDIARIES

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## NOTES TO UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

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### 1. Corporate Information

Manila Electric Company or *MERALCO*, holds a congressional franchise under Republic Act or *RA* No. 9209 effective June 28, 2003. *RA* No. 9209 grants *MERALCO* a 25-year franchise valid through June 28, 2028 to construct, operate, and maintain the electric distribution system in the cities and municipalities of Bulacan, Cavite, Metro Manila, and Rizal and certain cities, municipalities, and barangays in the provinces of Batangas, Laguna, Pampanga, and Quezon. On October 20, 2008, the Energy Regulatory Commission or *ERC*, granted *MERALCO* a consolidated Certificate of Public Convenience and Necessity for the operation of electric service within its franchise coverage, effective until the expiration of *MERALCO*'s congressional franchise. *MERALCO*'s participation in retail electricity supply or *RES*, is through its local *RES* unit, otherwise known as *MPower*.

The power segment, primarily power distribution, consists of operations of *MERALCO* and its subsidiary, Clark Electric Distribution Corporation or *CEDC*. *CEDC* is registered with Clark Development Corporation or *CDC*, under *RA* No. 9400, the *Bases Conversion Development Act of 1992*, as a Clark Special Economic Zone or *CSEZ*, enterprise, primarily engaged in the operation, and maintenance of a power distribution system within *CSEZ*.

*MERALCO* has a minority equity interest in a power generating company, Global Business Power Corporation or *GBPC*, and is developing power generation plants through its wholly owned subsidiary, *MERALCO* PowerGen Corporation or *MGen*. Through several subsidiaries in the service segment, it provides engineering, design, construction and consulting services, bill collection services, distribution and energy management services and information systems and technology services.

The single largest shareholder of *MERALCO* as at June 30, 2014 is Beacon Electric Asset Holdings, Inc. or *Beacon Electric*, which owns 49.96% of the common shares. *Beacon Electric* is jointly owned by Metro Pacific Investments Corporation or *Metro Pacific*, and *PLDT* Communications and Energy Ventures, Inc., or *PCEV*, both of which are domestic corporations and are affiliates of First Pacific Company Limited or *First Pacific*, a Hong Kong-based investment and management company. On June 24, 2014, *Beacon Electric* and *MPIC*, in conformity with *PCEV*'s approval, entered into a Share Purchase Agreement or *SPA* to sell 56 million common shares, comprising approximately 5% interest in *MERALCO* to *MPIC*. Based on the agreement, the consideration payable by *MPIC* to *Beacon Electric* will be settled in two installments: upon signing of the *SPA* and on or before February 2015. Upon completion of the sale, *MPIC* will directly own 5% of *MERALCO* shares, and *Beacon Electric* will own 44.96% of *MERALCO* shares.

In December 2013, JG Summit Holdings, Inc. or *JG Summit*, completed the purchase of the remaining 27.12% equity interest of San Miguel Corporation or *SMC*, San Miguel Pure Foods Company, Inc. and San Miguel Global Power Holdings Corp. in *MERALCO*. In July 2013, *SMC* sold its 5.71%-interest in *MERALCO* through the market. First Philippine Holdings Corporation or *First Holdings*, and First Philippine Utilities Corporation, collectively own 3.95%. The balance of *MERALCO*'s common shares is held by the public.

The common shares of *MERALCO* are listed on and traded in the Philippine Stock Exchange or *PSE*, with security symbol, *MER*.

The registered office address of *MERALCO* is Lopez Building, Ortigas Avenue, Pasig City, Philippines.

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## 2. Rate Regulations

As distribution utilities or *DUs*, *MERALCO* and *CEDC* are subject to the rate-making regulations and regulatory policies of the *ERC*. Billings of *MERALCO* and *CEDC* to customers are itemized or “unbundled” into a number of bill components that reflect the various activities and costs incurred in providing electric service. The adjustment to each bill component is governed by mechanisms promulgated and enforced by the *ERC*, mainly: [i] the “Rules Governing the Automatic Cost Adjustment and True-up Mechanisms and Corresponding Confirmation Process for Distribution Utilities”, which govern the recovery of pass-through costs, including over- or under-recoveries of the bill components, namely, (a) generation charge, (b) transmission charge, (c) system loss or *SL*, charge, (d) lifeline subsidy, and (e) local franchise tax or *LFT*, and (f) business tax; and [ii] the “Rules for the Setting of Distribution Wheeling Rates” or *RDWR*, as modified by *ERC* Resolution No. 20, Series of 2008, which govern the determination of *MERALCO*’s distribution, supply, and metering charges.

The rate-setting mechanism of *CEDC* is likewise in accordance with the *ERC* regulations. The following is a discussion of matters related to rate-setting of *MERALCO* and *CEDC*:

### *Performance-Based Regulations or PBR*

#### *MERALCO*

*MERALCO* was among the Group A entrants to the *PBR*, together with two other private *DUs*.

Rate-setting under *PBR* is governed by the *RDWR*. The *PBR* scheme sets tariffs based on the regulated asset base of the *DUs*, and the required operating and capital expenditures once every regulatory period or *RP*, to meet operational performance and service level requirements responsive to the needs for adequate, reliable and quality power, efficient service, and growth of all customer classes in the franchise area as approved by the *ERC*. *PBR* also employs a mechanism that penalizes or rewards a *DU* depending on its network and service performance.

Rate filings and settings are done on an *RP* basis. One (1) *RP* consists of four (4) Regulatory Years or *RYs*. An *RY* for *MERALCO* begins on July 1 and ends on June 30 of the following year. June 30, 2014 marked the end of the third *RY* of the third *RP* of *MERALCO*. The third *RP* is from July 1, 2011 to June 30, 2015.

#### *Maximum Average Price or MAP for RY 2008 and RY 2009*

On January 11 and April 1, 2008, *MERALCO* filed separate applications for the approval of its proposed translation of the *MAP* for *RY* 2008 and *RY* 2009, respectively, into different rate schedules for its various customer segments. A portion of the distribution charge under-recoveries as a result of the delayed implementation of the *PBR* was incorporated in the proposed *MAP* for *RY* 2009.

In April 2009, the *ERC* approved the implementation of *MERALCO*’s average distribution rate of ₱1.2227 per kilowatt-hour or *kWh* effective billing period of May 2009. This rate is inclusive of the under-recoveries for calendar year 2007 of ₱0.1285 per *kWh*.

On May 28, 2009, certain electricity consumer groups filed a Petition with the Court of Appeals, or *CA*, questioning the decision and Order of the *ERC* on *MERALCO*'s rate translation application for *RY* 2008 and *RY* 2009. In a decision dated January 27, 2010, the *CA* denied the Petition. Consequently, the consumer groups brought the case to the Supreme Court of the Philippines or *SC*. Comments and responses were filed by both parties with a Manifestation filed by *MERALCO* on January 26, 2011. As at June 30, 2014, the *SC* has yet to render a decision on this case.

#### *MAP for RY 2012*

On June 21, 2011, *MERALCO* filed an application for the approval of its *MAP* for *RY* 2012 and translation into rate tariffs by customer category. On October 6, 2011, the *ERC* provisionally approved the *MAP* for *RY* 2012 of ₱1.6012 per *kWh* and the rate translation per customer class was reflected commencing with the October 2011 customer bills. Hearings for the final approval of the application have been completed and all parties have submitted their respective memoranda. As at June 30, 2014, the application is pending final approval by the *ERC*.

#### *MAP for RY 2013*

On June 11, 2012, the *ERC* provisionally approved the *MAP* for *RY* 2013 of ₱1.6303 per *kWh* which was reflected starting with the July 2012 customer bills. Hearings on this case have been completed. As at June 30, 2014, the application is pending final approval by the *ERC*.

#### *MAP for RY 2014*

On April 1, 2013, *MERALCO* filed its application for the approval of its *MAP* for *RY* 2014 of ₱1.6510 per *kWh* and the translation thereof into rate tariffs by customer category. On June 10, 2013, the *ERC* provisionally approved the *MAP* for *RY* 2014 of ₱1.6474 per *kWh* and the rate translation per customer class. As at June 30, 2014, the application is pending final approval by the *ERC*.

#### *MAP for RY 2015*

On March 31, 2014, *MERALCO* filed its application for the approval of its *MAP* for *RY* 2015 of ₱1.5562 per *kWh* and the translation thereof into rate tariffs by customer category. On May 5, 2014, the *ERC* provisionally approved *MERALCO*'s *MAP* for 2015 of ₱1.5562 per *kWh* and the rate translation per customer class.

#### *CEDC*

*CEDC* was among the four (4) Group D entrants to the *PBR*. Similar to *MERALCO*, it is subject to operational performance and service level requirements approved by the *ERC*. The *RP* of *CEDC* began on October 1, 2011 and ends on September 30, 2015.

#### *MAP for RY 2013*

On August 30, 2012, *CEDC* filed its application for the approval of its *MAP* for *RY* 2013. On December 17, 2012, the *ERC* approved the *MAP* of ₱0.8953 per *kWh*. The revised rates based on the approved *MAP* for *RY* 2013 were implemented by *CEDC* starting January 2013.

### *SC Decision on Unbundling Rate Case*

On May 30, 2003, the *ERC* issued an Order approving *MERALCO*'s unbundled tariffs that resulted in a total increase of ₱0.17 per *kWh* over the May 2003 tariff levels. However, on August 4, 2003, certain consumer and civil society groups filed a Petition for Review of the *ERC*'s ruling with the *CA*. On July 22, 2004, the *CA* set aside the *ERC*'s ruling on *MERALCO*'s rate unbundling and remanded the case to the *ERC*. Further, the *CA* opined that the *ERC* should have asked the Commission on Audit or *COA*, to audit the books of *MERALCO*. The *ERC* and *MERALCO* subsequently filed separate motions asking the *CA* to reconsider its decision. On January 24, 2005, as a result of the denial by the *CA* of the motions, the *ERC* and *MERALCO* elevated the case to the *SC*.

In an *En Banc* decision promulgated on December 6, 2006, the *SC* set aside and reversed the *CA* ruling saying that a *COA* audit was not a prerequisite in the determination of a utility's rates. However, while the *SC* affirmed *ERC*'s authority in rate-fixing, the *SC* directed the *ERC* to request *COA* to undertake a complete audit of the books, records and accounts of *MERALCO*. On January 15, 2007, in compliance with the directive of the *SC*, the *ERC* requested *COA* to conduct an audit of the books, records and accounts of *MERALCO* using calendar years 2004 and 2007 as test years.

The *COA* audit, which began in September 2008, was completed in August 2009.

On February 17, 2010, the *ERC* issued its Order directing *MERALCO* and all intervenors in the case to submit, within 15 days from receipt of the Order, their respective comments on the *COA*'s "Report No. 2009-01 Rate Audit Unbundled Charges."

On July 1, 2011, the *ERC* maintained and affirmed its findings and conclusions in its Order dated March 20, 2003. The *ERC* stated that the *COA* recommendation to apply disallowances under *PBR* to rate unbundling violates the principle against retroactive rate-making. An intervenor group filed a motion for reconsideration of the said Order. On September 5, 2011, *MERALCO* filed its comment to the intervenor's motion for reconsideration. On February 4, 2013, the *ERC* denied the intervenor's motion for reconsideration. The intervenor filed a petition for review before the *CA*. As at June 30, 2014, *MERALCO* is awaiting further action of the *CA* on this matter.

### *Applications for the Recovery of Generation Costs and SL Charges*

*MERALCO* filed separate applications for the full recovery of generation costs, including value-added tax or *VAT*, incurred for the supply months of August 2006 to May 2007 or total under-recoveries of ₱12,679 million for generation charges and ₱1,295 million for *SL* charges.

The separate applications for the full recovery of generation charges have been approved by the *ERC* in its decisions released on January 18, 2008, September 3, 2008 and August 16, 2010.

As at June 30, 2014, the remaining balance of ₱137 million of generation costs were fully recovered.

With respect to the ₱1,295 million *SL* charge under-recoveries, the *ERC* ordered *MERALCO* to file a separate application for the recovery of *SL* adjustments after the *ERC* confirms the transmission rate to be used in the calculation of the *SL* rate in accordance with the *SL* rate formula of the Automatic Generation Rate Adjustments Guidelines or *AGRA*. *MERALCO* has filed the application for recovery of the ₱1,295 million *SL* charge under-recoveries with the *ERC*. This was included in the Consolidated Application of over- or under- recoveries in generation,

transmission, *SL* and lifeline subsidies filed on March 31, 2011 with the *ERC*. Hearings were completed on October 25, 2011. On December 12, 2011, *MERALCO* filed for the admission of its Supplemental Application. An expository hearing was conducted on February 1, 2012. As at June 30, 2014, *MERALCO* has already filed its *FOE* and is awaiting the final resolution by the *ERC*.

*Consolidated Applications for the Confirmation of Over/Under-recoveries of  
Pass-through Charges*

On August 12, 2009, the *ERC* issued Resolution No. 16, Series of 2009, adopting the “Rules Governing the Automatic Cost Adjustment and True-up Mechanisms and Corresponding Confirmation Process for Distribution Utilities.” These rules govern the recovery of pass-through costs, including over- or under-recoveries with respect to the following bill components: generation charge, transmission charge, *SL* charge, lifeline and interclass rate subsidies, *LFT* and business tax. On October 18, 2010, the *ERC* promulgated *ERC* Resolution No. 21, Series of 2010, amending certain formula contained in *ERC* Resolution No. 16, Series of 2009, and setting March 31, 2011 (covering adjustments implemented until the billing month of December 2010) and March 31, 2014 (covering adjustments from January 2011 to December 2013) as the new deadlines for *DUs* in Luzon to file their respective applications. Subsequent filings shall be made every three (3) years thereafter.

On March 31, 2011, *MERALCO* filed a consolidated application with the *ERC* to confirm its under- or over-recoveries accumulated from June 2003 to December 2010 in compliance with Resolution No. 16, Series of 2009, as subsequently amended by Resolution No. 21, Series of 2010. Hearings were completed on October 25, 2011. On December 8, 2011, *MERALCO* filed an Omnibus Motion praying for, among other things, the admission of the Supplemental Application. In an Order dated December 12, 2011, the *ERC* granted *MERALCO*’s Omnibus Motion and admitted its Supplemental Application. Accordingly, hearings for the Supplemental Application were conducted where *MERALCO* presented additional evidence. *MERALCO* filed its *FOE* on September 13, 2012. The consolidated filing includes net generation charge under-recoveries of ₱1,000 million, net transmission charge over-recoveries of ₱111 million, net lifeline subsidy under-recoveries of ₱9 million and net *SL* over-recoveries of ₱425 million, excluding any applicable carrying charges.

On July 6, 2012, *MERALCO* filed a consolidated application with the *ERC* to confirm its under- or over-recoveries for the calendar year 2011. The consolidated filing includes net generation charge under-recoveries of ₱1,826 million, transmission charge under-recoveries of ₱253 million, net lifeline subsidy under-recoveries of ₱39 million and *SL* over-recoveries of ₱445 million, excluding any applicable carrying charges. Hearings on the application have been completed and *MERALCO* has submitted its *FOE* on January 25, 2013. As at June 30, 2014, the application is pending approval by the *ERC*.

On March 31, 2014, *MERALCO* filed a consolidated application with the *ERC* to confirm its under- or over-recoveries from January 2012 to October 2013. The consolidated filing includes net generation charge under-recoveries of ₱559 million, transmission charge over-recoveries of ₱639 million, net lifeline subsidy over-recoveries of ₱75 million, *SL* over-recoveries of ₱502 million, and net Senior Citizen Discount over-recoveries of ₱0.4 million, excluding any applicable carrying charges. As at June 30, 2014, the application is yet to be set for initial hearing by the *ERC*.

On April 23, 2014, *ERC* released its Proposed Resolution Amending Articles 2 and 3 of Resolution 16, Series of 2009, the Resolution Governing the Automatic Cost adjustment and True-

Up Mechanisms and Corresponding Confirmation Process for *DUs*. The proposal will allow automatic inclusion of the monthly over/under-recoveries in the monthly generation, transmission and system loss rate calculations. Public consultations were held for its first and second drafts but the final amendments have not yet been released.

#### *Application for the Recovery of Differential Generation Costs*

On February 14, 2014, *MERALCO* filed for the recovery of the unbilled generation cost for December 2013 supply month amounting to ₱11,075 million. A supplemental application was filed on March 20, 2014 to adjust the unbilled generation cost for recovery to ₱1,310 million following the receipt of *WESM* billing adjustments based on regulated Luzon *WESM* prices. First hearing was conducted on May 26, 2014 where *ERC* ruled for the suspension of further hearings indefinitely.

#### *Deferred PPA*

On October 14, 2009, the *ERC* released its findings on *MERALCO*'s implementation of the collection of the approved pass-through cost under-recoveries in 2004. *ERC* directed *MERALCO* to refund ₱268 million of deferred *PPA* transmission line costs related to Quezon Power (Philippines) Limited Company or *QPPL* and deferred accounting adjustments or *DAA* incurred to customers, along with ₱184 million in carrying charges, or an equivalent of ₱0.0169 per *kWh*. *MERALCO* implemented the refund beginning November 2009 until September 2010. However, the *ERC* has yet to rule on *MERALCO*'s deferred *PPA* under-recoveries of ₱106 million, which does not represent the transmission line fee. As at June 30, 2014, *MERALCO* has filed a Motion for Reconsideration, which is pending decision by the *ERC*.

#### *Application for Recovery of LFT*

On March 25, 2011, *MERALCO* filed with the *ERC* an application for recovery of *LFT* paid but not yet billed to customers for the period beginning first quarter of 1993 up to the second quarter of 2004 for five (5) provinces, namely: Bulacan, Batangas, Cavite, Laguna and Rizal; and 14 cities, namely: San Jose Del Monte, Batangas, San Pablo, Tagaytay, Lucena, Mandaluyong, Marikina, Quezon, Caloocan, Pasay, Las Piñas, Manila, Pasig and Calamba. The *LFT* is recognized as a valid and reasonable *DU* expense in the *ERC*'s unbundling decision.

In a Decision dated February 27, 2012, the *ERC* released its Order approving with modifications *MERALCO*'s application. The *ERC* approved recovery of *LFT* amounting to ₱1,571 million plus carrying charges of ₱730 million. As directed by the *ERC*, the recovery was reflected as a separate item in the *MERALCO* billing statement to its customers beginning April 2012. As at June 30, 2014, a total of ₱1,016 million *LFT* and carrying charges have been billed to affected customers. The amount recoverable within 12 months is included in the "Trade and other receivables" account while the long-term portion is included in the "Other noncurrent assets" account.

On June 13, 2014 *MERALCO* filed an application with the *ERC* for authority to collect *LFT* in the City of Trece Martires, with prayer for provisional authority, beginning the date of effectivity of the "*The 2012 Revenue Code of Trece Martires City*" on July 1, 2012. In its Decision dated April 28, 2014, the *ERC* approved said application, with modification, and authorized *MERALCO* to recover the new *LFT* at the rate of 82.5% of 1% prospectively, or effective its next billing cycle. With respect to the difference between the previous and the new *LFT* rates from the time said revenue code took effect, the *ERC* said that the same shall be considered in a separate application to be filed by *MERALCO*. On July 24, 2014, *MERALCO* filed a motion seeking the partial

reconsideration of the Decision insofar as the filing of a separate application for *LFT* for the prior years is concerned. As of June 30, 2014, the motion for reconsideration is pending resolution by the *ERC*.

On July 26, 2013 *MERALCO* filed an application with the *ERC* for authority to collect *LFT* in the City of Bacoor, separate from the previous authority granted to the Province of Cavite, beginning the date of effectivity of its “*City Ordinance No. 39, Series of 2012*” on April 4, 2013. In its Decision dated April 28, 2014, the *ERC* approved said application and authorized *MERALCO* to recover the the *LFT* at the rate of 50% of 1% and the proceeds thereof remitted to said City.

#### *SC Decision on the ₱0.167 per kWh Refund*

Following the *SC*’s final ruling that directed *MERALCO* to refund affected customers ₱0.167 per *kWh* for billings made from February 1994 to April 2003, the *ERC* approved the release of the refund in four (4) phases. The refund is still ongoing.

See Note 20 – Customers’ Refund.

### 3. Basis of Preparation and Statement of Compliance

The accompanying unaudited interim consolidated financial statements have been prepared on a historical cost basis, except for *MERALCO*’s utility plant and others and investment properties acquired before January 1, 2004, which are carried at deemed cost, and available-for-sale, or *AFS*, financial assets, which are measured at fair value. *AFS* financial assets are included as part of “Other noncurrent assets” account in the unaudited interim consolidated statement of financial position.

All values are rounded to the nearest million peso, except when otherwise indicated.

#### *Statement of Compliance*

The unaudited interim consolidated financial statements of *MERALCO* and its subsidiaries have been prepared in compliance with Philippine Financial Reporting Standards or *PFRS*.

#### *Basis of Consolidation*

The unaudited interim consolidated financial statements comprise the financial statements of *MERALCO* and the following directly and indirectly-owned subsidiaries (collectively referred to as *MERALCO Group*) for the six months ended June 30 of each year.

| Subsidiaries                                             | Place of Incorporation | Principal Business Activity                     | 2014                    |          | 2013   |          |
|----------------------------------------------------------|------------------------|-------------------------------------------------|-------------------------|----------|--------|----------|
|                                                          |                        |                                                 | Percentage of Ownership |          | Direct | Indirect |
|                                                          |                        |                                                 | Direct                  | Indirect |        |          |
| Corporate Information Solutions, Inc., or <i>CIS</i>     | Philippines            | e-Transactions                                  | 100                     | –        | 100    | –        |
| <i>CIS Bayad Center, Inc.</i> , or <i>Bayad Center</i>   | Philippines            | Bills payment collection                        | –                       | 100      | –      | 100      |
| <i>Customer Frontline Solutions, Inc.</i> or <i>CFSI</i> | Philippines            | Teller services                                 | –                       | 100      | –      | 100      |
| Meralco Energy, Inc., or <i>MEI</i>                      | Philippines            | Energy systems management                       | 100                     | –        | 100    | –        |
| eMERALCO Ventures, Inc., or <i>e-MVI</i>                 | Philippines            | e-Business development                          | 100                     | –        | 100    | –        |
| <i>Paragon Vertical Corporation</i>                      | Philippines            | Information technology and multi-media services | –                       | 100      | –      | 100      |
| <i>MGen</i>                                              | Philippines            | Development of power generation plants          | 100                     | –        | 100    | –        |
| <i>Calamba Aero Power Corporation</i> <sup>1</sup>       | Philippines            | Power generation                                | –                       | 100      | –      | 100      |
| <i>Atimonan Land Ventures Development Corporation</i>    | Philippines            | Real estate                                     | –                       | 100      | –      | 100      |

| Subsidiaries                                                                                  | Place of Incorporation | Principal Business Activity                                               | 2014                    |          | 2013   |          |
|-----------------------------------------------------------------------------------------------|------------------------|---------------------------------------------------------------------------|-------------------------|----------|--------|----------|
|                                                                                               |                        |                                                                           | Percentage of Ownership |          |        |          |
|                                                                                               |                        |                                                                           | Direct                  | Indirect | Direct | Indirect |
| <i>Atimonan One Energy, Inc.( formerly Luzon Natural Gas Energy Corporation) <sup>2</sup></i> | Philippines            | Power generation                                                          | –                       | 100      | –      | 100      |
| <i>MPG Asia Limited</i>                                                                       | British Virgin Island  | Holding company                                                           | –                       | 100      | –      | 100      |
| Meralco Financial Services Corporation or <i>Finserve</i>                                     | Philippines            | Financial services provider                                               | 100                     | –        | 100    | –        |
| Republic Surety and Insurance Company, Inc. or <i>RSIC</i>                                    | Philippines            | Insurance                                                                 | 100                     | –        | 100    | –        |
| Lighthouse Overseas Insurance Limited or <i>LOIL</i>                                          | Bermuda                | Insurance                                                                 | 100                     | –        | 100    | –        |
| <i>MIESCOR</i>                                                                                | Philippines            | Engineering, construction and consulting services                         | 99                      | –        | 99     | –        |
| <i>MIESCOR Builders Inc. or MBI</i>                                                           | Philippines            | Electric transmission and distribution operation and maintenance services | –                       | 100      | –      | 100      |
| <i>MIESCOR Logistics Inc. or MLI</i>                                                          | Philippines            | General services, manpower/maintenance                                    | –                       | 100      | –      | 100      |
| <i>Miescorrail, Inc. or Miescorrail</i> <sup>3</sup>                                          | Philippines            | Engineering, construction and maintenance of mass transit system          | 100                     | –        | 100    | –        |
| <i>CEDC</i>                                                                                   | Philippines            | Power distribution                                                        | 65                      | –        | 65     | –        |

<sup>1</sup> Incorporated February 15, 2011 and has not started commercial operations as at June 30, 2014.

<sup>2</sup> Incorporated January 11, 2013 and has not started commercial operations as at June 30, 2014.

<sup>3</sup> On December 26, 2013, *MIESCOR* assigned its entire shareholdings in *Miescorrail* to *MERALCO*.

Control is achieved when the *MERALCO Group* is exposed, or has the right, to variable returns from its involvement with the investee. Specifically, the *MERALCO Group* controls an investee if and only if the *MERALCO Group* has (a) power over the investee; (b) exposure, or rights, to variable returns from its involvement with the investee, and; (c) the ability to use its power over the investee to affect its returns.

When the *MERALCO Group* has less than a majority of the voting or similar rights of an investee, it considers all relevant facts and circumstances in assessing whether it has power over an investee, including (a) the contractual arrangement with the other vote holders of the investee; (b) rights arising from other contractual arrangements (c) *MERALCO Group*'s voting rights and potential voting rights.

The *MERALCO Group* re-assesses whether or not it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control. Consolidation of a subsidiary begins when the *MERALCO Group* obtains control over the subsidiary and ceases when it loses control of the subsidiary. Assets, liabilities, income and expenses of a subsidiary acquired or disposed of during the period are included in the unaudited interim consolidated statement of comprehensive income from the date it gains control until the date it ceases to control the subsidiary.

The unaudited interim consolidated financial statements are prepared using uniform accounting policies for like transactions and other events with similar circumstances. All intra-group balances, income and expenses, unrealized gains and losses and dividends resulting from intra-group transactions are eliminated in full.

Non-controlling interests represent the portion of profit or loss and net assets in *CEDC* and *MIESCOR* and its subsidiaries not held by *MERALCO* and are presented separately in the consolidated statement of income, consolidated statement of comprehensive income and within equity in the consolidated statement of financial position, separately from equity attributable to equity holders of the parent.

Total comprehensive income within a subsidiary is attributed to the non-controlling interest even if such results in a deficit.

A change in the ownership interest of a subsidiary, without a change of control, is accounted for as an equity transaction.

If the *MERALCO Group* loses control over a subsidiary, it: (a) derecognizes the assets (including goodwill) and liabilities of the subsidiary; (b) derecognizes the carrying amount of any non-controlling interest; (c) derecognizes the cumulative translation adjustments deferred in equity; (d) recognizes the fair value of the consideration received; (e) recognizes the fair value of any investment retained; (f) recognizes any surplus or deficit in profit or loss; and (g) reclassifies *MERALCO's* share of components previously recognized in the consolidated statement of comprehensive income to the consolidated statement of income.

#### *Seasonality of Operations and Growth Drivers*

Approximately 98% of *MERALCO Group's* operating revenues pertain to sale of electricity distributed by *MERALCO* and *CEDC*.

The electricity sales of *MERALCO* and *CEDC* exhibit a degree of quarterly seasonality. The *kWh* sales in the first quarter is lower than the average of the year as this period is characterized by cooler temperature and softer consumer demand following heightened consumer spending in the last quarter of the year. The second quarter is marked by higher than average *kWh* sales. This is due to a number of factors, including: increased consumption of households and commercial establishments due the summer season; increased production of industries to replenish stocks and in preparation for the opening of classes; and, heightened construction activity to take advantage of the sunny weather. Despite the onset of the rainy season which tapers cooling requirements of commercial establishments, *kWh* sales typically peaks on the third quarter of the year. Manufacturing industries that cater to the export market have their peak production schedule at this time as they rush to meet shipping deadlines to foreign markets. Industries catering to the domestic market are also now starting production in preparation for the Christmas season. Lastly, the fourth quarter performance is about the average of the year. Industrial production winds down while households and commercial establishments also cut down on their cooling loads. Given this perspective on the seasonality of *kWh* sales, a higher proportion of the *MERALCO's* and *CEDC's* revenues are earned on the second half of the year.

Aside from the quarterly seasonal pattern, *kWh* sales on a year-on-year basis adjust as a result of a number of factors. Sales of electricity normally increase in periods of economic growth, low inflation and electricity rates, and in periods of high temperatures over extended period of time, e.g. the El Niño episodes.

The following table sets forth *MERALCO Group's* quarterly sales in *GWh*.

| Period         | 2014   | 2013   |
|----------------|--------|--------|
| First Quarter  | 7,908  | 7,777  |
| Second Quarter | 9,391  | 9,086  |
| Third Quarter  | –      | 8,753  |
| Fourth Quarter | –      | 8,468  |
| Total          | 17,299 | 34,084 |

The businesses of all other subsidiaries are not highly seasonal.

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#### 4. Significant Accounting Policies, Changes and Improvements

##### *Changes in Accounting Policies and Disclosures*

The accounting policies adopted in the preparation of unaudited interim consolidated financial statements are consistent with those of the previous financial year except for the adoption of the following amendments and improvements to existing standards, which were effective beginning January 1, 2014.

##### *PAS 36, Impairment of Assets - Recoverable Amount Disclosures for Non-Financial Assets (Amendments)*

These amendments remove the unintended consequences of *PFRS 13* on the disclosures required under *PAS 36*. In addition, these amendments require disclosure of the recoverable amounts for the assets or cash-generating units for which impairment loss has been recognized or reversed during the period. These amendments are effective retrospectively for annual periods beginning on or after January 1, 2014 with earlier application permitted, provided *PFRS 13* is also applied. The amendments affect disclosures only and have no impact on *MERALCO Group's* financial position or performance.

##### *Investment Entities (Amendments to PFRS 10, PFRS 12 and PAS 27)*

These amendments provide an exception to the consolidation requirement for entities that meet the definition of an investment entity under *PFRS 10*. The exception for consolidation requires investment entities to account for subsidiaries at fair value through profit or loss. The amendment is not relevant to the *MERALCO Group* since none of the entities in the *MERALCO Group* qualify to be an investment entity under *PFRS 10*.

##### *Philippine Interpretation IFRIC 21, Levies (IFRIC 21)*

*IFRIC 21* clarifies that an entity recognizes a liability for a levy when the activity that triggers payment, as identified by the relevant legislation, occurs. For a levy that is triggered upon reaching a minimum threshold, the interpretation clarifies that no liability should be anticipated before the specified minimum threshold is reached. *IFRIC 21* has no impact in the consolidated financial statements of *MERALCO Group*.

##### *PAS 39, Financial Instruments: Recognition and Measurement - Novation of Derivatives and Continuation of Hedge Accounting (Amendments)*

These amendments provide relief from discontinuing hedge accounting when novation of a derivative designated as a hedging instrument meets certain criteria. The *MERALCO Group* has not novated its derivatives during the current period. However, these amendments would be considered for future any novations.

##### *PAS 32, Financial Instruments: Presentation – Offsetting Financial Assets and Financial Liabilities*

The amendments clarify the meaning of “currently has a legally enforceable right to set-off” and also clarify the application of the *PAS 32* offsetting criteria to settlement systems (such as central clearing house systems), which apply gross settlement mechanisms that are not simultaneous. The amendments affect presentation only and have no impact on the *MERALCO Group's* financial position or performance.

*Effective 2015*

*PAS 19, Employee Benefits – Defined Benefit Plans: Employee Contributions  
(Amendments)*

The amendments apply to contributions from employees or third parties to defined benefit plans. Contributions that are set out in the formal terms of the plan shall be accounted for as reductions to current service costs if they are linked to service or as part of the remeasurements of the net defined benefit asset or liability if they are not linked to service. Contributions that are discretionary shall be accounted for as reductions of current service cost upon payment of these contributions to the plans. The amendments to *PAS 19* are to be retrospectively applied for annual periods beginning on or after July 1, 2014.

*Annual Improvements to PFRSs (2010-2012 cycle)*

The *Annual Improvements to PFRS (2010-2012 cycle)* contain non-urgent but necessary amendments to the following standards:

*PFRS 2, Share-based Payment – Definition of Vesting Condition*

The amendment revised the definitions of vesting condition and market condition and added the definitions of performance condition and service condition to clarify various issues. This amendment shall be prospectively applied to share-based payment transactions for which the grant date is on or after July 1, 2014. This amendment does not apply to the *MERALCO Group* as it has no share-based payments.

*PFRS 3, Business Combinations – Accounting for Contingent Consideration in a  
Business Combination*

The amendment clarifies that a contingent consideration that meets the definition of a financial instrument should be classified as a financial liability or as equity in accordance with *PAS 32*. Contingent consideration that is not classified as equity is subsequently measured at fair value through profit or loss whether or not it falls within the scope of *PFRS 9* (or *PAS 39*, if *PFRS 9* is not yet adopted). The amendment shall be prospectively applied to business combinations for which the acquisition date is on or after July 1, 2014. The *MERALCO Group* shall consider this amendment for future business combinations.

*PFRS 8, Operating Segments – Aggregation of Operating Segments and  
Reconciliation of the Total of the Reportable Segments' Assets to the Entity's  
Assets*

The amendments require entities to disclose the judgment made by management in aggregating two or more operating segments. This disclosure should include a brief description of the operating segments that have been aggregated in this way and the economic indicators that have been assessed in determining that the aggregated operating segments share similar economic characteristics. The amendments also clarify that an entity shall provide reconciliations of the total of the reportable segments' assets to the entity's assets if such amounts are regularly provided to the chief operating decision maker. These amendments are effective for annual periods beginning on or after July 1, 2014 and are applied retrospectively. The amendments affect disclosures only and have no impact on the *MERALCO Group's* financial position or performance.

*PFRS 13, Fair Value Measurement – Short-term Receivables and Payables*

The amendment clarifies that short-term receivables and payables with no stated interest rates can be held at invoice amounts when the effect of discounting is immaterial.

*PAS 16, Property, Plant and Equipment – Revaluation Method – Proportionate Restatement of Accumulated Depreciation*

The amendment clarifies that, upon revaluation of an item of property, plant and equipment, the carrying amount of the asset shall be adjusted to the revalued amount, and the asset shall be treated in one of the following ways:

- a. The gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. The accumulated depreciation at the date of revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account any accumulated impairment losses.
- b. The accumulated depreciation is eliminated against the gross carrying amount of the asset.

The amendment is effective for annual periods beginning on or after July 1, 2014. The amendment shall apply to all revaluations recognized in annual periods beginning on or after the date of initial application of this amendment and in the immediately preceding annual period. The amendment has no impact on *MERALCO Group's* financial position or performance.

*PAS 24, Related Party Disclosures – Key Management Personnel*

The amendments clarify that an entity is a related party of the reporting entity if the said entity, or any member of a group for which it is a part of, provides key management personnel services to the reporting entity or to the parent company of the reporting entity. The amendments also clarify that a reporting entity that obtains management personnel services from another entity (also referred to as management entity) is not required to disclose the compensation paid or payable by the management entity to its employees or directors. The reporting entity is required to disclose the amounts incurred for the key management personnel services provided by a separate management entity. The amendments are effective for annual periods beginning on or after July 1, 2014 and are applied retrospectively. The amendments affect disclosures only and have no impact on *MERALCO Group's* financial position or performance.

*PAS 38, Intangible Assets – Revaluation Method – Proportionate Restatement of Accumulated Amortization*

The amendments clarify that, upon revaluation of an intangible asset, the carrying amount of the asset shall be adjusted to the revalued amount, and the asset shall be treated in one of the following ways:

- a. The gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. The accumulated amortization at the date of revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account any accumulated impairment losses.
- b. The accumulated amortization is eliminated against the gross carrying amount of the asset.

The amendments also clarify that the amount of the adjustment of the accumulated amortization should form part of the increase or decrease in the carrying amount accounted for in accordance with the standard.

The amendments are effective for annual periods beginning on or after July 1, 2014. The amendments shall apply to all revaluations recognized in annual periods beginning on or after the date of initial application of this amendment and in the immediately preceding annual period. The amendments have no impact on the *MERALCO Group's* financial position or performance.

*Annual Improvements to PFRSs (2011-2013 cycle)*

The *Annual Improvements to PFRSs (2011-2013 cycle)* contain non-urgent but necessary amendments to the following standards:

*PFRS 1, First-time Adoption of Philippine Financial Reporting Standards – Meaning of 'Effective PFRSs'*

The amendment clarifies that an entity may choose to apply either a current standard or a new standard that is not yet mandatory, but that permits early application, provided either standard is applied consistently throughout the periods presented in the entity's first *PFRS* financial statements. This amendment is not applicable to the *MERALCO Group's* as it is not a first-time adopter of *PFRS*.

*PFRS 3, Business Combinations – Scope Exceptions for Joint Arrangements*

The amendment clarifies that *PFRS 3* does not apply to the accounting for the formation of a joint arrangement in the financial statements of the joint arrangement itself. The amendment is effective for annual periods beginning on or after July 1, 2014 and is applied prospectively.

*PFRS 13, Fair Value Measurement – Portfolio Exception*

The amendment clarifies that the portfolio exception in *PFRS 13* can be applied to financial assets, financial liabilities and other contracts. The amendment is effective for annual periods beginning on or after July 1, 2014 and is applied prospectively. The amendment has no significant impact on *MERALCO Group's* financial position or performance.

*PAS 40, Investment Property*

The amendment clarifies the interrelationship between *PFRS 3* and *PAS 40* when classifying property as investment property or owner-occupied property. The amendment states that judgment is needed when determining whether the acquisition of investment property is the acquisition of an asset or a group of assets or a business combination within the scope of *PFRS 3*. This judgment is based on the guidance of *PFRS 3*. This amendment is effective for annual periods beginning on or after July 1, 2014 and is applied prospectively. The amendment has no significant impact on *MERALCO Group's* financial position or performance.

*Deferred Effectivity*

*Philippine Interpretation IFRIC 15, Agreements for the Construction of Real Estate*

This interpretation covers accounting for revenue and associated expenses by entities that undertake the construction of real estate directly or through subcontractors. The interpretation

requires that revenue on construction of real estate be recognized only upon completion, except when such contract qualifies as construction contract to be accounted for under *PAS 11* or involves rendering of services in which case revenue is recognized based on stage of completion. Contracts involving provision of services with the construction materials and where the risks and rewards of ownership are transferred to the buyer on a continuous basis will also be accounted for based on stage of completion. The *SEC* and the Financial Reporting Standards Council or *FRSC* have deferred the effectivity of this interpretation until the final “Revenue” standard is issued by the International Accounting Standards Board or *IASB* and an evaluation of the requirements of the final “Revenue” standard against the practices of the Philippine real estate industry is completed. Adoption of the interpretation when it becomes effective will not have any impact on the consolidated financial statements.

#### *PFRS 9, Financial Instruments: Classification and Measurement*

*PFRS 9*, as issued, reflects the first and third phases of the project to replace *PAS 39* and applies to the classification and measurement of financial assets and financial liabilities and hedge accounting, respectively. Work on second phase, which relates impairment of financial instruments, and the limited amendments to the classification and measurement model is still ongoing, with a view to replace *PAS 39* in its entirety. *PFRS 9* requires all financial assets to be measured at fair value at initial recognition. A debt financial asset may, if the fair value option or *FVO*, is not invoked, be subsequently measured at amortized cost if it is held within a business model that has the objective to hold the assets to collect the contractual cash flows and its contractual terms give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal outstanding. All other debt instruments are subsequently measured at fair value through profit or loss. All equity financial assets are measured at fair value either through Other Comprehensive Income or *OCI* or profit or loss. All equity financial assets held for trading must be measured at fair value through profit or loss. For liabilities designated as at *FVPL* using the fair value option, the amount of change in the fair value of a liability that is attributable to changes in credit risk must be presented in *OCI*. The remainder of the change in fair value is presented in profit or loss, unless presentation of the fair value change relating to the entity’s own credit risk in *OCI* would create or enlarge an accounting mismatch in profit or loss. All other *PAS 39* classification and measurement requirements for financial liabilities have been carried forward into *PFRS 9*, including the embedded derivative separation rules and the criteria for using the *FVO*. The *MERALCO Group* conducted an evaluation of the early adoption of *PFRS 9* and has assessed that the first phase of *PFRS 9* will have an effect on the classification and measurement of financial assets. The *MERALCO Group* will quantify the effect on the consolidated financial statements in conjunction with the other phases, when issued, to present a comprehensive picture.

On hedge accounting, *PFRS 9* replaces the rules-based hedge accounting model of *PAS 39* with a more principles-based approach. Changes include replacing the rules-based hedge effectiveness test with an objectives-based test that focuses on the economic relationship between the hedged item and the hedging instrument, and the effect of credit risk on that economic relationship; allowing risk components to be designated as the hedged item, not only for financial items, but also for non-financial items, provided that the risk component is separately identifiable and reliably measurable; and allowing the time value of an option, the forward element of a forward contract and any foreign currency basis spread to be excluded from the designation of a financial instrument as the hedging instrument and accounted for as costs of hedging. *PFRS 9* also requires more extensive disclosures for hedge accounting.

*PFRS 9* currently has no mandatory effective date. *PFRS 9* may be applied before the completion of the limited amendments to the classification and measurement model and impairment

methodology. The *MERALCO Group* will not adopt the standard before the completion of the limited amendments and the second phase of the project.

### ***Significant Accounting Policies***

The principal accounting policies adopted in the preparation of the consolidated financial statements are as follows:

#### ***Business Combinations and Goodwill***

Business combinations are accounted for using the acquisition method. The cost of an acquisition is measured as the aggregate of the consideration transferred, measured at acquisition-date fair value and the amount of any non-controlling interest in the acquiree. For each business combination, the *MERALCO Group* elects whether to measure the non-controlling interest in the acquiree at fair value or at the proportionate share of the acquiree's identifiable net assets. Acquisition-related costs in a business combination are expensed.

When a business is acquired, an assessment is made of the identifiable assets acquired and liabilities assumed for appropriate classification and designation in accordance with the contractual terms, economic and other pertinent conditions as at the acquisition date. This includes the separation of embedded derivatives in host contracts by the acquiree.

If the business combination is achieved in stages, the acquirer's previously held equity interest in the acquiree is remeasured at fair value as at acquisition date and any resulting gain or loss is recognized in profit or loss.

Any contingent consideration to be transferred by the acquirer will be recognized at fair value at the acquisition date. Subsequent changes to the fair value of the contingent consideration, which is deemed to be an asset or liability will be recognized in accordance with *PAS 39*, either in profit or loss or other comprehensive income. If the contingent consideration is classified as equity, it shall not be remeasured until it is finally settled within equity.

Goodwill is initially measured at cost being the excess of the aggregate of the consideration transferred, any non-controlling interest in the acquiree and, in a business combination achieved in stages, the acquisition-date fair value of the previously held equity interest in the acquiree, over the fair value of net identifiable assets acquired. If the difference is negative, such difference is recognized as gain in the consolidated statement of income.

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the business combination occurs, the provisional amounts of the items for which the accounting is incomplete are reported in the consolidated financial statements. During the measurement period which is no longer than one year from the acquisition date, the provisional amounts recognized at acquisition date are retrospectively adjusted to reflect new information obtained about facts and circumstances that existed as at the acquisition date and, if known, would have affected the measurement of the amounts recognized as of that date. During the measurement period, additional assets or liabilities are also recognized if new information is obtained about facts and circumstances that existed as at the acquisition date and, if known, would have resulted in the recognition of those assets and liabilities as at that date.

After initial recognition, goodwill is measured at cost less any accumulated impairment losses. For the purpose of impairment testing, goodwill acquired in a business combination is, from acquisition date, allocated to each of the cash generating units that are expected to benefit from the

combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units, beginning on the acquisition date.

Where goodwill forms part of a cash-generating unit and part of the operation within that unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in such circumstance is measured based on relative values of the operation disposed and the portion of the cash-generating unit retained.

Business combinations involving entities under common control are accounted for similar to the pooling-of-interest method. The assets and liabilities of the combining entities are reflected at their carrying amounts reported in the consolidated financial statements of the controlling holding company. Any difference between the consideration paid and the share capital of the “acquired” entity is reflected within equity as additional paid-in capital. The consolidated statement of income reflects the results of the combining entities for the full period, irrespective of when the combination takes place. Comparatives are presented as if the entities had always been combined since the date the entities were under common control.

#### *Utility Plant and Others*

Utility plant and others, except land, are stated at cost, net of accumulated depreciation and amortization and accumulated impairment losses, if any. Costs include the cost of replacing part of such utility plant and other properties when such cost is incurred, if the recognition criteria are met. All other repair and maintenance costs are recognized as incurred in the consolidated statement of income. The present value of the expected cost for the decommissioning of the asset after use is included in the cost of the respective asset if the recognition criteria for a provision are met.

Land is stated at cost less any impairment in value.

*MERALCO's* utility plant and others are stated at deemed cost. The revalued amount recorded as at January 1, 2004 was adopted as deemed cost as allowed by the transitional provisions of *PFRS 1*. The balance of revaluation increment was closed to retained earnings. See *Note 15 – Equity* for the related discussion.

Depreciation and amortization of utility plant and others are computed using the straight-line method (except for certain subtransmission and distribution assets, which use straight-line functional group method) over the following estimated useful lives:

| Asset Type                                     | Estimated Useful Lives                                      |
|------------------------------------------------|-------------------------------------------------------------|
| Subtransmission and distribution               | 10-50 years, depending on the life of the significant parts |
| Buildings and improvements                     | 15-40 years                                                 |
| Communication equipment                        | 10 years                                                    |
| Office furniture, fixtures and other equipment | 5-15 years                                                  |
| Transportation equipment                       | 5-10 years                                                  |
| Others                                         | 5-20 years                                                  |

An item of utility plant and others is derecognized upon disposal or when no future economic benefits are expected from its use or disposal. Any gain or loss arising as a result of the derecognition of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is included in the consolidated statement of income in the period the asset is derecognized.

The asset's residual values, useful lives and methods of depreciation and amortization are reviewed, and adjusted prospectively if appropriate, at each reporting date to ensure that the residual values, periods and methods of depreciation and amortization are consistent with the expected pattern of economic benefits from items of utility plant and others.

#### *Construction in Progress*

Construction in progress is stated at cost, which includes cost of construction, plant and equipment, capitalized borrowing costs and other direct costs. Construction in progress is not depreciated until such time that the relevant assets are substantially completed and available for their intended use.

#### *Borrowing Costs*

Borrowing costs are capitalized if they are directly attributable to the acquisition, construction or production of a qualifying asset. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Capitalization of borrowing costs commences when the activities necessary to prepare the qualifying asset for its intended use or sale have been undertaken and expenditures and borrowing costs have been incurred. Borrowing costs are capitalized until the asset is substantially available for its intended use.

Borrowing costs include interest charges and other costs incurred in connection with the borrowing of funds, as well as any exchange differences arising from any foreign currency-denominated borrowings used to finance the projects, to the extent that they are regarded as an adjustment to interest costs.

All other borrowing costs are expensed as incurred.

#### *Investment Properties*

Investment properties, except land, are stated at cost, net of accumulated depreciation and accumulated impairment loss, if any. The carrying amount includes transaction costs and costs of replacing part of an existing investment property at the time such costs are incurred if the recognition criteria are met and excludes the costs of day-to-day servicing of an investment property.

Investment properties include properties that are being constructed or developed for future use as investment property.

Land classified as investment property is carried at cost less any impairment in value.

MERALCO's investment properties acquired before January 1, 2004 are stated at deemed cost. See *Note 15 – Equity* for the related discussions.

Investment properties, except land, are being depreciated on a straight-line basis over the useful life of five (5) to thirty-five (35) years.

Investment properties are derecognized either when they have been disposed of or when these are permanently withdrawn from use and no future economic benefit is expected from its disposal. Any gain or loss from the derecognition of the investment properties are recognized in the consolidated statement of income in the period these are disposed or retired.

Transfers are made to investment property when and only when there is a change in use, evidenced by ending of owner-occupation or commencement of an operating lease to another party. If owner-occupied property becomes an investment property, the *MERALCO Group* accounts for such property in accordance with the policy stated under utility plant and others up to the date of the change in use. Transfers are made from investment property when, and only when, there is a change in use, evidenced by commencement of owner-occupation or commencement of development with a view to sale. Transfers from investment property are recorded using the carrying amount of the investment property at the date of change in use.

#### *Asset Retirement Obligations*

Under the terms of certain lease contracts, the *MERALCO Group* is required to dismantle the installations made in leased sites and restore such sites to their original condition at the end of the term of the lease contracts. The *MERALCO Group* recognizes a liability measured at the present value of the estimated costs of these obligations and capitalizes such costs as part of the balance of the related item of utility plant and others and investment properties. The amount of asset retirement obligations is accreted and such accretion is recognized as interest expense.

#### *Intangible Assets*

Intangible assets acquired separately are initially measured at cost. Following initial recognition, intangible assets are carried at cost less accumulated amortization and any accumulated impairment loss. The useful lives of intangible assets are assessed at the individual asset level as having either finite or indefinite useful lives.

Intangible assets with finite lives are amortized over the useful economic lives of five years using the straight-line method and assessed for impairment whenever there is an indication that the intangible assets may be impaired. At a minimum, the amortization period and the amortization method for an intangible asset with a finite useful life are reviewed at each reporting date. Changes in the expected useful life or the expected consumption pattern of future economic benefit embodied in the asset are accounted for by changing the amortization period or method, as appropriate, and treated as change in accounting estimates. The amortization expense of intangible assets with finite lives is recognized in the consolidated statement of income.

Intangible assets with indefinite useful lives are not amortized, but are assessed for impairment annually either individually or at the cash-generating unit level. The assessment of indefinite useful life is done annually at every reporting date to determine whether such indefinite useful life continues to exist. Otherwise, the change in the useful life assessment from indefinite to finite is made on a prospective basis.

Gains or losses arising from derecognition of an intangible asset are measured as the difference between the net disposal proceeds and the carrying amount of the asset, and are recognized in the consolidated statement of income.

Intangible assets generated within the business are not capitalized and expenditures are charged to profit or loss in the period these are incurred.

#### *Investments in Associates and Joint Ventures*

An associate is an entity where *MERALCO* has significant influence. Significant influence is the power to participate in the financial and operating policy decisions of the investee, but has no control or joint control over those policies.

A joint venture is a type of joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the joint venture. Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require unanimous consent of the parties sharing control.

The considerations made in determining significant influence or joint control are similar to those necessary to determine control over subsidiaries.

Investments in associates and joint ventures are accounted for using the equity method of accounting and are initially recognized at cost.

Under the equity method, the investment in an associate or a joint venture is initially recognized at cost. The carrying amount of the investment is adjusted to recognize changes in the *MERALCO Group's* share of net assets of the associate or joint venture since the acquisition date. Goodwill relating to the associate or joint venture is included in the carrying amount of the investment and is neither amortized nor individually tested for impairment.

The consolidated statement of income reflects the *MERALCO Group's* share of the results of operations of the associate or joint venture. Any change in *OCI* of those investees is presented as part of *MERALCO Group's OCI*. In addition, when there has been a change recognized directly in the equity of the associate or joint venture, the *MERALCO Group* recognizes its share of any changes, when applicable, in the consolidated statement of changes in equity. Unrealized gains and losses resulting from transactions between the *MERALCO Group* and the associate or joint venture are eliminated to the extent of the interest in the associate or joint venture.

The aggregate of the *MERALCO Group's* share of profit or loss of an associate and a joint venture is shown on the face of the consolidated statement of income outside operating income and represents profit or loss after tax and non-controlling interests in the subsidiaries of the associate or joint venture.

The financial statements of the associate or joint venture are prepared for the same reporting period as the *MERALCO Group*. When necessary, adjustments are made to bring the accounting policies in line with those of the *MERALCO Group*.

After application of the equity method, the *MERALCO Group* determines whether it is necessary to recognize an impairment loss on its investment in its associate or joint venture. At each reporting date, the *MERALCO Group* determines whether there is objective evidence that the investment in the associate or joint venture is impaired. If there is such evidence, the *MERALCO Group* calculates the amount of impairment as the difference between the recoverable amount of the associate or joint venture and its carrying value, then recognizes the loss as equity in net earnings of an associate and a joint venture in the consolidated statement of income.

Upon loss of significant influence over the associate or joint control over the joint venture, the *MERALCO Group* measures and recognizes any retained investment at its fair value. Any difference between the carrying amount of the associate or joint venture upon loss of significant influence or joint control and the fair value of the retained investment and proceeds from disposal is recognized in profit or loss.

### *Impairment of Nonfinancial Assets*

The *MERALCO Group* assesses at each reporting date whether there is an indication that a nonfinancial asset (utility plant and others, investment properties, investments in and advances to associates and joint ventures, receivable from the Bureau of Internal Revenue or *BIR* and intangible assets), other than goodwill and intangible assets with indefinite useful life, may be impaired. If any such indication exists, the *MERALCO Group* makes an estimate of the asset's recoverable amount. An asset's recoverable amount is the higher of an individual asset's or a cash generating unit's fair value less costs to sell and its value in use. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount. The fair value is the amount obtainable from the sale of the asset in an arm's-length transaction. In determining fair value less costs to sell, an appropriate valuation model is used. These calculations are corroborated by valuation factors/parameters, quoted share prices for publicly traded securities or other available fair value indicators. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. Impairment losses are recognized in the consolidated statement of income.

An assessment is also made at each reporting date as to whether there is any indication that previously recognized impairment losses may no longer exist or may have decreased. If such indication exists, the *MERALCO Group* estimates the individual asset's or cash generating unit's recoverable amount. A previously recognized impairment loss is reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized. If a reversal of impairment loss is to be recognized, the carrying amount of the asset is increased to its recoverable amount. The increased amount cannot exceed the carrying amount that would have been determined had no impairment loss been recognized for the asset in prior years. Such reversal is recognized in the consolidated statement of income. After such reversal, the depreciation and amortization expense are adjusted in future periods to allocate the asset's revised carrying amount, less any residual value, on a systematic basis over its remaining useful life.

Intangible assets with indefinite useful lives are tested for impairment annually at every reporting date or more frequently if events or changes in circumstances indicate that the carrying value may be impaired, either individually or at the cash generating unit level, as appropriate. The amount of impairment is calculated as the difference between the recoverable amount of the intangible asset and its carrying amount. The impairment loss is recognized in the consolidated statement of income. Impairment losses relating to intangible assets may be reversed in future periods.

Goodwill is reviewed for impairment annually at every reporting date or more frequently if events or changes in circumstances indicate that the carrying value may be impaired. Impairment is determined for goodwill by assessing the recoverable amount of the cash generating unit or group of cash generating units, to which the goodwill relates. Where the recoverable amount of the cash generating unit or group of cash generating units is less than the carrying amount of the cash generating unit or group of cash generating units to which goodwill has been allocated, an impairment loss is recognized. Impairment losses relating to goodwill may not be reversed in future periods.

If there is incomplete allocation of goodwill acquired in a business combination to cash generating units or group of cash generating units, an impairment testing of goodwill is only carried out when impairment indicators exist. Where impairment indicators exist, impairment testing of goodwill is performed at a level at which the acquirer can reliably test for impairment.

### *Fair Value Measurement*

The *MERALCO Group* measures financial instruments at fair value at each reporting date.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transactions between market participants at the measurement date. The fair value measurement is based on the presumption that the transaction to sell the asset or transfer the liability takes place either (a) in the principal market for the asset or liability, or (b) in the absence of a principal market, in the most advantageous market for the asset or liability. The principal or the most advantageous market must be accessible to the *MERALCO Group*.

The fair value of an asset or a liability is measured using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest. A fair value measurement of a nonfinancial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.

The *MERALCO Group* uses valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs.

All assets and liabilities for which fair value is measured or disclosed in the consolidated financial statements are categorized within the fair value hierarchy, described as follows, based on the lowest level input that is significant to the fair value measurement as a whole:

- i. Level 1 - Quoted (unadjusted) market prices in active markets for identical assets or liabilities;
- ii. Level 2 - Valuation techniques for which the lowest level input that is significant to the fair value measurement is directly or indirectly observable; and
- iii. Level 3 - Valuation techniques for which the lowest level input that is significant to the fair value measurement is unobservable.

For assets and liabilities that are recognized in the consolidated financial statements on a recurring basis, the *MERALCO Group* determines whether transfers have occurred between Levels in the hierarchy by re-assessing categorization (based on the lowest level input that is significant to the fair value measurement as a whole) at the end of each reporting year.

For the purpose of fair value disclosures, the *MERALCO Group* has determined classes of assets and liabilities on the basis of the nature, characteristics and risks of the asset or liability and the level of the fair value hierarchy.

### *Inventories*

Inventories are stated at the lower of cost or net realizable value. Costs of acquiring materials and supplies including costs incurred in bringing each item to their present location and condition are accounted using the moving average cost method. Net realizable value is the estimated selling price in the ordinary course of business less the estimated cost to sell or the current replacement cost of the asset.

## *Financial Assets*

### *Initial Recognition*

Financial assets are classified as at fair value through profit or loss or *FVPL*, loans and receivables, held-to-maturity or *HTM* investments, *AFS* financial assets, or as derivatives designated as hedging instruments in an effective hedge, as appropriate. The classification of financial assets is determined at initial recognition and, where allowed and appropriate, re-evaluated at each reporting date.

Financial assets are recognized initially at fair value. Transaction costs are included in the initial measurement of all financial assets, except for financial instruments measured at *FVPL*.

Purchases or sales of financial assets that require delivery of assets within a timeframe established by regulation or convention in the market place (regular way purchase) are recognized on the trade date, which is the date the *MERALCO Group* commits to purchase or sell the asset.

The *MERALCO Group*'s financial assets include cash and cash equivalents, trade and non-trade receivables, advance payments to a supplier, quoted and unquoted equity securities and embedded derivatives that are not accounted for as effective accounting hedges.

### *Subsequent Measurement*

The subsequent measurement of financial assets depends on the classification as follows:

#### *Financial Assets at FVPL*

Financial assets at *FVPL* include financial assets held-for-trading and financial assets designated upon initial recognition as at *FVPL*. Financial assets are classified as held-for-trading if they are acquired for the purpose of selling in the near term. Derivative assets, including separated embedded derivatives are also classified as held-for-trading unless they are designated as effective hedging instruments.

Financial assets may be designated at initial recognition as at *FVPL* if any of the following criteria are met: (i) the designation eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets or recognizing gains or losses on them on a different basis; (ii) the financial assets are part of a group, which are managed and their performance are evaluated on a fair value basis, in accordance with a documented risk management strategy; or (iii) the financial assets contain one or more embedded derivatives that would need to be recorded separately.

Financial assets at *FVPL* are carried in the consolidated statement of financial position at fair value with gains or losses on fair value changes recognized in the consolidated statement of income under "Interest and other financial income" or "Interest and other financial charges" account, respectively. Interest earned and dividends received from investment at *FVPL* are also recognized in the consolidated statement of income under "Interest and other financial income" account.

Derivatives embedded in host contracts are accounted for as separate derivatives when their risks and characteristics are not closely related to those of the host contracts and the host contracts are not carried at fair value. These embedded derivatives are measured at fair value with gains and losses arising from changes in fair value recognized in the consolidated statement of income.

Reassessment only occurs if there is a change in the terms of the contract that significantly modifies the cash flows that would otherwise be required under the contract.

#### *Loans and Receivables*

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Such financial assets are carried at amortized cost using the effective interest method. This method uses an effective interest rate that discounts estimated future cash receipts through the expected life of the financial asset to the net carrying amount of the financial asset. Gains or losses are recognized in the consolidated statement of income when the loans and receivables are derecognized or impaired, as well as when these are amortized. Interest earned or incurred is recorded in "Interest and other financial income" or "Interest and other financial charges" account, respectively, in the consolidated statement of income. Assets in this category are included under current assets except for assets with maturities beyond 12 months from the reporting date, which are classified as noncurrent assets.

#### *HTM Investments*

Non-derivative financial assets with fixed or determinable payments and fixed maturities are classified as *HTM* when the *MERALCO Group* has the positive intention and ability to hold these assets to maturity. After initial measurement, *HTM* investments are measured at amortized cost using the effective interest method. Gains or losses are recognized in the consolidated statement of income. Assets in this category are included in the current assets except for maturities beyond 12 months from the reporting date, which are classified as noncurrent assets.

#### *AFS Financial Assets*

*AFS* financial assets are non-derivative financial assets that are designated as *AFS* or are not classified in any of the three foregoing categories. They are purchased and held indefinitely and may be sold in response to liquidity requirements or changes in market conditions. After initial measurement, *AFS* financial assets are measured at fair value with unrealized gains or losses recognized in other comprehensive income until the investment is derecognized, at which time the cumulative gain or loss recorded in other comprehensive income is recognized in the consolidated statement of income, or determined to be impaired, at which time the cumulative loss recorded in other comprehensive income is recognized in the consolidated statement of income. Interest earned on holding *AFS* debt securities are included under "Interest and other financial income" account in the consolidated statement of income. Dividends earned on holding *AFS* equity are recognized in the consolidated statement of income under "Interest and other financial income" account when the right of the payment has been established. These are included under noncurrent assets unless there is an intention to dispose of the investment within 12 months from the reporting date.

#### *Financial Liabilities*

##### *Initial Recognition*

Financial liabilities are classified as financial liabilities at *FVPL*, other financial liabilities, or as derivatives designated as hedging instruments in an effective hedge, as appropriate. The classification of the financial liability is determined at initial recognition.

Financial liabilities are recognized initially at fair value inclusive of directly attributable transaction costs, except for financial liabilities at *FVPL*.

The *MERALCO Group*'s financial liabilities include notes payable, interest-bearing long-term financial liabilities, trade payables and other current liabilities (excluding output *VAT*, accrued taxes, reinsurance liabilities and deferred lease income), customers' deposits, refundable service extension costs, customers' refund and other noncurrent liabilities.

#### *Subsequent Measurement*

The subsequent measurement of financial liabilities depends on their classification as follows:

##### *Financial Liabilities at FVPL*

Financial liabilities at *FVPL* include financial liabilities held-for-trading and financial liabilities designated upon initial recognition as at *FVPL*. Financial liabilities are classified as held-for-trading if they are incurred for the purpose of repurchasing in the near term. Derivative liabilities, including separated embedded liabilities are also classified as held-for-trading unless they are designated as effective hedging instruments. Financial liabilities at *FVPL* are carried in the consolidated statement of financial position at fair value with gains or losses recognized in the consolidated statement of income under "Interest and other financial income" or "Interest and other financial charges" account, respectively. Interest incurred on financial liabilities designated as at *FVPL* is recognized in the consolidated statement of income under "Interest and other financial charges" account.

Financial liabilities may be designated at initial recognition as at *FVPL*, if any of the following criteria are met: (i) the designation eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the liabilities or recognizing gains or losses on them on a different bases; (ii) the financial liabilities are part of a group which are managed and their performance are evaluated on a fair value basis, in accordance with a documented risk management strategy; or (iii) the financial liabilities contain one or more embedded derivatives that would need to be recorded separately. The *MERALCO Group* does not have financial liabilities designated as at *FVPL* as at June 30, 2014 and 2013.

##### *Other Financial Liabilities*

After initial recognition, other financial liabilities are subsequently measured at amortized cost using the effective interest method.

Gains and losses are recognized in the consolidated statement of income when the liabilities are derecognized as when these are amortized. Amortized cost is calculated by taking into account any discount or premium on acquisition and fees or costs that are integral part of the effective interest rate. The effective interest amortization is included under "Interest and other financial charges" account in the consolidated statement of income.

#### *Derivative Financial Instruments*

##### *Initial Recognition and Subsequent Measurement*

*MERALCO* has separated embedded foreign currency forwards which are derivative financial instruments used to hedge risks associated with foreign currency fluctuations.

Derivative instruments, including separated embedded derivatives, are initially recognized at fair value on the date at which a derivative transaction is entered into or separated, and are subsequently re-measured at fair value. Changes in fair value of derivative instruments, other than

those accounted for as effective hedges, are recognized immediately in the consolidated statement of income. Changes in fair value of derivative instruments accounted as effective hedges are recognized in other comprehensive income. Derivatives are carried as assets when the fair value is positive and as liabilities when the fair value is negative. *MERALCO Group* does not have derivatives accounted for under hedge accounting.

An embedded derivative is separated from the hybrid or combined contract if all the following conditions are met: (a) the economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract; (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and (c) the hybrid instrument is not recognized as at *FVPL*.

Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed.

See Note 27 – *Financial Assets and Financial Liabilities*.

#### *Offsetting of Financial Instruments*

Financial assets and financial liabilities are offset and the net amount is reported in the consolidated statement of financial position if, and only if, there is currently enforceable legal right to offset the recognized amounts and there is an intention to settle on a net basis, or to realize the assets and settle the liabilities simultaneously.

#### *Amortized Cost of Financial Instruments*

Amortized cost is computed using the effective interest method less any allowance for impairment and principal repayment, plus or minus the cumulative amortization of premium or discount. The calculation takes into account any premium or discount on acquisition and includes transaction costs and fees that are an integral part of effective interest.

#### *'Day 1' Profit or Loss*

Where the transaction price in a non-active market is different from the fair value of other observable current market transactions in the same instrument or based on a valuation technique whose variables include only data from observable market, the *MERALCO Group* recognizes the difference between the transaction price and fair value (a 'Day 1' profit or loss) in the consolidated statement of income, unless it qualifies for recognition as some other type of asset or liability. In cases where data used are not observable, the difference between the transaction price and model value is only recognized in the consolidated statement of income when the inputs become observable or when the instrument is derecognized. For each transaction, the *MERALCO Group* determines the appropriate method of recognizing the 'Day 1' profit or loss amount.

#### *Impairment of Financial Assets*

The *MERALCO Group* assesses at each reporting date whether a financial asset or group of financial assets is impaired. A financial asset or a group of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment as a result of one or more events that has occurred after the initial recognition of the asset (an incurred "loss event") and that loss event has an impact on the estimated future cash flows of the financial asset or the group of

financial assets that can be reliably estimated. Evidence of impairment may include indications that the debtor or a group of debtors is experiencing significant financial difficulty, default or delinquency in interest or principal payments, the probability that they will enter bankruptcy or other financial reorganization and where observable data indicate that there is a measurable decrease in the estimated future cash flows, such as changes in arrears or economic conditions that correlate with defaults.

#### *Financial Assets Carried at Amortized Cost*

For financial assets carried at amortized cost, the *MERALCO Group* first assesses whether objective evidence of impairment exists individually. If it is determined that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, the asset is included in a group of financial assets with similar credit risk characteristics and that group of financial assets is collectively assessed for impairment based on historical loss experience. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognized are not included in a collective assessment of impairment. *MERALCO* and *CEDC* consider termination or disconnection of service and significant financial difficulties of debtors as objective evidence that a financial asset or group of financial assets is impaired. For both specific and collective assessments, any deposits, collateral and credit enhancement are considered in determining the amount of impairment loss.

If there is objective evidence that an impairment loss has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed at initial recognition). If a loan is subject to variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate. The carrying amount of the asset is reduced either directly or through the use of an allowance account and the amount of the loss is recognized in the consolidated statement of income. Interest income continues to be accrued on the reduced carrying amount based on the original effective interest rate of the asset. The financial asset together with associated allowance is written off when there is no realistic prospect of future recovery and all collateral or deposits has been realized or has been transferred to the *MERALCO Group*.

If, in a subsequent period, the amount of the estimated impairment loss increases or decreases because of an event occurring after the impairment was recognized, the previously recognized impairment loss is increased or reduced by adjusting the allowance account. If an asset written off is recovered, the recovery is recognized in the consolidated statement of income. Any reversal of an impairment loss is recognized in the consolidated statement of income, to the extent that the carrying value of the asset does not exceed its amortized cost at the reversal date.

#### *AFS Financial Assets*

In the case of equity instruments classified as *AFS*, objective evidence would include a significant or prolonged decline in the fair value of the investment below its cost. When a decline in the fair value of an *AFS* financial asset has been recognized in other comprehensive income and there is objective evidence that the asset is impaired, the cumulative loss that had been recognized in other comprehensive income is reclassified from equity to profit or loss even though the financial asset has not been derecognized. The amount of the cumulative loss that is reclassified from equity to profit or loss is the difference between the acquisition cost (net of any principal repayment and amortization) and current fair value, less any impairment loss on the financial asset previously recognized in profit or loss. Impairment losses recognized in profit or loss for investment in equity

instruments are not reversed in the consolidated statement of income. Subsequent increases in fair value after impairment are recognized directly in other comprehensive income.

In the case of debt instruments classified as *AFS*, impairment is assessed based on the same criteria as financial assets carried at amortized cost. Future interest income is based on the reduced carrying amount and is accrued based on the rate of interest used to discount future cash flows for the purpose of measuring impairment loss. Such accrual is recorded as part of “Interest and other financial income” in the consolidated statement of income. If, in a subsequent period, the fair value of a debt instrument increases and the increase can be objectively related to an event occurring after the impairment loss was recognized in the consolidated statement of income, the impairment loss is reversed in the consolidated statement of income.

#### *Assets Carried at Cost*

If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of the loss is measured as the difference between the asset’s carrying amount and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset.

#### *Derecognition of Financial Instruments*

##### *Financial Assets*

A financial asset (or where applicable, a part of a financial asset or part of a group of similar financial assets) is derecognized when:

- the right to receive cash flows from the asset has expired;
- the *MERALCO Group* has transferred its right to receive cash flows from the asset or has assumed an obligation to receive cash flows in full without material delay to a third party under a “pass-through” arrangement; and
- either the *MERALCO Group* (a) has transferred substantially all the risks and rewards of the asset, or (b) has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

Where the *MERALCO Group* has transferred its right to receive cash flows from an asset or has entered into a “pass-through” arrangement, and has neither transferred nor retained substantially all the risks and rewards of the asset nor transferred control of the asset, a new asset is recognized to the extent of the *MERALCO Group*’s continuing involvement in the asset.

Continuing involvement that takes the form of a guarantee over the transferred asset is measured at the lower of original carrying amount of the asset and the maximum amount of consideration that the *MERALCO Group* could be required to repay.

##### *Financial Liabilities*

A financial liability is derecognized when the obligation under the liability is discharged or cancelled or has expired.

Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability, and the difference in the carrying amount of a financial liability extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed is recognized in the consolidated statement of income.

#### *Redeemable Preferred Stock*

*MERALCO*'s peso-denominated redeemable preferred stock has characteristics of a liability and is thus recognized as a liability in the consolidated statement of financial position. The corresponding dividends on those shares are recognized as part of "Interest and other financial charges" account in the consolidated statement of income. Dividends are no longer accrued when such shares have been called for redemption.

#### *Provisions*

Provisions are recognized when the *MERALCO Group* has a present obligation, legal or constructive, as a result of a past event, and when it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Where the *MERALCO Group* expects a provision, or a portion, to be reimbursed, for example under an insurance contract, the reimbursement is recognized as a separate asset but only when the reimbursement is virtually certain. The expense relating to any provision is presented in the consolidated statement of income, net of any reimbursement. If the effect of the time value of money is material, provisions are discounted using a current pre-tax rate that reflects, where appropriate, the risks specific to the liabilities.

#### *Retirement Benefits*

*MERALCO* and substantially all of its subsidiaries have distinct, funded, noncontributory defined benefit retirement plans covering all permanent employees. *MERALCO*'s retirement plan provides for post-retirement benefits in addition to a lump sum payment to employees hired as at December 31, 2003. Retirement benefits for employees hired commencing January 1, 2004 were amended to provide for a defined lump sum payment only. *MERALCO* also has a contributory Provident Plan introduced in January 2009 whereby employees hired commencing January 1, 2004 may elect to participate.

The net defined benefit liability or asset is the aggregate of the present value of the defined benefit obligation at the end of the reporting period reduced by the fair value of plan assets (if any), adjusted for any effect of limiting a net defined benefit asset to the asset ceiling. The asset ceiling is the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

The cost of providing benefits under the defined benefit plans is actuarially determined using the projected unit credit method.

Defined benefit costs comprise the following:

- Service cost
- Net interest on the net defined benefit liability or asset

Service costs, which include current service costs, past service costs and gains or losses on non-routine settlements are recognized as expense in profit or loss. Past service costs are recognized

when plan amendment or curtailment occurs. These amounts are calculated periodically by independent qualified actuaries.

Net interest on the net defined benefit liability or asset is the change during the period in the net defined benefit liability or asset that arises from the passage of time, which is determined by applying the discount rate based on government bonds to the net defined benefit liability or asset. Net interest on the net defined benefit liability or asset is recognized as expense or income in profit or loss.

Remeasurements comprising actuarial gains and losses, return on plan assets and any change in the effect of the asset ceiling (excluding net interest on defined benefit liability) are recognized immediately in other comprehensive income in the period in which they arise. Remeasurements are not reclassified to profit or loss in subsequent periods.

Plan assets are assets that are held by a long-term employee benefit fund or qualifying insurance policies. Plan assets are not available to the creditors of the *MERALCO Group*, nor can they be paid directly to the *MERALCO Group*. Fair value of plan assets is based on market price information. When no market price is available, the fair value of plan assets is estimated by discounting expected future cash flows using a discount rate that reflects both the risk associated with the plan assets and the maturity or expected disposal date of those assets (or, if they have no maturity, the expected period until the settlement of the related obligations). If the fair value of the plan assets is higher than the present value of the defined benefit obligation, the measurement of the resulting defined benefit asset is limited to the present value of economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

The *MERALCO Group*'s right to be reimbursed of some or all of the expenditure required to settle a defined benefit obligation is recognized as a separate asset at fair value when and only when reimbursement is virtually certain.

The retirement costs under the defined contribution plan are recorded based on *MERALCO*'s contribution to the defined contribution plan as services are rendered by the employee.

#### *Termination Benefits*

Termination benefits are employee benefits provided in exchange for the termination of an employee's employment as a result of either an entity's decision to terminate an employee's employment before the normal retirement date or an employee's decision to accept an offer of benefits in exchange for the termination of employment.

A liability and expense for a termination benefit is recognized at the earlier of when the entity can no longer withdraw the offer of those benefits and when the entity recognizes related restructuring costs. Initial recognition and subsequent changes to termination benefits are measured in accordance with the nature of the employee benefit, as either post-employment benefits, short-term employee benefits, or other long-term employee benefits.

#### *Employee Leave Entitlements*

Employee entitlements to annual leave are recognized as a liability when they are accrued to the employees. The undiscounted liability for leave expected to be settled wholly before 12 months after the end of the annual reporting period is recognized for services rendered by employees up to the end of the reporting period.

### *Long-term Incentive Plan*

The liability relating to the long-term incentive plan comprises the present value of the defined benefit obligation at the end of the reporting period.

### *Employee Stock Purchase Plan or ESPP*

Up to 2009, *MERALCO* had an employee stock purchase plan, which covered active and retired employees. Under the plan, the qualified participant may purchase fixed number of shares of stock at a pre-agreed price. The plan features include vesting requirements and payment terms.

The cost of equity-settled transactions with employees is measured by reference to the difference between the fair value of the shares on the grant date and the price at which the share may be purchased under the award or offer. In valuing equity-settled transactions, no account is taken of any performance conditions other than market conditions.

The cost of equity-settled transactions is recognized, together with a corresponding increase in equity, over the period in which the performance and/or service conditions are fulfilled, ending on the date at which the relevant employees become fully entitled to the award ('the vesting date'). The cumulative expense recognized for equity-settled transactions at each reporting date until the vesting date reflects the extent to which the vesting period has expired and *MERALCO*'s best estimate of the number of equity instruments that will ultimately vest. The profit or loss charge or credit for a period represents the movement in cumulative expense recognized as at the beginning and end of the reporting period.

No expense is recognized for awards that do not ultimately vest.

When the terms of the equity-settled awards are modified and the modification increases the fair value of the equity instruments granted, as measured immediately before and after the modification, the entity shall include the incremental fair value granted in the measurement of the amount recognized for services received as consideration for the equity instrument granted. The incremental fair value granted is the difference between the fair value of the modified equity instrument and that of the original equity instrument, both estimated as at the date of the modification. If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognized for services received over the period from the modification date until the date when the modified equity instruments vest, in addition to the amount based on the grant date fair value of the original equity instruments, which is recognized over the remainder of the original vesting period. If the modification occurs after vesting date, the incremental fair value granted is recognized immediately or over the vesting period if the employee is required to complete an additional period of service before becoming unconditionally entitled to those modified equity instruments.

### *Revenue Recognition*

Revenues are stated at amounts invoiced to customers, inclusive of pass-through components, net of discounts, rebates, *VAT* and other taxes, where applicable. Revenue is recognized to the extent that it is probable that the economic benefits will flow to the *MERALCO Group* and the revenue can be reliably measured. In addition, collectability is reasonably assured and the delivery of the goods or rendering of the service has occurred. The *MERALCO Group* assesses its revenue arrangements against specific criteria in order to determine if it is acting as principal or agent. The *MERALCO Group* concluded that it is acting as principal in all of its revenue arrangements. The following specific recognition criteria must also be met before revenue is recognized:

### *Sale of Electricity*

Revenues are recognized upon supply of power to the customers. The Uniform Filing Requirements or *UFR*, on the rate unbundling released by the *ERC* on October 30, 2001 specified the following bill components: (a) generation charge, (b) transmission charge, (c) *SL* charge, (d) distribution charge, (e) supply charge, (f) metering charge, (g) Currency Exchange Rate Adjustment or *CERA* I and II, where applicable and (h) interclass and lifeline subsidies. *VAT*, *LFT*, the Power Act Reduction (for residential customers) adjustment and universal charges are also separately presented in the customer's billing statement. *VAT*, *LFT* and universal charges are billed and collected on behalf of the national and local governments and do not form part of *MERALCO* and *CEDC*'s revenues.

### *Sale of Services*

Revenues from construction contracts are recognized and measured using the percentage-of-completion method of accounting for the physical portion of the contract work, determined based on the actual costs incurred in relation to the total estimated costs of the contract. Revenue from contracts to manage, supervise or coordinate construction activity for others and contracts where materials and services are supplied by project owners are recognized only to the extent of the contracted fees.

Contract costs principally include subcontracted costs related to contract performance. Expected losses on contracts are recognized immediately when it is probable that the total contract costs will exceed total contract revenues. The amount of such loss is determined irrespective of whether or not work has commenced on the contract; the stage of completion of contract activity; or the amount of profits expected to arise on other contracts, which are not treated as a single construction contract. Changes in contract performance, contract conditions and estimated profitability, including those arising after final contract settlements and after gross margins are recognized in the period in which the changes are determined.

Service and consulting fees are recognized when the services are rendered.

### *Interest Income*

Revenue is recognized as interest accrues, using the effective interest method. The effective interest rate is the rate that discounts estimated future cash receipts through the expected life of the financial instrument.

### *Dividends*

Revenue is recognized when the *MERALCO Group*'s right to receive the payment is established.

### *Lease Income*

Income arising from lease of investment properties and poles is accounted for on a straight-line basis over the lease term.

Lease income is included under "Revenues - Sale of other services" account in the consolidated statement of income.

### *Expense Recognition*

Expenses are decreases in economic benefits during the financial reporting period in the form of outflows or decrease of assets or incurrence of liabilities that result in decrease in equity, other than those relating to distributions to equity participants. These are recognized when incurred.

### *Leases*

The determination of whether an arrangement is, or contains, a lease is based on the substance of the arrangement at the inception date of whether the fulfillment of the arrangement is dependent on the use of a specific asset or the arrangement conveys a right to use the asset.

#### *Company as Lessee*

Operating lease payments are recognized as expense in the consolidated statement of income on a straight-line basis over the lease term.

#### *Company as Lessor*

Leases where the *MERALCO Group* does not transfer substantially all the risk and benefits of ownership of the asset are classified as operating lease. Initial direct costs incurred in negotiating an operating lease are added to the carrying amount of the leased asset and recognized over the lease term on the same basis as rental income. Contingent rents are recognized as revenue in the period in which they are earned.

### *Foreign Currency-Denominated Transactions and Translations*

The consolidated financial statements are presented in Philippine peso, which is also *MERALCO*'s functional and presentation currency. The Philippine peso is the currency of the primary economic environment in which *MERALCO Group* operates, except for *LOIL* and *MPG Asia*. This is also the currency that mainly influences the revenue from and cost of rendering services. Each entity in *MERALCO Group* determines its own functional currency and items included in the financial statements of each entity are measured using that functional currency.

The functional currency of *LOIL* and *MPG Asia* is the United States or U.S. dollar.

Transactions in foreign currencies are initially recorded in the functional currency rate prevailing at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are re-translated using functional currency closing rate of exchange prevailing at the end of the reporting period. All differences are recognized in the consolidated statement of income except for foreign exchange differences that relate to capitalizable borrowing costs on qualifying assets. Nonmonetary items that are measured in terms of historical cost in foreign currency are translated using the exchange rate as at the date of the initial transactions.

As at the reporting date, the monetary assets and liabilities of associates, *LOIL* and *MPG Asia* whose functional currency is other than Philippine peso, are translated into Philippine peso at the rate of exchange prevailing at the end of the reporting period, and income and expenses of an associate are translated monthly using the weighted average exchange rate for the month. The exchange differences arising on translation are recognized as a separate component of other comprehensive income as cumulative translation adjustments. On disposal of the associate, the amount of cumulative translation adjustments recognized in other comprehensive income is recognized in the consolidated statement of income.

## *Income Taxes*

### *Current Income Tax*

Current income tax assets and liabilities for the current and prior period are measured at the amount expected to be recovered from or paid to the taxation authority. The tax rate and tax laws used to compute the amount are those that are enacted or substantively enacted as at the reporting date.

### *Deferred Income Tax*

Deferred income tax is provided using the balance sheet liability method on all temporary differences at the reporting date between the income tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred income tax liabilities are recognized for all taxable temporary differences, except:

- where the deferred income tax liability arises from the initial recognition of goodwill or of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- in respect of taxable temporary differences associated with investments in associates and joint ventures, where the timing of the reversal of the temporary differences can be controlled and it is probable that the temporary differences will not reverse in the foreseeable future.

Deferred income tax assets are recognized for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilized except:

- when the deferred income tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- in respect of deductible temporary differences associated with investments in subsidiaries, associates and joint ventures, deferred income tax assets are recognized only to the extent that it is probable that the temporary differences will reverse in the foreseeable future and taxable profit will be available against which the temporary differences can be utilized.

The carrying amount of deferred income tax assets is reviewed at each reporting date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax assets to be utilized. Unrecognized deferred income tax assets are reassessed at each reporting date and are recognized to the extent these have become probable that future taxable profit will allow the deferred income tax assets to be recovered.

Deferred income tax assets and liabilities are measured at the tax rates that are expected to apply in the period when the asset is realized or the liability is settled, based on tax rates and tax laws that are enacted or substantively enacted as at the reporting date.

Deferred income tax assets and deferred income tax liabilities are offset, if a legally enforceable right exists to offset current income tax assets against current income tax liabilities and the deferred taxes relate to the same taxable entity and the same taxation authority.

Deferred income tax items are recognized in correlation to the underlying transaction either in profit or loss or directly in equity.

#### *Earnings per Share*

Basic earnings per share is calculated by dividing the net income for the period attributable to equity holders of the parent by the weighted average number of common shares outstanding during the period.

Diluted earnings per share is calculated by dividing the net income for the period attributable to equity holders of the parent by the weighted average number of shares outstanding, adjusted for the effects of any dilutive potential common shares.

#### *Contingencies*

Contingent liabilities are not recognized in the consolidated financial statements. These are disclosed in the notes to consolidated financial statements unless the possibility of an outflow of resources embodying economic benefits is remote. Contingent assets are not recognized unless the realization of the assets is virtually certain. These are disclosed in the notes to consolidated financial statements when an inflow of economic benefits is probable.

#### *Events After the Reporting Date*

Post reporting date events that provide additional information about the *MERALCO Group's* financial position at the reporting date (adjusting events) are reflected in the consolidated financial statements. Post reporting date events that are not adjusting events are disclosed in the notes to consolidated financial statements, when material.

#### *Equity*

Common stock is measured at par value for all shares issued. Incremental costs incurred directly attributable to the issuance of new shares are shown as a deduction from equity, net of any related tax. The amount of proceeds and/or fair value of consideration received, net of incremental costs incurred directly attributable to the issuance of new shares in excess of par value is recognized as additional paid-in capital.

Employee stock purchase plan cost represents the cumulative compensation expense recognized based on the amount determined using an option pricing model. The 14<sup>th</sup> and last *ESPP*, which was awarded in 2009 fully vested in October 2012. Since 2009, there have been no *ESPPs* implemented.

Change in the ownership interest of a subsidiary, without loss of control, is accounted for as an equity transaction and presented as "Excess of acquisition cost over carrying value of non-controlling interest acquired".

Other comprehensive income comprises items of income and expense, which are not recognized in profit or loss as required or permitted by *PFRS*.

Retained earnings include net income attributable to the equity holders of the Parent, reduced by dividends declared on common stock. Dividends are recognized as a liability and deducted from retained earnings when they are declared. Dividend declarations approved after the financial reporting date are disclosed as events after the financial reporting date.

Non-controlling interests represent the equity interests in *CEDC* and *MIESCOR* and its subsidiaries, which are not held by *MERALCO*.

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## 5. Management's Use of Significant Judgments, Accounting Estimates and Assumptions

The preparation of the *MERALCO Group's* unaudited interim consolidated financial statements requires management to make judgments, estimates and assumptions that affect the reported amounts of revenues, expenses, assets and liabilities, and the disclosure of contingent assets and liabilities, at the end of the reporting period. However, uncertainty about these assumptions and estimates could result in outcomes that require a material adjustment to the carrying amount of the asset or liability affected in future periods.

### *Judgments*

In the process of applying the *MERALCO Group's* accounting policies, management has made the following judgments, which have the most significant effect on the amounts recognized in the unaudited interim consolidated financial statements.

### *Determination of Functional Currency*

The functional currencies of the entities under the *MERALCO Group* are the currencies of the primary economic environment in which each entity operates. It is the currency that mainly influences the revenue and cost of rendering services.

Based on the economic substance of the underlying circumstances, the functional and presentation currency of *MERALCO* and its subsidiaries, except *LOIL* and *MPG Asia*, is the Philippine peso. The functional and presentation currency of *LOIL* and *MPG Asia* is the U.S. dollar.

### *Operating Lease Commitments*

#### *As Lessor*

As a lessor, the *MERALCO Group* has several lease arrangements. Based on the terms and conditions of the arrangements, it has evaluated that the significant risks and rewards of ownership of such properties are retained by the *MERALCO Group*. The lease agreements do not transfer ownership of the assets to the lessees at the end of the lease term and do not give the lessees a bargain purchase option over the assets. Consequently, the lease agreements are accounted for as operating leases.

#### *As Lessee*

As a lessee, *MERALCO Group* has commercial lease arrangements covering certain office spaces, payment offices and substation sites and towers. The *MERALCO Group* has determined, based on the evaluation of the terms and conditions of the arrangements, that it has not acquired any significant risks and rewards of ownership of such properties because the lease arrangements do not transfer to the *MERALCO Group* the ownership over the assets at the end of the lease term and do not provide the *MERALCO Group* a bargain purchase option over the leased assets. Consequently, the lease agreements are accounted for as operating leases.

### *Arrangement that Contains a Lease*

*MERALCO's* Purchased Power Agreements or *PPAs* and Purchase Supply Agreements or *PSAs* with certain power generating companies qualify as leases on the basis that *MERALCO* and these

power generating companies have ‘take or pay’ or *TOP* arrangements where payments for purchased power are made on the basis of the availability of the power plant and not based solely on actual consumption. In determining the lease classification, it is judged that substantially all the risks and rewards incident to the ownership of the power plants are with these power generating companies. Thus, the *PPAs* and *PSAs* are classified as operating leases. Accordingly, capacity fees, fixed operating and maintenance, and transmission line fees that form part of purchased power expense are accounted for similar to a lease.

Components of purchased power cost, which have been accounted for similar to a lease, amounted to ₱21,428 million and ₱23,169 million for the six months ended June 30, 2014 and 2013, respectively. These are recognized as “Purchased Power” in the consolidated statements of income.

See Note 24 – Revenues and Purchased Power.

*Entity in which the MERALCO Group Holds More Than the Majority of the Voting Rights Accounted for as joint Venture*

*MERALCO* has 51% equity in San Buenaventura Power Ltd. Co. or *SBPL*. While *MERALCO* owns majority of the voting rights in *SBPL*, it does not have sole control over *SBPL*. *MERALCO*’s investment in *SBPL* is accounted for as a joint venture since key operating and financial decisions of *SBPL* require the unanimous vote and consent of the parties sharing control.

*Contingencies*

The *MERALCO Group* has possible claims from or obligation to other parties from past events and whose existence may only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within its control. Management has determined that the present obligations with respect to contingent liabilities and claims with respect to contingent assets do not meet the recognition criteria, and therefore has not recorded any such amounts.

See Note 29 – Contingencies and Legal Proceedings.

*Estimates and Assumptions*

The key assumptions concerning the future and other key sources of estimation uncertainty as at the reporting date that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial period are discussed in the following:

*Estimating Useful Lives of Utility Plant and Others, Intangible Assets with Finite Lives and Investment Properties*

The *MERALCO Group* estimates the useful lives of utility plant and others, intangible assets with finite lives and, investment properties based on the periods over which such assets are expected to be available for use. The estimate of the useful lives of the utility plant and others, intangible assets with finite lives and investment properties is based on management’s collective assessment of industry practice, internal technical evaluation and experience with similar assets. The estimated useful lives are reviewed at least at each financial year-end and are updated if expectations differ from previous estimates due to physical wear and tear, technical or commercial obsolescence and legal or other limitations on the use of such assets. It is possible, however, that future results of operations could be materially affected by changes in estimates brought about by changes in the factors mentioned in the foregoing. The amounts and timing of recorded expenses for any period would be affected by changes in these factors and circumstances. A reduction in the

estimated useful lives of utility plant and others, intangible assets with finite lives and investment properties would increase recorded operating expenses and decrease noncurrent assets.

The total depreciation and amortization expense of utility plant and others amounted to ₱2,520 million and ₱2,932 million for the six months ended June 30, 2014 and 2013, respectively. Total carrying values of utility plant and others, net of accumulated depreciation and amortization, amounted to ₱116,721 million and ₱112,586 million as at June 30, 2014 and December 31, 2013, respectively.

Total depreciation of investment properties amounted to ₱3 million and ₱5 million for the six months ended June 30, 2014 and 2013, respectively. Total carrying value of investment properties, net of accumulated depreciation, amounted to ₱1,528 million and ₱1,526 million as at June 30, 2014 and December 31, 2013, respectively.

Total amortization of intangible assets with finite lives amounted to ₱146 million and ₱85 million for the six months ended June 30, 2014 and 2013, respectively. Total carrying value of intangible assets with finite lives, net of accumulated amortization, amounted to ₱2,104 million and ₱1,728 million as at June 30, 2014 and December 31, 2013, respectively.

See *Note 7 – Utility Plant and Others*, *Note 9 – Investment Properties* and *Note 10 – Other Noncurrent Assets*.

#### *Impairment of Nonfinancial Assets*

*PFRS* requires that an impairment review be performed when certain impairment indicators are present. These conditions include obsolescence, physical damage, significant changes in the manner by which an asset is used, worse than expected economic performance, drop in revenues or other external indicators, among others. In the case of goodwill, at a minimum, such asset is subject to an annual impairment test and more frequently whenever there is an indication that such asset may be impaired. This requires an estimation of the value in use of the cash generating unit to which the goodwill is allocated. Estimating the value in use requires preparation of an estimate of the expected future cash flows from the cash generating unit and choosing an appropriate discount rate in order to calculate the present value of those cash flows.

Determining the recoverable amount of utility plant and others, investment properties, investments in and advances to associates and joint ventures, goodwill and other noncurrent assets, requires (i) the determination of future cash flows expected to be generated from the continued use as well as ultimate disposition of such assets and (ii) making estimates and assumptions that can materially affect the consolidated financial statements. Future events may cause management to conclude that utility plant and others, construction in progress, investment properties, investments in and advances to associates and joint ventures, and other noncurrent assets are impaired. Any resulting impairment loss could have a material adverse impact on the *MERALCO Group's* consolidated financial position and results of operations.

The preparation of estimated future cash flows involves significant estimations and assumptions. While management believes that the assumptions are appropriate and reasonable, significant changes in the assumptions may materially affect the assessment of recoverable values and may lead to future impairment charges under *PFRS*.

The carrying values of nonfinancial assets as at June 30, 2014 and December 31, 2013 subject to impairment review are as follows:

| Account                                      | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|----------------------------------------------|---------------------------------|-----------------------------------|
| <i>(Amounts in millions)</i>                 |                                 |                                   |
| Utility plant and others                     | <b>₱116,721</b>                 | ₱112,586                          |
| Investments in associates and joint ventures | <b>14,457</b>                   | 13,422                            |
| Investment properties                        | <b>1,528</b>                    | 1,526                             |
| Intangible assets                            | <b>2,104</b>                    | 1,728                             |
| Receivable from the BIR                      | <b>181</b>                      | 577                               |
| Goodwill                                     | <b>36</b>                       | 36                                |

See Note 7 – Utility Plant and Others, Note 8 – Investments in Associates and Joint Ventures, Note 9 – Investment Properties and Note 10 – Other Noncurrent Assets.

#### *Goodwill*

The *MERALCO Group's* consolidated financial statements and the results of operations reflect acquired businesses after the completion of the respective acquisition. The *MERALCO Group* accounts for the acquisition of businesses using the acquisition method of accounting, which requires extensive use of accounting judgments and estimates to allocate the purchase price to the fair market values of the acquiree's identifiable assets and liabilities and contingent liabilities, if any, at the acquisition date. Any excess in the purchase price over the estimated fair market values of the net assets acquired is recorded as goodwill in the consolidated statement of financial position. Thus, the number of items, which involve judgments made in estimating the fair market value to be assigned to the acquiree's assets and liabilities can materially affect the *MERALCO Group's* financial position.

#### *Realizability of Deferred Tax Assets*

The *MERALCO Group* reviews the carrying amounts of deferred tax assets at the end of each reporting period and reduces these to the extent that it is no longer probable that sufficient taxable income will be available to allow all or part of the deferred income tax assets to be utilized.

Assessment on the recognition of deferred tax assets on deductible temporary differences is based on the level and timing of forecasted taxable income for the subsequent reporting periods. This forecast is based on past results and future expectations on revenues and expenses as well as future tax planning strategies. Management believes that sufficient taxable profit will be generated to allow all or part of the deferred tax assets to be utilized. The amounts of the deferred tax assets considered realizable could be adjusted in the future if estimates of taxable income are revised. Based on the foregoing assessment, following are the relevant consolidated information with respect to deferred tax assets:

|                                  | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|----------------------------------|---------------------------------|-----------------------------------|
| <i>(Amounts in millions)</i>     |                                 |                                   |
| Recognized deferred tax assets   | <b>₱17,104</b>                  | ₱15,391                           |
| Unrecognized deferred tax assets | <b>299</b>                      | 210                               |

See Note 28 – Income Taxes and Local Franchise Taxes.

*Determination of Fair Values of Financial Assets and Financial Liabilities*

Where fair value of financial assets and financial liabilities recorded in the consolidated statement of financial position cannot be derived from active markets, they are determined using valuation techniques including the discounted cash flows model. The inputs to these models are taken from observable markets where possible, but when this is not feasible, a degree of judgment is required in establishing fair values. The judgments include considerations of inputs such as liquidity risk, credit risk and volatility. Changes in assumptions about these factors could affect the reported fair value of financial instruments.

See Note 27 – *Financial Assets and Financial Liabilities*.

*Estimating Allowance for Doubtful Accounts*

If there is objective evidence that an impairment loss has been incurred in the trade and other receivables balance of the *MERALCO Group*, an estimate of the allowance for doubtful accounts related to trade and other receivables that are specifically identified as doubtful of collection is made. The amount of allowance is evaluated by management on the basis of factors that affect the collectability of the accounts. In such case, use of judgment based on the best available facts and circumstances, including but not limited to, the length of the *MERALCO Group*'s relationship with the customer and the customer's credit status based on third party credit reports and known market factors, to record specific reserves for customers against amounts due in order to reduce the *MERALCO Group*'s receivables to amounts that management expects to collect is applied. These specific reserves are reevaluated and adjusted as additional information received affect the amounts estimated.

In addition to specific allowance against individually significant receivables, an assessment for collective impairment allowance against credit exposures of the customers, which were grouped based on common credit characteristics, although not specifically identified as requiring a specific allowance, have a greater risk of default than when the receivables were originally granted to customers is done. This collective allowance is based on historical loss experience using various factors, such as historical performance of the customers within the collective group, deterioration in the markets in which the customers operate, and identified structural weaknesses or deterioration in the cash flows of customers.

Total asset impairment provision for trade and other receivables and other current assets, net of recoveries, recognized in the consolidated statements of income amounted to ₱230 million for the six months ended June 30, 2014 and 2013. Trade and other receivables, net of asset impairment, amounted to ₱31,157 million and ₱32,718 million as at June 30, 2014 and December 31, 2013, respectively.

See Note 12 – *Trade and Other Receivables* and Note 14 – *Other Current Assets*.

*Estimating Net Realizable Value of Inventories*

Inventories consist of materials and supplies used in the power distribution and services segments. The excess of cost over net realizable value relating to inventories consists of collective and specific provisions. The cost of inventories is written down whenever the net realizable value of inventories becomes lower than the cost due to damage, physical deterioration, obsolescence, change in price levels or other causes. The lower of cost or net realizable value of inventories is reviewed on a periodic basis. Inventory items identified to be obsolete and unusable are written-off and charged as expense in the consolidated statement of income.

The carrying values of inventories amounted to ₱2,238 million and ₱2,750 million as at June 30, 2014 and December 31, 2013, respectively.

See *Note 13 – Inventories*.

#### *Estimation of Retirement Benefit Costs*

The cost of defined benefit pension plans and other post-employment benefits as well as the present value of the pension obligation are determined using actuarial valuations. The actuarial valuation involves making various assumptions. These include the determination of the discount rates, future salary increases, mortality rates and future pension increases. Due to the complexity of the valuation, the underlying assumptions and its long-term nature, defined benefit obligations are highly sensitive to changes in these assumptions. All assumptions are reviewed at each reporting date. The pension and other post-employment benefit liabilities as at June 30, 2014 and December 31, 2013 amounted to ₱2,857 million and ₱2,978 million, respectively.

In determining the appropriate discount rate, management considers the interest rates of government bonds in the respective currencies, with extrapolated maturities corresponding to the expected duration of the defined benefit obligation. The underlying bonds are further reviewed for quality, and those having excessive credit spreads are removed from the population of bonds on which the discount rate is based, on the basis that they do not represent high quality bonds.

The mortality rate is based on publicly available mortality tables for the specific country and is modified accordingly with estimates of mortality improvements. Future salary increases and pension increases are based on expected future inflation rates for the specific country.

See *Note 25 – Expenses and Income* and *Note 26 – Long-term Employee Benefits*.

#### *Insurance Liabilities Arising from Insurance Contracts*

RSIC estimates the expected ultimate costs of claims reported and claims incurred but not yet reported at reporting date. It takes a significant period of time to establish with certainty the ultimate cost of claims.

The primary technique adopted by RSIC's management in estimating the cost of claims incurred but not yet reported is using the past claims settlement trend to predict the future claims settlement trend. At each reporting date, estimates of prior period claims are reassessed for adequacy and any changes are charged to provisions. Insurance contract liabilities are not discounted for the time value of money.

As at June 30, 2014 and December 31, 2013, gross carrying values of insurance liabilities arising from insurance contracts, included in "Other noncurrent liabilities" account, amounted to ₱333 million and ₱371 million, respectively.

#### *Provision for Asset Retirement Obligations*

Provision for asset retirement obligations is recognized in the period in which they are incurred if a reasonable estimate of fair value can be made. This requires an estimation of the cost to restore or dismantle, on a per area basis, depending on the location, and is based on the best estimate of the expenditure required to settle the obligation at the future restoration/dismantlement date, discounted using a pre-tax rate that reflects the current market assessment of the time value of money and, where appropriate, the risk specific to the liability.

No asset retirement obligation was recognized since the amount is immaterial.

#### *Provisions*

*MERALCO Group* is involved in various legal proceedings as discussed in Note 29 – *Contingencies and Legal Proceedings*. *MERALCO Group*'s estimate for probable costs for the resolution of these claims, assessments and cases has been developed in consultation with external counsels handling the defense in these claims, assessments and cases and is based upon thorough analysis of potential outcome.

*MERALCO*, in consultation with its external legal counsels, does not believe that these proceedings will have a material adverse effect in the consolidated financial statements. It is possible, however, that future financial performance could be materially affected by changes in the estimates or the effectiveness of management's strategies and actions relating to these proceedings.

*MERALCO* recognized provisions amounting to ₱5,155 million and ₱5,199 million for the six months ended June 30, 2014 and 2013, respectively.

See Note 19 – *Provisions*.

#### *Revenue Recognition*

The *MERALCO Group*'s revenue recognition policies require the use of estimates and assumptions that may affect the reported amounts of its revenues and receivables.

Revenues from sale of electricity by *MERALCO* and *CEDC* are billed based on customer-specific billing cycle cut-off date for each customer, while recording of related purchased power cost in the accounts is based on calendar month as provided in the terms of the *PSAs*. The recognition of unbilled revenues for billing cycles with earlier than month-end cut-off dates requires the use of estimates.

The difference between the amount initially recognized based on provisional invoices and the settlement of the actual billings by the generators is taken up in the subsequent period. Management believes that such use of estimates will not result in material adjustments in future periods.

Revenues and costs from construction contracts of *MIESCOR* are recognized based on the percentage of completion method. This is measured principally on the basis of the estimated completion of a physical proportion of the contract work as determined from the reports of the contractors and project consultants.

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## **6. Segment Information**

Each operating segment of the *MERALCO Group* engages in business activities from which revenues are earned and expenses are incurred (including revenue and expenses relating to transactions with other business segments within the *MERALCO Group*). The operating results of each of the operating segments are regularly reviewed by *MERALCO*'s chief operating decision-maker (Management Committee) to determine how resources are to be allocated to the operating segments and to assess their performances for which discrete financial information is available.

For management purposes, the *MERALCO Group*'s operating businesses are organized and managed separately according to the nature of services provided, with each segment representing a strategic business unit that offers different products and/or services, as follows:

- Power

The Power segment consists of (a) electricity distribution, (b) power generation and (c) *RES*.

Electricity distribution – This is principally electricity distribution and supply of power on a pass-through basis covering all captive customers in the *MERALCO* franchise area and the *CEDC* franchise area in the Luzon Grid. Electricity distribution within the *MERALCO* franchise area accounts for approximately 55% of the power requirements of the country. *CEDC*'s service area covers the Clark Special Economic Zone.

Power generation – The *MERALCO Group*'s re-entry in the power generation business is through investment in operating companies or participation in the development of power generation projects. *MGen*, the power generation arm of the *MERALCO Group* acquired a 22% equity interest in *GBPC*. *GBPC* operates a total of 627 *MW* gross capacity of coal and diesel-fired power plants. In addition, it has 232 *MW* of coal-fired power plants under construction in the Visayas.

In March 2013, *MGen* acquired an effective 28% equity in PacificLight Power Pte Ltd. or *PacificLight Power*, in Jurong Island, Singapore. The *PacificLight Power* plants began full commercial operations in June 2014.

*MGen* is currently developing a 460 *MW* net capacity of supercritical coal-fired power plant in Mauban, Quezon. On the other hand, land development for its 2 x 300 *MW* Circulating Fluidized Bed or *CFB*, coal-fired power generation plant in the Subic Freeport Zone under Redondo Peninsula Energy, Inc. or *RP Energy* is substantially completed.

Further, *MGen* is in various stages of pre-development of other power generation projects in the Philippines.

See Note 8 – *Investments in Associates and Joint Ventures*.

*RES* – This covers the sourcing and supply of electricity to qualified contestable customers. The *MERALCO Group* serves as a local *RES* within its franchise area only under the brand, *MPower*. Starting June 26, 2013, certain qualified contestable customers sourced their electricity supply from *MPower*.

- Other Services

The other services segment is involved principally in electricity-related services such as electro-mechanical engineering, construction, consulting and related manpower as well as light rail- related maintenance services, e-transaction and bills collection, insurance and e-business development and distribution and energy systems management. These services are provided by *MIESCOR*, *MBI* and *MLI* (collectively known as “*MIESCOR Group*”), *CIS*, *Bayad Center* and *CFSI* (collectively referred to as “*CIS Group*”), *Miescorrail*, *RSIC*, *LOIL*, *Finserve*, *e-MVI* and *MEI*.

The Management Committee monitors the operating results of each business unit separately for the purpose of determining resource allocation and assessing performance. Performance is

evaluated based on (i) net income for the period, (ii) consolidated core earnings before interest, taxes, and depreciation and amortization or consolidated core *EBITDA*; and (iii) consolidated core net income or *CCNI*. Net income for the period is measured consistent with reported consolidated net income in the consolidated financial statements.

Core *EBITDA* is measured as *CCNI* excluding depreciation and amortization, interest and other financial charges, interest and other financial income, equity in net earnings or losses of associates and joint ventures and provision for income tax.

*CCNI* for the period is measured as consolidated net income attributable to equity holders of the parent adjusted for foreign exchange gain or loss, mark-to-market gain or loss, impairment or reversal of impairment of noncurrent assets and other non-recurring gain or loss, if any, net of tax effect of the foregoing adjustments.

Billings between operating segments are done on an arm's-length basis in a manner similar to transactions with third parties. Segment revenues, segment expenses and segment results include transfers among business segments. Those transfers are eliminated upon consolidation.

The *MERALCO Group* operates and generates substantially all of its revenues in the Philippines (i.e., one geographical location). Thus, geographical segment information is not presented. The *MERALCO Group* has no revenues from transactions with a single external customer accounting for 10% or more of its revenues from external customers.

|                                                         | Note | Power                            |                 |               | Other Services                   |               |               | Inter-segment Transactions       |                 |      | Total                            |      |      |
|---------------------------------------------------------|------|----------------------------------|-----------------|---------------|----------------------------------|---------------|---------------|----------------------------------|-----------------|------|----------------------------------|------|------|
|                                                         |      | For the Six Months Ended June 30 |                 |               | For the Six Months Ended June 30 |               |               | For the Six Months Ended June 30 |                 |      | For the Six Months Ended June 30 |      |      |
|                                                         |      | 2014                             | 2013            | 2014          | 2013                             | 2014          | 2013          | 2014                             | 2013            | 2014 | 2013                             | 2014 | 2013 |
| Revenues                                                |      | <b>P129,720</b>                  | <b>P139,697</b> | <b>P2,984</b> | <b>P2,702</b>                    | <b>(P536)</b> | <b>(P685)</b> | <b>P132,168</b>                  | <b>P141,714</b> |      |                                  |      |      |
| <i>(Amounts in Millions)</i>                            |      |                                  |                 |               |                                  |               |               |                                  |                 |      |                                  |      |      |
| Segment results                                         |      | <b>P16,713</b>                   | <b>P15,723</b>  | <b>P408</b>   | <b>P605</b>                      | <b>P-</b>     | <b>P-</b>     | <b>P17,121</b>                   | <b>P16,328</b>  |      |                                  |      |      |
| Depreciation and amortization                           |      | <b>(2,564)</b>                   | <b>(2,912)</b>  | <b>(105)</b>  | <b>(110)</b>                     | <b>-</b>      | <b>-</b>      | <b>(2,669)</b>                   | <b>(3,022)</b>  |      |                                  |      |      |
| Interest and other financial income                     | 25   | 319                              | 731             | 10            | 1                                | -             | -             | 329                              | 732             |      |                                  |      |      |
| Equity in net losses of associates and joint ventures   | 8    | (52)                             | (48)            | -             | -                                | -             | -             | (52)                             | (48)            |      |                                  |      |      |
| Interest and other financial charges                    | 25   | (835)                            | (706)           | (4)           | (2)                              | -             | -             | (839)                            | (708)           |      |                                  |      |      |
| Provision for income tax - net                          |      | <b>(4,099)</b>                   | <b>(3,655)</b>  | <b>(115)</b>  | <b>(153)</b>                     | <b>-</b>      | <b>-</b>      | <b>(4,214)</b>                   | <b>(3,808)</b>  |      |                                  |      |      |
| Net income attributable to non-controlling interests    |      | -                                | -               | -             | -                                | <b>(39)</b>   | <b>(33)</b>   | <b>(39)</b>                      | <b>(33)</b>     |      |                                  |      |      |
| Net income attributable to equity holders of the Parent |      | <b>P9,482</b>                    | <b>P9,133</b>   | <b>P194</b>   | <b>P341</b>                      | <b>(P39)</b>  | <b>(P33)</b>  | <b>P9,637</b>                    | <b>P9,441</b>   |      |                                  |      |      |

|                                                         | Note | Power                              |                |               | Other Services                     |               |               | Inter-segment Transactions         |                |      | Total                              |      |      |
|---------------------------------------------------------|------|------------------------------------|----------------|---------------|------------------------------------|---------------|---------------|------------------------------------|----------------|------|------------------------------------|------|------|
|                                                         |      | For the Three Months Ended June 30 |                |               | For the Three Months Ended June 30 |               |               | For the Three Months Ended June 30 |                |      | For the Three Months Ended June 30 |      |      |
|                                                         |      | 2014                               | 2013           | 2014          | 2013                               | 2014          | 2013          | 2014                               | 2013           | 2014 | 2013                               | 2014 | 2013 |
| Revenues                                                |      | <b>P75,675</b>                     | <b>P75,536</b> | <b>P1,523</b> | <b>P1,689</b>                      | <b>(P139)</b> | <b>(P331)</b> | <b>P77,059</b>                     | <b>P76,894</b> |      |                                    |      |      |
| <i>(Amounts in Millions)</i>                            |      |                                    |                |               |                                    |               |               |                                    |                |      |                                    |      |      |
| Segment results                                         |      | <b>P9,526</b>                      | <b>P8,916</b>  | <b>P204</b>   | <b>P322</b>                        | <b>P-</b>     | <b>P-</b>     | <b>P9,730</b>                      | <b>P9,238</b>  |      |                                    |      |      |
| Depreciation and amortization                           |      | <b>(1,323)</b>                     | <b>(1,498)</b> | <b>(51)</b>   | <b>(65)</b>                        | <b>-</b>      | <b>-</b>      | <b>(1,374)</b>                     | <b>(1,563)</b> |      |                                    |      |      |
| Interest and other financial income                     | 25   | 174                                | 321            | 4             | -                                  | -             | -             | 178                                | 321            |      |                                    |      |      |
| Equity in net losses of associates and joint ventures   | 8    | (13)                               | (52)           | -             | -                                  | -             | -             | (13)                               | (52)           |      |                                    |      |      |
| Interest and other financial charges                    | 25   | (401)                              | (334)          | (3)           | (1)                                | -             | -             | (404)                              | (335)          |      |                                    |      |      |
| Provision for income tax - net                          |      | <b>(2,409)</b>                     | <b>(2,088)</b> | <b>(59)</b>   | <b>(84)</b>                        | <b>-</b>      | <b>-</b>      | <b>(2,468)</b>                     | <b>(2,172)</b> |      |                                    |      |      |
| Net income attributable to non-controlling interests    |      | -                                  | -              | -             | -                                  | <b>(20)</b>   | <b>(20)</b>   | <b>(20)</b>                        | <b>(20)</b>    |      |                                    |      |      |
| Net income attributable to equity holders of the Parent |      | <b>P5,554</b>                      | <b>P5,265</b>  | <b>P95</b>    | <b>P172</b>                        | <b>(P20)</b>  | <b>(P20)</b>  | <b>P5,629</b>                      | <b>P5,417</b>  |      |                                    |      |      |

The inter-segment revenues mainly represent revenues of other services segment earned from the power segment.

The following table shows the reconciliation of the consolidated *EBITDA* to net income:

|                                                       | Unaudited                           |         |                                       |         |
|-------------------------------------------------------|-------------------------------------|---------|---------------------------------------|---------|
|                                                       | For the Six Months<br>Ended June 30 |         | For the Three Months<br>Ended June 30 |         |
|                                                       | 2014                                | 2013    | 2014                                  | 2013    |
|                                                       | <i>(Amounts in millions)</i>        |         |                                       |         |
| Consolidated <i>EBITDA</i>                            | ₱17,343                             | ₱16,051 | ₱9,893                                | ₱8,961  |
| Depreciation and amortization                         | (2,669)                             | (3,022) | (1,374)                               | (1,563) |
| Interest and other financial income                   | 329                                 | 732     | 178                                   | 321     |
| Interest and other financial charges                  | (839)                               | (708)   | (404)                                 | (335)   |
| Equity in net losses of associates and joint ventures | (52)                                | (48)    | (13)                                  | (52)    |
| Foreign exchange gain (loss)                          | (222)                               | 277     | (163)                                 | 277     |
| Consolidated income before income tax                 | 13,890                              | 13,282  | 8,117                                 | 7,609   |
| Provision for income tax                              | (4,214)                             | (3,808) | (2,468)                               | (2,172) |
| Net income                                            | ₱9,676                              | ₱9,474  | ₱5,649                                | ₱5,437  |

The following table shows the reconciliation of the *CCNI* to the net income:

|                                                                      | Unaudited                           |        |                                       |        |
|----------------------------------------------------------------------|-------------------------------------|--------|---------------------------------------|--------|
|                                                                      | For the Six Months<br>Ended June 30 |        | For the Three Months<br>Ended June 30 |        |
|                                                                      | 2014                                | 2013   | 2014                                  | 2013   |
|                                                                      | <i>(Amounts in millions)</i>        |        |                                       |        |
| <i>CCNI</i>                                                          | ₱9,870                              | ₱9,174 | ₱5,782                                | ₱5,150 |
| Add (deduct) non-core items, net of tax:                             |                                     |        |                                       |        |
| Foreign exchange loss (gain)                                         | (180)                               | 272    | (153)                                 | 272    |
| Non-core expense                                                     | (53)                                | (5)    | —                                     | (5)    |
| Net income for the year attributable to equity holders of the Parent | 9,637                               | 9,441  | 5,629                                 | 5,417  |
| Net income for the year attributable to non-controlling interests    | 39                                  | 33     | 20                                    | 20     |
| Net income                                                           | ₱9,676                              | ₱9,474 | ₱5,649                                | ₱5,437 |

## 7. Utility Plant and Others

The movements in utility plant and others are as follows:

| June 30, 2014 (Unaudited)                       |                                  |         |                            |                         |                 |                          |        |                          |          |
|-------------------------------------------------|----------------------------------|---------|----------------------------|-------------------------|-----------------|--------------------------|--------|--------------------------|----------|
| Office Furniture, Fixtures and Other Equipment  |                                  |         |                            |                         |                 |                          |        |                          |          |
|                                                 | Subtransmission and Distribution | Land    | Buildings and Improvements | Communication Equipment | Other Equipment | Transportation Equipment | Others | Construction in Progress | Total    |
| <i>(Amounts in millions)</i>                    |                                  |         |                            |                         |                 |                          |        |                          |          |
| Cost:                                           |                                  |         |                            |                         |                 |                          |        |                          |          |
| Balance at beginning of period                  | P138,321                         | P15,264 | P5,208                     | P6,511                  | P3,102          | P2,817                   | P3,190 | P3,297                   | P177,710 |
| Transfers from construction in progress         | 1,020                            | -       | 49                         | 187                     | -               | -                        | -      | (1,256)                  | -        |
| Additions                                       | 696                              | 6       | 5                          | 65                      | 81              | 36                       | 71     | 3,771                    | 4,731    |
| Disposals/retirements                           | (328)                            | -       | -                          | (6)                     | (47)            | (185)                    | (80)   | -                        | (646)    |
| Reclassification and others                     | 5,400                            | 5       | 256                        | (3,743)                 | (278)           | 71                       | (207)  | -                        | 1,504    |
| Balance at end of period                        | 145,109                          | 15,275  | 5,518                      | 3,014                   | 2,858           | 2,739                    | 2,974  | 5,812                    | 183,299  |
| Less accumulated depreciation and amortization: |                                  |         |                            |                         |                 |                          |        |                          |          |
| Balance at beginning of period                  | 52,596                           | -       | 2,176                      | 4,644                   | 2,083           | 1,828                    | 1,797  | -                        | 65,124   |
| Depreciation and amortization                   | 2,038                            | -       | 66                         | 63                      | 140             | 126                      | 87     | -                        | 2,520    |
| Disposals/retirements                           | (328)                            | -       | -                          | (6)                     | (47)            | (185)                    | (80)   | -                        | (646)    |
| Reclassification and others                     | 2,851                            | -       | (55)                       | (2,819)                 | (303)           | (86)                     | (8)    | -                        | (420)    |
| Balance at end of period                        | 57,157                           | -       | 2,187                      | 1,882                   | 1,873           | 1,683                    | 1,796  | -                        | 66,578   |
| Net book values                                 | P87,952                          | P15,275 | P3,331                     | P1,132                  | P985            | P1,056                   | P1,178 | P5,812                   | P116,721 |
| December 31, 2013 (Audited)                     |                                  |         |                            |                         |                 |                          |        |                          |          |
| Office Furniture, Fixtures and Other Equipment  |                                  |         |                            |                         |                 |                          |        |                          |          |
|                                                 | Subtransmission and Distribution | Land    | Buildings and Improvements | Communication Equipment | Other Equipment | Transportation Equipment | Others | Construction in Progress | Total    |
| <i>(Amounts in millions)</i>                    |                                  |         |                            |                         |                 |                          |        |                          |          |
| Cost:                                           |                                  |         |                            |                         |                 |                          |        |                          |          |
| Balance at beginning of period                  | P132,426                         | P15,259 | P5,132                     | P6,590                  | P3,492          | P2,689                   | P3,002 | P2,845                   | P171,435 |
| Transfers from construction in progress         | 5,484                            | -       | 54                         | 314                     | 1               | -                        | 15     | (5,868)                  | -        |
| Additions                                       | 1,815                            | 5       | 21                         | 123                     | 542             | 222                      | 263    | 6,320                    | 9,311    |
| Disposals/retirements                           | (1,161)                          | -       | -                          | (593)                   | (902)           | (89)                     | (63)   | -                        | (2,808)  |
| Reclassification and others                     | (243)                            | -       | 1                          | 77                      | (31)            | (5)                      | (27)   | -                        | (228)    |
| Balance at end of period                        | 138,321                          | 15,264  | 5,208                      | 6,511                   | 3,102           | 2,817                    | 3,190  | 3,297                    | 177,710  |
| Less accumulated depreciation and amortization: |                                  |         |                            |                         |                 |                          |        |                          |          |
| Balance at beginning of period                  | 49,192                           | -       | 2,030                      | 4,808                   | 2,751           | 1,694                    | 1,648  | -                        | 62,123   |
| Depreciation and amortization                   | 4,728                            | -       | 128                        | 415                     | 234             | 223                      | 213    | -                        | 5,941    |
| Disposals/retirements                           | (1,161)                          | -       | -                          | (593)                   | (902)           | (89)                     | (63)   | -                        | (2,808)  |
| Reclassification and others                     | (163)                            | -       | 18                         | 14                      | -               | -                        | (1)    | -                        | (132)    |
| Balance at end of period                        | 52,596                           | -       | 2,176                      | 4,644                   | 2,083           | 1,828                    | 1,797  | -                        | 65,124   |
| Net book values                                 | P85,725                          | P15,264 | P3,032                     | P1,867                  | P1,019          | P989                     | P1,393 | P3,297                   | P112,586 |

Construction in progress mainly pertains to on-going electric capital projects or *ECPs* and non-electric capital projects or *NEPs*. *ECPs* are capital projects involving construction of new electric distribution-related facilities and the upgrade and major rehabilitation of existing electrical facilities. Total interest capitalized amounted to ₱75 million and ₱52 million for the six months ended June 30, 2014 and 2013, respectively.

The average annual interest rates used for capitalization for the six months ended June 30, 2014 and 2013 ranged from 4.38% to 4.97% and 4.55% to 5.93%, respectively.

## 8. Investments in Associates and Joint Ventures

This account consists of the following as at June 30, 2014 and December 31, 2013:

|                                                                                   | Place of Incorporation | Principal Activity                                                | 2014<br>Percentage of Ownership | 2013<br>Percentage of Ownership |
|-----------------------------------------------------------------------------------|------------------------|-------------------------------------------------------------------|---------------------------------|---------------------------------|
| <b>Associates</b>                                                                 |                        |                                                                   |                                 |                                 |
| <i>RP Energy</i>                                                                  | Philippines            | Power generation                                                  | 47                              | 47                              |
| FPM Power Holdings Limited or <i>FPM Power</i>                                    | British Virgin Islands | Power generation                                                  | 40                              | 40                              |
| Buang Private Power Corporation or <i>BPPC</i>                                    | Philippines            | Power generation                                                  | 38                              | 38                              |
| General Electric Philippines Meter and Instrument Company, Inc. or <i>GEPMICI</i> | Philippines            | Sale of metering products and services                            | 35                              | 35                              |
| <i>GBPC</i>                                                                       | Philippines            | Power generation                                                  | 22                              | 20                              |
| <b>Joint Ventures</b>                                                             |                        |                                                                   |                                 |                                 |
| <i>SBPL</i>                                                                       | Philippines            | Power generation                                                  | 51                              | 51                              |
| <i>Indra Philippines</i>                                                          | Philippines            | Management and information technology, or <i>IT</i> , consultancy | 50                              | 50                              |
| Rockwell Business Center                                                          | Philippines            | Real estate                                                       | 30                              | 30                              |

The movements in investments in associates and joint ventures account are as follows:

|                                                            | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|------------------------------------------------------------|---------------------------------|-----------------------------------|
| <i>(Amounts in millions)</i>                               |                                 |                                   |
| Acquisition costs:                                         |                                 |                                   |
| Balance at beginning of period                             | ₱13,461                         | ₱1,563                            |
| Additions                                                  | 1,227                           | 11,898                            |
| Balance at end of period                                   | 14,688                          | 13,461                            |
| Accumulated equity in net earnings (losses):               |                                 |                                   |
| Balance at beginning of period                             | (421)                           | 249                               |
| Equity in net losses                                       | (52)                            | (259)                             |
| Dividends                                                  | —                               | (411)                             |
| Balance at end of period                                   | (473)                           | (421)                             |
| Share in cumulative translation adjustments of associates: |                                 |                                   |
| Balance at beginning of period                             | 382                             | 3                                 |
| Translation adjustments                                    | (140)                           | 379                               |
| Balance at end of period                                   | 242                             | 382                               |
|                                                            | ₱14,457                         | ₱13,422                           |

#### *FPM Power*

*FPM Power* is 40%-owned by *MERALCO* through *MPG Asia Limited*, a subsidiary of *MGen*, and 60% owned by *First Pacific*. On March 28, 2013, *FPM Power* acquired a 70% interest in *PacificLight Power*, which owns and operates a 2 x 400 *MW* liquefied natural gas or *LNG*-fired power plant in Jurong Island, Singapore. *PacificLight Power*'s wholly owned subsidiary, *PacificLight Energy Pte. Ltd.*, is engaged in energy trading.

#### *RP Energy*

On July 22, 2011, *MGen* signed a Shareholders' Agreement with *Therma Power, Inc.* or *TPI*, and *Taiwan Cogeneration International Corporation – Philippine Branch* or *TCIC*, for the construction and operation of a 2 x 300 *MW CFB* independent, coal-fired power plant to be located in the Subic Bay Freeport Zone. *RP Energy* is a partnership among *TPI*, *MGen* and *TCIC*.

The Department of Environment and Natural Resources or *DENR* issued *RP Energy* Environmental Compliance Certificate or *ECC* for the 2 x 300 *MW* units. Separately on January 22, 2013, the Board of Investments approved *RP Energy*'s registration, which entitles *RP Energy* to various incentives, subject to compliance with the pre-registration requirements. On April 2, 2013, the *BOI* held in abeyance *RP Energy*'s registration pending the finality of the Supreme Court's or *SC* decision on the validity of the *ECC*.

A Writ of *Kalikasan* was filed with the *SC* by certain parties opposing the *RP Energy* project. The case was remanded by the *SC* to the *CA* for hearing on the merits thereof. A decision has been issued by the *CA* denying the Writ of *Kalikasan*, but noting certain deficiencies in the process of the *DENR* in its issuance of the original *ECC* for the 300 *MW* coal-fired power plant and in the process of the Subic Bay Metropolitan Authority or *SBMA* in the conclusion of the original Lease and Development Agreement or *LDA* with *RP Energy*, and declaring these invalid. *DENR*, *SBMA* and *RP Energy* have filed their respective Motions to the *SC* to review the *CA* decision. On December 19, 2013, *RP Energy* filed a manifestation and Motion requesting that the *SC* deem the petitioners to have waived their rights to file their comments and requested that *RP Energy*'s Petition for Review of Certiorari which was filed with the *SC* on July 17, 2013, be submitted for resolution without the need for further submissions. As at June 30, 2014, no resolution has been issued by the *SC*. Meanwhile, *RP Energy* is proceeding with certain development activities that are not hampered by the *SC* proceedings.

While the original *LDA* was declared invalid by the *CA*, the *SBMA* is also set to ratify an Amended and Restated *LDA* to reflect additional terms.

#### *SBPL*

On August 29, 2013, *MGen* signed a Joint Development Agreement with *New Growth B.V.*, a 100% subsidiary of *Electricity Generating Public Company Limited* of Thailand or *EGCO*, for the development of a new 460 *MW* (net) supercritical coal-fired power plant in Mauban, Quezon. *MGen*'s equity in the joint venture company, *SBPL*, is 51%, with the option to assign or transfer 2% thereof to a party or investor of its preference. *SBPL*, together with their consultants are evaluating the Engineering, Procurement and Construction or *EPC*, tenders and is expected to sign the same by third quarter of 2014. Simultaneously with its financial advisors, *SBPL* is in discussions with several

banks for the financing of the project. On May 30, 2014, *MERALCO* signed a long-term *PSA* with *SBPL*.

#### *GBPC*

On October 7, 2013, *MGen* executed a Share Sale and Purchase Agreement with First Metro Investment Corporation or *FMIC*, and signed a Shareholders Agreement on October 22, 2013, for the sale by *FMIC* of a 20% equity interest in *GBPC* to *MGen*. *GBPC* owns an aggregate of 627 *MW* (gross) capacity of combined coal and diesel power plants in operation in the Visayas region. An 82 *MW* (gross) coal power plant in Cebu and a 150 *MW* (gross) coal power plant in Panay are under construction and are expected to be in commercial operation by late 2014 and 2016, respectively.

In June 2014, *MGen* increased its 20% stake in *GBPC* by an additional 2% and made additional capital infusion to fund the 150 *MW* coal power plant in Iloilo of Panay Energy Development Corporation of *GPBC*. This new plant is in addition to *GBPC*'s existing two 82 *MW* coal-fired units located in La Paz, Iloilo City.

#### *BPPC*

*BPPC* was organized in October 1992 to engage in the power generation business.

In accordance with the Build-Operate-Transfer or *BOT*, Agreement signed in 1993, First Private Power Corporation or *FPPC*, then parent company, constructed the 215 *MW* Bauang Power Plant or *Bauang Plant*, and operated the same under a 15-year Cooperation Period up to July 25, 2010.

The *Bauang Plant* has since been turned over to the National Power Corporation or *NPC*, without any compensation and free of any liens. Thereafter, *FPPC* and *BPPC* were legally merged, with *BPPC* as the surviving entity. *BPPC* is in the process of winding down operations.

#### *GEPMICI*

*GEPMICI* was established in 1979 together with General Electric Company of U.S.A., to serve the Philippine market for ANSI-type Watt-hour meters.

#### *Indra Philippines*

*Indra Philippines* is an *IT* service provider in the country and in the Asia Pacific region, with a wide range of services across various industries. *Indra Philippines* supports *MERALCO*'s information technology requirements in the area of system development, outsourcing of *IS* and *IT* operations and management consulting.

#### Rockwell Business Center

The Rockwell Business Center is a joint venture between *Rockwell Land* and *MERALCO*, where *Rockwell Land* shall construct three (3) Business Process Outsourcing or *BPO*, enabled buildings in a non-regulatory asset base property of *MERALCO* over a pre-agreed cooperation period. Investment in Rockwell Business Center represents *MERALCO*'s 30% interest in the joint venture, accounted for using the equity method. *Rockwell Land* owns 70% interest in Rockwell Business Center.

*MERALCO* and *Rockwell Land* share in earnings before depreciation and amortization at 80% and 20%, respectively until December 31, 2014 or until certain operational indicators are reached, whichever comes first. Sharing of depreciation and amortization is proportionate to their contribution.

The carrying values of investments in associates and joint ventures follow:

|                                 | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|---------------------------------|---------------------------------|-----------------------------------|
| <i>(Amounts in millions)</i>    |                                 |                                   |
| <i>GBPC</i>                     | <b>₱7,956</b>                   | <b>₱6,820</b>                     |
| <i>FPM Power</i>                | <b>4,379</b>                    | <b>4,522</b>                      |
| <i>Rockwell Business Center</i> | <b>935</b>                      | <b>917</b>                        |
| <i>RP Energy</i>                | <b>653</b>                      | <b>660</b>                        |
| <i>Indra Philippines</i>        | <b>326</b>                      | <b>291</b>                        |
| <i>SBPL</i>                     | <b>129</b>                      | <b>140</b>                        |
| <i>GEPMICI</i>                  | <b>69</b>                       | <b>62</b>                         |
| <i>BPPC</i>                     | <b>10</b>                       | <b>10</b>                         |
|                                 | <b>₱14,457</b>                  | <b>₱13,422</b>                    |

The condensed statements of financial position of material associates follow:

|                              | June 30, 2014 (Unaudited) |                  |                  |
|------------------------------|---------------------------|------------------|------------------|
|                              | <i>GBPC</i>               | <i>FPM Power</i> | <i>RP Energy</i> |
| <i>(Amounts in millions)</i> |                           |                  |                  |
| Current assets               | <b>₱19,680</b>            | <b>₱6,711</b>    | <b>₱276</b>      |
| Noncurrent assets            | <b>44,388</b>             | <b>48,529</b>    | <b>1,088</b>     |
| Current liabilities          | <b>(7,129)</b>            | <b>(16,371)</b>  | <b>(81)</b>      |
| Noncurrent liabilities       | <b>(26,795)</b>           | <b>(26,959)</b>  | <b>(1)</b>       |
| Non-controlling interests    | <b>(5,041)</b>            | <b>(962)</b>     | <b>—</b>         |
| Total net assets             | <b>₱25,103</b>            | <b>₱10,948</b>   | <b>₱1,282</b>    |

|                              | December 31, 2013 (Audited) |                  |                  |
|------------------------------|-----------------------------|------------------|------------------|
|                              | <i>GBPC</i>                 | <i>FPM Power</i> | <i>RP Energy</i> |
| <i>(Amounts in millions)</i> |                             |                  |                  |
| Current assets               | <b>₱17,276</b>              | <b>₱4,901</b>    | <b>₱323</b>      |
| Noncurrent assets            | <b>42,599</b>               | <b>48,052</b>    | <b>1,055</b>     |
| Current liabilities          | <b>(10,763)</b>             | <b>(14,245)</b>  | <b>(80)</b>      |
| Noncurrent liabilities       | <b>(25,369)</b>             | <b>(26,070)</b>  | <b>(1)</b>       |
| Non-controlling interests    | <b>(4,002)</b>              | <b>(1,333)</b>   | <b>—</b>         |
| Total net assets             | <b>₱19,741</b>              | <b>₱11,305</b>   | <b>₱1,297</b>    |

The condensed statements of comprehensive income of material associates are as follows:

| <b>Unaudited</b>                                               |                              |                  |                  |                  |                  |
|----------------------------------------------------------------|------------------------------|------------------|------------------|------------------|------------------|
| <b>For the Six Months Ended June 30</b>                        |                              |                  |                  |                  |                  |
|                                                                | <b>2014</b>                  |                  |                  | <b>2013</b>      |                  |
|                                                                | <i>GBPC</i>                  | <i>FPM Power</i> | <i>RP Energy</i> | <i>FPM Power</i> | <i>RP Energy</i> |
|                                                                | <i>(Amounts in millions)</i> |                  |                  |                  |                  |
| Revenues                                                       | <b>₱9,471</b>                | <b>₱14,944</b>   | <b>₱1</b>        | <b>₱—</b>        | <b>₱7</b>        |
| Costs and expenses                                             | <b>(8,467)</b>               | <b>(15,633)</b>  | <b>(16)</b>      | <b>(20)</b>      | <b>(164)</b>     |
| Net income (loss)                                              | <b>1,004</b>                 | <b>(689)</b>     | <b>(15)</b>      | <b>(20)</b>      | <b>(157)</b>     |
| Non-controlling interests                                      | <b>(534)</b>                 | <b>294</b>       | <b>—</b>         | <b>—</b>         | <b>—</b>         |
| Net income (loss) attributable to equity holders of the parent | <b>470</b>                   | <b>(395)</b>     | <b>(15)</b>      | <b>(20)</b>      | <b>(157)</b>     |
| Other comprehensive income (loss)                              | <b>—</b>                     | <b>(350)</b>     | <b>—</b>         | <b>261</b>       | <b>—</b>         |
| Total comprehensive income (loss)                              | <b>₱470</b>                  | <b>(₱745)</b>    | <b>(₱15)</b>     | <b>₱241</b>      | <b>(₱157)</b>    |

The reconciliation of the net assets of the foregoing material associates to the carrying amounts of the interest in these associates recognized in the consolidated statements of financial position is as follows:

| <b>June 30, 2014 (Unaudited)</b>           |                                                     |                  |                  |
|--------------------------------------------|-----------------------------------------------------|------------------|------------------|
|                                            | <i>GBPC</i>                                         | <i>FPM Power</i> | <i>RP Energy</i> |
|                                            | <i>(Amounts in millions, except % of ownership)</i> |                  |                  |
| Net assets of associates                   | <b>₱25,103</b>                                      | <b>₱10,948</b>   | <b>₱1,282</b>    |
| Proportionate ownership in associates in % | <b>22</b>                                           | <b>40</b>        | <b>47</b>        |
|                                            | <b>5,523</b>                                        | <b>4,379</b>     | <b>603</b>       |
| Goodwill                                   | <b>2,433</b>                                        | <b>—</b>         | <b>50</b>        |
|                                            | <b>₱7,956</b>                                       | <b>₱4,379</b>    | <b>₱653</b>      |

  

| <b>December 31, 2013 (Audited)</b>         |                                                     |                  |                  |
|--------------------------------------------|-----------------------------------------------------|------------------|------------------|
|                                            | <i>GBPC</i>                                         | <i>FPM Power</i> | <i>RP Energy</i> |
|                                            | <i>(Amounts in millions, except % of ownership)</i> |                  |                  |
| Net assets of associates                   | <b>₱19,741</b>                                      | <b>₱11,305</b>   | <b>₱1,297</b>    |
| Proportionate ownership in associates in % | <b>20</b>                                           | <b>40</b>        | <b>47</b>        |
|                                            | <b>3,948</b>                                        | <b>4,522</b>     | <b>610</b>       |
| Goodwill                                   | <b>2,872</b>                                        | <b>—</b>         | <b>50</b>        |
|                                            | <b>₱6,820</b>                                       | <b>₱4,522</b>    | <b>₱660</b>      |

The following is the aggregate information of *GEPMICI* and *BPPC* that are not individually material:

|                                     | <b>Unaudited</b>                        |             |
|-------------------------------------|-----------------------------------------|-------------|
|                                     | <b>For the Six Months Ended June 30</b> |             |
|                                     | <b>2014</b>                             | <b>2013</b> |
|                                     | <i>(Amounts in millions)</i>            |             |
| Share in net income                 | <b>₱2</b>                               | <b>₱1</b>   |
| Share in other comprehensive income | <b>—</b>                                | <b>—</b>    |
| Share in total comprehensive income | <b>₱2</b>                               | <b>₱1</b>   |

*Joint Ventures*

The condensed statements of financial position of Rockwell Business Center, a material joint venture, follow:

|                        | <b>June 30,<br/>2014<br/>(Unaudited)</b> | <b>December 31,<br/>2013<br/>(Audited)</b> |
|------------------------|------------------------------------------|--------------------------------------------|
|                        | <i>(Amounts in millions)</i>             |                                            |
| Current assets         | <b>₱510</b>                              | <b>₱613</b>                                |
| Noncurrent assets      | <b>2,823</b>                             | <b>2,566</b>                               |
| Current liabilities    | <b>(262)</b>                             | <b>(166)</b>                               |
| Noncurrent liabilities | <b>(5)</b>                               | <b>(7)</b>                                 |
| Net assets             | <b>₱3,066</b>                            | <b>₱3,006</b>                              |

Current assets include cash and cash equivalents of ₱381 million and ₱594 million as at June 30, 2014 and December 31, 2013, respectively. Noncurrent assets represent substantially the two (2) *BPO* towers for lease and the costs of ongoing construction of the third building of Rockwell Business Center. Current liabilities represent trade payables.

The condensed statements of comprehensive income of Rockwell Business Center for the six months ended June 30, 2014 and 2013 are as follows:

|                                | <b>Unaudited</b>                        |             |
|--------------------------------|-----------------------------------------|-------------|
|                                | <b>For the Six Months Ended June 30</b> |             |
|                                | <b>2014</b>                             | <b>2013</b> |
|                                | <i>(Amounts in millions)</i>            |             |
| Revenues                       | <b>₱152</b>                             | <b>₱151</b> |
| Costs and expenses             | <b>(62)</b>                             | <b>(52)</b> |
| Provision for income tax - net | <b>(30)</b>                             | <b>(30)</b> |
| Net income                     | <b>60</b>                               | <b>69</b>   |
| Other comprehensive income     | <b>—</b>                                | <b>—</b>    |
| Total comprehensive income     | <b>₱60</b>                              | <b>₱69</b>  |

The foregoing condensed statements of comprehensive income include the following:

|                          | <b>Unaudited</b>                |             |
|--------------------------|---------------------------------|-------------|
|                          | <b>For the Six Months Ended</b> |             |
|                          | <b>June 30</b>                  |             |
|                          | <b>2014</b>                     | <b>2013</b> |
|                          | <i>(Amounts in millions)</i>    |             |
| Depreciation             | <b>₱71</b>                      | <b>₱53</b>  |
| Interest income          | <b>(2)</b>                      | <b>(4)</b>  |
| Provision for income tax | <b>30</b>                       | <b>30</b>   |

The reconciliation of the net assets of the Rockwell Business Center to the carrying amount of the interest in Rockwell Business Center recognized in the consolidated financial statements is as follows:

|                                                                                                              | <b>June 30,<br/>2014<br/>(Unaudited)</b>            | <b>December 31,<br/>2013<br/>(Audited)</b> |
|--------------------------------------------------------------------------------------------------------------|-----------------------------------------------------|--------------------------------------------|
|                                                                                                              | <i>(Amounts in millions, except % of ownership)</i> |                                            |
| Net assets                                                                                                   | <b>₱3,066</b>                                       | <b>₱3,006</b>                              |
| Proportionate ownership in %                                                                                 | <b>30</b>                                           | <b>30</b>                                  |
|                                                                                                              | <b>920</b>                                          | <b>902</b>                                 |
| Effect of the difference between <i>MERALCO's</i> percentage share in net income and proportionate ownership | <b>15</b>                                           | <b>15</b>                                  |
|                                                                                                              | <b>₱935</b>                                         | <b>₱917</b>                                |

The following is the condensed financial information of *Indra Philippines* and *SBPL*, which are not considered material joint ventures:

|                                     | <b>Unaudited</b>                        |             |
|-------------------------------------|-----------------------------------------|-------------|
|                                     | <b>For the Six Months Ended June 30</b> |             |
|                                     | <b>2014</b>                             | <b>2013</b> |
|                                     | <i>(Amounts in millions)</i>            |             |
| Share in net income                 | <b>₱24</b>                              | <b>₱13</b>  |
| Share in other comprehensive income | <b>—</b>                                | <b>—</b>    |
| Share in total comprehensive income | <b>₱24</b>                              | <b>₱13</b>  |

## 9. Investment Properties

The movements in investment properties are as follows:

| <b>June 30, 2014 (Unaudited)</b> |               |                                   |               |
|----------------------------------|---------------|-----------------------------------|---------------|
|                                  | <b>Land</b>   | <b>Buildings and Improvements</b> | <b>Total</b>  |
| <i>(Amounts in millions)</i>     |               |                                   |               |
| Cost:                            |               |                                   |               |
| Balance at beginning of period   | <b>₱1,446</b> | <b>₱181</b>                       | <b>₱1,627</b> |
| Additions                        | –             | 5                                 | 5             |
| Balance at end of period         | <b>1,446</b>  | <b>186</b>                        | <b>1,632</b>  |
| Less accumulated depreciation:   |               |                                   |               |
| Balance at beginning of period   | –             | 101                               | 101           |
| Depreciation                     | –             | 3                                 | 3             |
| Balance at end of period         | –             | 104                               | 104           |
|                                  | <b>₱1,446</b> | <b>₱82</b>                        | <b>₱1,528</b> |

  

| <b>December 31, 2013 (Audited)</b> |               |                                   |               |
|------------------------------------|---------------|-----------------------------------|---------------|
|                                    | <b>Land</b>   | <b>Buildings and Improvements</b> | <b>Total</b>  |
| <i>(Amounts in millions)</i>       |               |                                   |               |
| Cost:                              |               |                                   |               |
| Balance at beginning of period     | <b>₱1,535</b> | <b>₱206</b>                       | <b>₱1,741</b> |
| Disposals                          | (89)          | (25)                              | (114)         |
| Balance at end of period           | <b>1,446</b>  | <b>181</b>                        | <b>1,627</b>  |
| Less accumulated depreciation:     |               |                                   |               |
| Balance at beginning of period     | –             | 107                               | 107           |
| Depreciation                       | –             | 8                                 | 8             |
| Disposals                          | –             | (14)                              | (14)          |
| Balance at end of period           | –             | 101                               | 101           |
|                                    | <b>₱1,446</b> | <b>₱80</b>                        | <b>₱1,526</b> |

Investment properties are stated at cost. These consist of real properties held for capital appreciation, former substation sites and other non-regulatory asset base real properties, some of which are being leased out.

The aggregate fair values of the investment properties as at June 30, 2014 and December 31, 2013 are as follows:

|                              | <b>June 30,<br/>2014<br/>(Unaudited)</b> | <b>December 31,<br/>2013<br/>(Audited)</b> |
|------------------------------|------------------------------------------|--------------------------------------------|
| <i>(Amounts in millions)</i> |                                          |                                            |
| Land                         | <b>₱1,863</b>                            | <b>₱1,863</b>                              |
| Buildings and improvements   | <b>131</b>                               | <b>131</b>                                 |

Land pertains primarily to properties where the BPO building and “Strip” mall are located and other non-regulated asset base properties.

The fair values of investment properties were determined by independent, professionally qualified appraisers. The fair value represents the price that would be received to sell an investment property in an orderly transaction between market participants at the measurement date.

The fair value disclosures of the investment properties are categorized as Level 3 as there is no active market for identical or similar properties. The inputs include price per square meter ranging from ₱500 to ₱94,000. There have been no changes in the valuation techniques used.

In conducting the appraisal, the independent professional appraisers used any of the following approaches:

a. Market Data or Comparative Approach

Under this approach, the value of the property is based on sales and listings of comparable property registered within the vicinity. This approach requires the establishment of a comparable property by reducing comparative sales and listings to a common denominator with the subject. This is done by adjusting the differences between the subject property and those actual sales and listings regarded as comparables. The properties used are either situated within the immediate vicinity or at different floor levels of the same building, whichever is most appropriate to the property being valued. Comparison was premised on the factors of location, size and physical attributes, selling terms, facilities offered and time element.

b. Depreciated Replacement Cost Approach

This method of valuation considers the cost to reproduce or replace in new condition the assets appraised in accordance with current market prices for similar assets, with allowance for accrued depreciation based on physical wear and tear and obsolescence.

## 10. Other Noncurrent Assets

This account consists of:

|                                | <i>Note</i> | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|--------------------------------|-------------|---------------------------------|-----------------------------------|
| <i>(Amounts in millions)</i>   |             |                                 |                                   |
| Unbilled receivables           | 12          | ₱9,633                          | ₱18,394                           |
| Intangible assets              | 7           | 2,104                           | 1,728                             |
| Deferred input <i>VAT</i>      |             | 1,677                           | 1,702                             |
| Advance payments to a supplier | 30          | 578                             | 474                               |
| Receivable from the <i>BIR</i> | 29          | 181                             | 577                               |
| <i>AFS</i> financial assets    | 27          | 164                             | 161                               |
| Deferred reinsurance premium   |             | 151                             | 231                               |
| <i>HTM</i> investments         |             | 129                             | 129                               |
| Goodwill                       |             | 36                              | 36                                |
| Others                         |             | 309                             | 171                               |
|                                |             | <b>₱14,962</b>                  | <b>₱23,603</b>                    |

### *Unbilled Receivables*

This account represents generation and other pass-through costs incurred by *MERALCO* and *CEDC* as *DUs*, which are still to be billed and which are covered by the approved recovery mechanism of the *ERC*. The balance also includes other unbilled generation and pass-through charges of current and prior periods, which are the subject of various applications for recovery and approval by the *ERC*.

### *Intangible Assets*

The movements of intangible assets are as follows:

| June 30, 2014 (Unaudited)      |          |           |        |
|--------------------------------|----------|-----------|--------|
|                                | Software | Franchise | Total  |
| <i>(Amounts in millions)</i>   |          |           |        |
| Cost:                          |          |           |        |
| Balance at beginning of period | ₱2,401   | ₱49       | ₱2,450 |
| Additions                      | 140      | 15        | 155    |
| Reclassification               | 863      | —         | 863    |
| Balance at end of period       | 3,404    | 64        | 3,468  |
| Less accumulated amortization: |          |           |        |
| Balance at beginning of period | 722      | —         | 722    |
| Amortization                   | 139      | 7         | 146    |
| Reclassification               | 496      | —         | 496    |
| Balance at end of period       | 1,357    | 7         | 1,364  |
|                                | ₱2,047   | ₱57       | ₱2,104 |
| December 31, 2013 (Audited)    |          |           |        |
|                                | Software | Franchise | Total  |
| <i>(Amounts in millions)</i>   |          |           |        |
| Cost:                          |          |           |        |
| Balance at beginning of period | ₱1,525   | ₱49       | ₱1,574 |
| Additions                      | 876      | —         | 876    |
| Balance at end of period       | 2,401    | 49        | 2,450  |
| Less accumulated amortization: |          |           |        |
| Balance at beginning of period | 553      | —         | 553    |
| Amortization                   | 169      | —         | 169    |
| Balance at end of period       | 722      | —         | 722    |
|                                | ₱1,679   | ₱49       | ₱1,728 |

## 11. Cash and Cash Equivalents

This account consists of:

|                              | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|------------------------------|---------------------------------|-----------------------------------|
| <i>(Amounts in millions)</i> |                                 |                                   |
| Cash on hand and in banks    | ₱4,713                          | ₱5,129                            |
| Cash equivalents             | 62,340                          | 54,722                            |
|                              | <b>₱67,053</b>                  | <b>₱59,851</b>                    |

Cash in banks earns interest at prevailing bank deposit rates. Cash equivalents are temporary cash investments, which are made for varying periods up to three (3) months depending on the *MERALCO Group's* immediate cash requirements, and earn interest at the prevailing short-term investment rates.

## 12. Trade and Other Receivables

This account consists of:

|                                                                               | Note | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|-------------------------------------------------------------------------------|------|---------------------------------|-----------------------------------|
| <i>(Amounts in millions)</i>                                                  |      |                                 |                                   |
| Trade:                                                                        |      |                                 |                                   |
| Electricity:                                                                  |      |                                 |                                   |
| Billed                                                                        |      | ₱25,058                         | ₱27,281                           |
| Unbilled                                                                      | 10   | 3,798                           | 4,175                             |
| Service contracts                                                             |      | 1,886                           | 1,490                             |
| Insurance receivable                                                          |      | 81                              | 453                               |
| Cost and estimated earnings in excess of<br>billings on uncompleted contracts |      | 692                             | 455                               |
| Nontrade                                                                      |      | 3,086                           | 2,016                             |
|                                                                               |      | <b>34,601</b>                   | <b>35,870</b>                     |
| Less allowance for doubtful accounts                                          |      | 3,444                           | 3,152                             |
|                                                                               |      | <b>₱31,157</b>                  | <b>₱32,718</b>                    |

Billed receivables from sale of electricity of *MERALCO* and *CEDC* consist of the following:

|                                      | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|--------------------------------------|---------------------------------|-----------------------------------|
| <i>(Amounts in millions)</i>         |                                 |                                   |
| Residential                          | ₱10,768                         | ₱9,446                            |
| Commercial                           | 9,780                           | 12,179                            |
| Industrial                           | 3,902                           | 5,128                             |
| Flat streetlights                    | 608                             | 528                               |
|                                      | 25,058                          | 27,281                            |
| Less allowance for doubtful accounts | 3,239                           | 2,969                             |
|                                      | ₱21,819                         | ₱24,312                           |

Movements in allowance for doubtful accounts for trade and other receivables are as follows:

| June 30, 2014 (Unaudited)    |                                      |            |            |                                |
|------------------------------|--------------------------------------|------------|------------|--------------------------------|
|                              | Balance<br>at beginning of<br>period | Provisions | Write-offs | Balance<br>at end<br>of period |
| <i>(Amounts in millions)</i> |                                      |            |            |                                |
| Billed trade receivables:    |                                      |            |            |                                |
| Commercial                   | ₱1,165                               | ₱42        | (₱16)      | ₱1,191                         |
| Residential                  | 1,068                                | 289        | (95)       | 1,262                          |
| Industrial                   | 533                                  | 22         | (5)        | 550                            |
| Flat streetlights            | 203                                  | 33         | —          | 236                            |
|                              | 2,969                                | 386        | (116)      | 3,239                          |
| Nontrade receivables         | 183                                  | 22         | —          | 205                            |
|                              | ₱3,152                               | ₱408       | (₱116)     | ₱3,444                         |

| June 30, 2014 (Unaudited)    |            |             |            |                      |                         |        |
|------------------------------|------------|-------------|------------|----------------------|-------------------------|--------|
|                              | Commercial | Residential | Industrial | Flat<br>Streetlights | Nontrade<br>Receivables | Total  |
| <i>(Amounts in millions)</i> |            |             |            |                      |                         |        |
| Individually impaired        | ₱410       | ₱899        | ₱336       | ₱69                  | ₱205                    | ₱1,919 |
| Collectively impaired        | 781        | 363         | 214        | 167                  | —                       | 1,525  |
|                              | ₱1,191     | ₱1,262      | ₱550       | ₱236                 | ₱205                    | ₱3,444 |

| December 31, 2013 (Audited)  |                                    |                           |            |                              |
|------------------------------|------------------------------------|---------------------------|------------|------------------------------|
|                              | Balance<br>at beginning of<br>year | Provisions<br>(Reversals) | Write-offs | Balance<br>at end<br>of year |
| <i>(Amounts in millions)</i> |                                    |                           |            |                              |
| Billed trade receivables:    |                                    |                           |            |                              |
| Commercial                   | ₱1,028                             | ₱175                      | (₱38)      | ₱1,165                       |
| Residential                  | 556                                | 743                       | (231)      | 1,068                        |
| Industrial                   | 772                                | (201)                     | (38)       | 533                          |
| Flat streetlights            | 203                                | 5                         | (5)        | 203                          |
|                              | 2,559                              | 722                       | (312)      | 2,969                        |
| Nontrade receivables         | 147                                | 36                        | —          | 183                          |
|                              | ₱2,706                             | ₱758                      | (₱312)     | ₱3,152                       |

| December 31, 2013 (Audited) |                              |             |            |                      |                         |        |
|-----------------------------|------------------------------|-------------|------------|----------------------|-------------------------|--------|
|                             | Commercial                   | Residential | Industrial | Flat<br>Streetlights | Nontrade<br>Receivables | Total  |
|                             | <i>(Amounts in millions)</i> |             |            |                      |                         |        |
| Individually impaired       | ₱123                         | ₱763        | ₱298       | ₱31                  | ₱183                    | ₱1,398 |
| Collectively impaired       | 1,042                        | 305         | 235        | 172                  | –                       | 1,754  |
|                             | ₱1,165                       | ₱1,068      | ₱533       | ₱203                 | ₱183                    | ₱3,152 |

*Trade Receivables – Electricity*

Trade receivables of *MERALCO* and *CEDC* include charges for pass-through costs. Pass-through costs consist largely of generation and transmission charges, which represent 59% and 13%, respectively, of the total billed amount in 2014 and 57% and 9%, respectively, of the total billed amount in 2013. Billed receivables are due 10 days after bill date.

Unbilled receivables represent electricity consumed after the meter reading cut-off dates, which will be billed to customers in the immediately following billing period. This also includes the current portion of pass-through cost under-recoveries, net of over-recoveries, which are billed to the customers over the period approved by the *ERC*. *MERALCO*'s and *CEDC*'s trade receivables are noninterest-bearing and are substantially secured by bill deposits.

See *Note 18 – Customers' Deposits* and *Note 27 – Financial Assets and Financial Liabilities*.

*Trade Receivables – Service Contracts*

Service contracts receivables arise from contracts entered into by *MIESCOR* and subsidiaries, *e-MVI* and subsidiary, *CIS*, *Bayad Center*, *Miescorrail* and *MEI* for construction, engineering, related manpower, consulting, light rail maintenance, data transport, bills collection, tellering and e-business development and energy management services to third parties.

Receivables from service contracts and others are noninterest-bearing and are generally on 30- to 60-day terms.

### 13. Inventories

|                                                                   | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|-------------------------------------------------------------------|---------------------------------|-----------------------------------|
|                                                                   | <i>(Amounts in millions)</i>    |                                   |
| Materials and supplies:                                           |                                 |                                   |
| At net realizable value                                           | ₱2,238                          | ₱2,750                            |
| At cost                                                           | 2,441                           | 2,953                             |
| Total inventories at the lower of cost or<br>net realizable value | ₱2,238                          | ₱2,750                            |

#### 14. Other Current Assets

|                              |           | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|------------------------------|-----------|---------------------------------|-----------------------------------|
|                              | Note      |                                 |                                   |
| <i>(Amounts in millions)</i> |           |                                 |                                   |
| Advances to an associate     | 8 and 23  | ₱4,801                          | ₱4,884                            |
| Pass-through VAT - net       |           | 1,785                           | 1,116                             |
| Prepaid tax                  |           | 1,487                           | 734                               |
| Input VAT                    |           | 88                              | 77                                |
| Prepaid expenses             |           | 66                              | 290                               |
| Short-term investments       | 18 and 27 | —                               | 4,841                             |
| Others                       |           | 182                             | 225                               |
|                              |           | <b>₱8,409</b>                   | <b>₱12,167</b>                    |

Pass-through VAT pertains to VAT on generation and transmission costs, as DU. Remittance of such deferred VAT to the generation companies is based on collection of billed receivables from the customers.

Short-term investments are temporary cash placements which are made for varying periods beyond three (3) months but not exceeding 12 months, and earn interest at the prevailing short-term placement investment rates.

#### 15. Equity

##### *Common Stock*

The movement in the number of shares of MERALCO's common stock is as follows:

|                                        | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|----------------------------------------|---------------------------------|-----------------------------------|
| <i>(In millions, except par value)</i> |                                 |                                   |
| Authorized - ₱10 par value a share     | 1,250                           | 1,250                             |
| Issued and outstanding:                |                                 |                                   |
| Balance at beginning and end of period | 1,127                           | 1,127                             |

The common shares of MERALCO were listed in the PSE on January 8, 1992. There are 46,067 and 46,409 shareholders of MERALCO's common shares as at June 30, 2014 and December 31, 2013, respectively.

##### *Unappropriated Retained Earnings*

The unappropriated retained earnings include undeclared accumulated earnings of subsidiaries, associates and joint ventures, and the balance of MERALCO's revaluation increment in utility plant and others and investment properties carried at deemed cost, deferred tax assets and derivative assets

amounting to ₱36,056 million and ₱34,684 million as at June 30, 2014 and December 31, 2013, respectively. These amounts are restricted for dividend declaration purposes as of the close of the respective reporting periods.

The following are cash dividends declared on common shares in the second half of 2014 and 2013:

| Declaration Date  | Record Date    | Payment Date   | Dividend<br>Per Share | Amount<br>(In millions) |
|-------------------|----------------|----------------|-----------------------|-------------------------|
| March 17, 2014    | April 15, 2014 | May 8, 2014    | ₱6.45                 | ₱7,269                  |
| February 25, 2013 | March 26, 2013 | April 24, 2013 | 6.10                  | 6,875                   |

*MERALCO* pays regular cash dividends equivalent to 50% of consolidated core net income for the year, which may be supplemented by a special dividend determined on a “look-back” basis. Declaration and payment of special dividend are dependent on the availability of unrestricted retained earnings and availability of free cash. The declaration, record and payment dates shall be consistent with the guidelines and regulations of the *SEC*.

#### *Appropriated Retained Earnings*

On February 22, 2010, retained earnings of ₱6,000 million have been appropriated specifically for the *MERALCO Group's* business expansion into power generation. The amount appropriated was increased by ₱5,000 million to cover the new development projects and investments in power generation initiatives. The additional appropriation was approved on March 22, 2013 by the *BOD*. As at June 30, 2014, the development of the first project, a 2 x 300 MW CFB coal-fired plant through *RP Energy*, is ongoing. *MERALCO* signed a Joint Development Agreement and Shareholders Agreement to develop a supercritical coal-fired power plant, which has a target completion by the end of 2017.

The commercial operations date of the 600 MW power plant of *RP Energy* is dependent on the *SC* decision on the appeal filed by *RP Energy* and other parties in connection with the decision reached by the *CA* on the Writ of Kalikasan case filed against the *RP Energy* project. On the other hand, the 2 x 400 MW LNG plant of *PacificLight Power* was fully synchronized to the Singapore power grid in January 2014.

See Note 8 – Investments in Associates and Joint Ventures.

#### *Treasury Shares*

Treasury shares represent subscribed shares and the related rights of employees who have opted to withdraw from the *ESPP* in accordance with the provisions of the *ESPP* and which *MERALCO* purchased. As at June 30, 2014, a total of 172,412 shares were acquired from employees who have opted to cancel their participation in the *ESPP*.

## 16. Employee Stock Purchase Plan

*MERALCO* has an *ESPP*, which entitles participants to purchase *MERALCO*'s common shares subject to certain terms and conditions during a nominated offer period. Movements in the number of common shares subscribed by employees under the *ESPP* are as follows:

| June 30, 2014 (Unaudited)      |                    |                  |           |
|--------------------------------|--------------------|------------------|-----------|
|                                | 13 <sup>th</sup> A | 14 <sup>th</sup> | Total     |
| Balance at beginning of period | 68,333             | 5,706,802        | 5,775,135 |
| Fully paid                     | (67,120)           | (326,202)        | (393,322) |
| Balance at end of period       | 1,213              | 5,380,600        | 5,381,813 |

| December 31, 2013 (Audited)    |                  |                    |                  |             |
|--------------------------------|------------------|--------------------|------------------|-------------|
|                                | 13 <sup>th</sup> | 13 <sup>th</sup> A | 14 <sup>th</sup> | Total       |
| Balance at beginning of period | 3,309            | 135,703            | 7,753,272        | 7,892,284   |
| Fully paid                     | (3,309)          | (67,370)           | (2,045,911)      | (2,116,590) |
| Cancelled                      | —                | —                  | (559)            | (559)       |
| Balance at end of period       | —                | 68,333             | 5,706,802        | 5,775,135   |

*MERALCO* allotted a total of 55 million common shares for *ESPP* awards. As at June 30, 2014, 12 million common shares are available for future offerings. There were no other *ESPP* awards since October 2009.

The fair value of the offerings was estimated at the dates of the grant using the Black-Scholes Option Pricing Model.

## 17. Interest-bearing Long-term Financial Liabilities

This account consists of the following:

|                                                               | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|---------------------------------------------------------------|---------------------------------|-----------------------------------|
| (Amounts in millions)                                         |                                 |                                   |
| Long-term portion of interest-bearing financial liabilities - |                                 |                                   |
| Long-term debt                                                | ₱27,579                         | ₱20,756                           |
| Current portion of interest-bearing financial liabilities:    |                                 |                                   |
| Long-term debt                                                | 673                             | 9,459                             |
| Redeemable preferred stock                                    | 1,554                           | 1,562                             |
|                                                               | 2,227                           | 11,021                            |
|                                                               | ₱29,806                         | ₱31,777                           |

All of the redeemable preferred shares have been called for redemption as at June 30, 2011, consistent with the terms of the Preferred Shares Subscription Agreement. The accrued interests amounted to ₱250 million as at June 30, 2014 and December 31, 2013. Interest is no longer accrued when the preferred shares have been called for redemption.

The details of interest-bearing long-term financial liabilities are as follows:

| Description                                                 | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|-------------------------------------------------------------|---------------------------------|-----------------------------------|
| <i>(Amounts in millions)</i>                                |                                 |                                   |
| <i>Bonds</i>                                                |                                 |                                   |
| ₱11.5 Billion 7-year Bonds                                  | ₱11,500                         | ₱11,500                           |
| ₱7.0 Billion 12-year Bonds                                  | 7,000                           | 7,000                             |
| <i>Fixed Rate Loans</i>                                     |                                 |                                   |
| ₱7.2 Billion Note Facility Agreement                        | 7,200                           | –                                 |
| ₱5.0 Billion Note Facility Agreement                        | –                               | 4,900                             |
| ₱4.8 Billion Note Facility Agreement                        | –                               | 3,417                             |
| ₱3.0 Billion Note Facility Agreement                        | –                               | 530                               |
| <i>Floating Rate Loans</i>                                  |                                 |                                   |
| ₱2.5 Billion Term Loan Facility                             | 2,463                           | 2,475                             |
| ₱3.0 Billion Term Loan Facility                             | 300                             | 600                               |
| Total long-term debt                                        | 28,463                          | 30,422                            |
| Less unamortized debt issuance costs                        | 211                             | 207                               |
|                                                             | 28,252                          | 30,215                            |
| <i>Redeemable Preferred Stock</i>                           | 1,554                           | 1,562                             |
|                                                             | 29,806                          | 31,777                            |
| Less current portion                                        | 2,227                           | 11,021                            |
| Long-term portion of interest-bearing financial liabilities | ₱27,579                         | ₱20,756                           |

All of *MERALCO*'s interest-bearing long-term financial liabilities as at June 30, 2014 and December 31, 2013 are denominated in Philippine pesos. The scheduled maturities of *MERALCO*'s outstanding long-term debt at nominal values as at June 30, 2014 are as follows:

|                     | Amount               |
|---------------------|----------------------|
|                     | <i>(In millions)</i> |
| June 30, 2015       | ₱673                 |
| June 30, 2016       | 373                  |
| June 30, 2017       | 373                  |
| June 30, 2018       | 2,785                |
| After June 30, 2018 | 24,048               |
|                     | ₱28,252              |

*Bonds*

*₱18.5 Billion Fixed Rate Putable Bonds*

On September 23, 2013, the *BOD* of *MERALCO* authorized the offer, sale and issuance by way of public offering in the Philippines, 7- and 12-year corporate bonds, putable in 5 and 10 years, respectively, with an aggregate principal amount of up to ₱15 billion with an overallotment option of up to ₱5.0 billion. The 12-year corporate bonds also include a call option, where *MERALCO* may redeem (in whole but not in part only) the outstanding bonds on the 7th year from issue date at the early redemption price of 101.0%. The put and call options are clearly and closely related to the host instruments, thus, were not recognized separately.

On December 12, 2013, the ₱11.5 billion fixed rate putable bonds due in 2020 and ₱7.0 billion fixed rate putable bonds due in 2025, were listed on the Philippine Dealing and Exchange Corporation.

The net proceeds of the bonds were and will be utilized for refinancing certain loans including principal payments, accrued interest, prepayment penalties and other financing costs.

#### *Fixed Rate Loans*

##### *₱7.2 Billion Note Facility Agreement*

In March 2014, *MERALCO* entered into a 10-year fixed rate loan from a major domestic universal bank. The principal is payable in nominal annual amortizations with a balloon payment on final maturity in February 2024.

##### *₱5.0 Billion Note Facility Agreement*

In June 2011, *MERALCO* entered into a Fixed Rate Note Facility Agreement for its ₱500 million, 7-year notes and ₱4,500 million, 10-year notes due in 2018 and 2021, respectively. The principal is payable in nominal annual amortizations with a balloon payment on each of the two final maturity dates. In June 2014, *MERALCO* pre-terminated and settled the remaining principal of ₱4,900 million.

##### *₱4.8 Billion Note Facility Agreement*

In November 2010, *MERALCO* signed a Fixed Rate Note Facility Agreement for its ₱1,997 million, 7-year fixed rate notes and ₱2,803 million, 10-year fixed rate notes. The notes were issued on December 2, 2010 and are payable in nominal annual amortizations with a balloon payment on each of the two maturity dates in December 2018 and December 2020. In December 2013, *MERALCO* pre-terminated and settled the principal amount of ₱1,334 million. In March 2014, *MERALCO* pre-terminated and settled the remaining principal of ₱3,417 million.

##### *₱3.0 Billion Note Facility Agreement*

On January 5, 2012, *MERALCO* signed a ₱3,000 million Fixed Rate Note Facility Agreement for its ₱1,000 million, 7-year notes and ₱2,000 million, 10-year notes due in 2019 and 2022, respectively. The notes were priced off the relevant 7-year and 10-year benchmarks plus a spread and were issued on January 9, 2012. Principal repayments are through annual nominal amortizations and a balloon payment on maturity date. In December 2013, *MERALCO* pre-terminated and settled the principal amount of ₱2,440 million. In January 2014, *MERALCO* pre-terminated and settled the remaining principal of ₱530 million.

#### *Floating Rate Loans*

##### *₱2.5 Billion Term Loan Facility*

The ₱2,500 million, 7-year Floating Rate Term Loan Facility, was drawn in January 2011 from a local bank. Interest rate is repriced every six months based on 6-month *PDST-F* plus a spread. The principal is payable in nominal annual amortizations with a balloon payment on final maturity in January 2018.

### *₱3.0 Billion Term Loan Facility*

The ₱3,000 million, 5-year bilateral Floating Rate Term Loan Facility, was drawn in October 2009. The principal is payable over five years with final maturity in October 2014.

Long-term debt amounting to ₱8,797 million, pre-terminated between January to June 30, 2014, were classified as part of the current portion of the long-term interest-bearing financial liabilities as at December 31, 2013.

The annual interest rates for the interest-bearing financial liabilities are as follows:

|                     | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|---------------------|---------------------------------|-----------------------------------|
| Bonds               | 4.38% to 4.88%                  | 4.38% to 4.88%                    |
| Fixed Rate Loans    | 4.50% to 6.89%                  | 5.23% to 6.89%                    |
| Floating Rate Loans | 0.80% to 1.74%                  | 0.80% to 1.74%                    |

### *Debt Covenants*

MERALCO's loan agreements require compliance with debt service coverage of 1.2 times calculated on specific measurement dates. The agreements also contain restrictions with respect to the creation of liens or encumbrances on assets, issuance of guarantees, mergers or consolidations, disposition of a significant portion of its assets and related party transactions.

As at June 30, 2014 and December 31, 2013, MERALCO is in compliance with all covenants of the loan agreements.

### *Unamortized Debt Issuance Costs*

Unamortized debt issuance costs amounted to ₱211 million and ₱207 million as at June 30, 2014 and December 31, 2013, respectively.

The following presents the changes to the unamortized debt issuance costs:

|                                                                 | Note | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|-----------------------------------------------------------------|------|---------------------------------|-----------------------------------|
| <i>(Amounts in millions)</i>                                    |      |                                 |                                   |
| Balance at beginning of period                                  |      | ₱207                            | ₱82                               |
| Additions                                                       |      | 36                              | 186                               |
| Amortization charged to interest<br>and other financial charges | 25   | (32)                            | (61)                              |
| Balance at end of period                                        |      | ₱211                            | ₱207                              |

### *Redeemable Preferred Stock*

The movements in the number of shares of the redeemable preferred stock, which have all been called, are as follows:

|                                | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|--------------------------------|---------------------------------|-----------------------------------|
| Balance at beginning of period | 156,189,168                     | 159,356,939                       |
| Redemptions                    | (814,496)                       | (3,167,771)                       |
| Balance at end of period       | 155,374,672                     | 156,189,168                       |

The original "Terms and Conditions" of *MERALCO's* Special Stock Subscription Agreement, which required an applicant to subscribe to preferred stock with 10% dividend to cover the cost of extension of, or new distribution facilities, have been amended by the *Magna Carta* and the Distribution Services and Open Access Rule, or *DSOAR*, effective June 17, 2004 and January 18, 2006, respectively. The amendment sets forth the guidelines for the issuance of preferred stock, only if such instrument is available.

## 18. Customers' Deposits

This account consists of:

|                       | June 30, 2014 (Unaudited)           |                       |         | December 31, 2013 (Audited)         |                       |         |
|-----------------------|-------------------------------------|-----------------------|---------|-------------------------------------|-----------------------|---------|
|                       | Current<br>Portion<br>(see Note 22) | Noncurrent<br>Portion | Total   | Current<br>Portion<br>(see Note 22) | Noncurrent<br>Portion | Total   |
| (Amounts in millions) |                                     |                       |         |                                     |                       |         |
| Bill deposits         | ₱7,425                              | ₱20,275               | ₱27,700 | ₱6,130                              | ₱21,600               | ₱27,730 |
| Meter deposits        | 505                                 | —                     | 505     | 2,119                               | —                     | 2,119   |
|                       | ₱7,930                              | ₱20,275               | ₱28,205 | ₱8,249                              | ₱21,600               | ₱29,849 |

### *Bill Deposits*

Bill deposits serve to guarantee payment of bills by a customer in accordance with existing regulations.

As provided for under the *Magna Carta* and *DSOAR*, all captive customers are required to pay a deposit to the *DU* an amount equivalent to the estimated monthly bill calculated based on applied load, which shall be recognized as bill deposit of the captive customer. Such deposit shall be adjusted after one year based on the historical 12-month average bill. A captive customer who has paid his electric bills on or before due date for three consecutive years may now apply for the full refund of the bill deposit, together with the accrued interests, prior to the termination of his service; otherwise bill deposits and accrued interests shall be refunded within one month from the termination of service, provided all bills have been paid.

On February 22, 2010, the amended *DSOAR*, which became effective on April 1, 2010, was promulgated by the *ERC*. Under the amended *DSOAR*, interest on bill deposits for both residential

and non-residential customers shall be computed using the equivalent peso savings account interest rate of the Land Bank of the Philippines or *Land Bank*, or other government banks, on the first working day of the year, subject to the confirmation of the *ERC*. Interest rate for bill deposits is 0.375% per annum starting January 1, 2013 and 0.250% per annum starting January 1, 2014.

As provided for under *ERC* Resolution No. 1, *A Resolution Adopting the Revised Rules for the Issuance of Licenses to Retail Electricity Suppliers*, a local *RES* may require security deposits from its contestable customers, which shall earn interest equivalent to the actual interest earnings of the total amount of deposits received from the customers.

The following are the movements of the bill deposits account:

|                                                           | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|-----------------------------------------------------------|---------------------------------|-----------------------------------|
|                                                           | <i>(Amounts in millions)</i>    |                                   |
| Balance at beginning of period                            | ₱27,730                         | ₱27,377                           |
| Additions                                                 | 3,833                           | 5,068                             |
| Refunds                                                   | (3,863)                         | (4,715)                           |
| Balance at end of period                                  | 27,700                          | 27,730                            |
| Less portion maturing within one year                     | 7,425                           | 6,130                             |
| Noncurrent portion of bill deposits and related interests | ₱20,275                         | ₱21,600                           |

#### *Meter Deposits*

Meter deposits were intended to guarantee the cost of meters installed.

The *Magna Carta* for residential customers (effective June 17, 2004) and *DSOAR* (effective January 18, 2006) for non-residential customers exempt all customer groups from payment of meter deposits beginning July 2004 for residential customers and April 2006 for non-residential customers.

The *ERC* released Resolution No. 8, Series of 2008, otherwise known as “Rules to Govern the Refund of Meter Deposits to Residential and Non-Residential Customers,” or *Rules*, which required the refund of meter deposits from the effectivity of the said *Rules* on July 5, 2008. Under the *Rules*, a customer has the option of receiving his refund in cash, credit to future monthly billings, or as an offset to other due and demandable claims of the *DU* against him.

The total amount of refund shall be equivalent to the meter deposit paid by the customer plus the total accrued interest earned from the time the customer paid the meter deposit until the day prior to the start of refund.

On August 8, 2008, in compliance with the *Rules*, *MERALCO* submitted to the *ERC* an accounting of the total meter deposit principal amount for refund. The actual refund of meter deposits commenced on November 3, 2008.

As at June 30, 2014 and December 31, 2013, total meter deposits refunded by *MERALCO* amounted to ₱2,591 million (inclusive of ₱1,345 million interest) and ₱977 million (inclusive of ₱503 million interest), respectively.

## 19. Provisions

Provisions consist of amounts recognized for probable costs, charges and expenses relating to claims against the *MERALCO Group*, among others. The movements follow:

|                                | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|--------------------------------|---------------------------------|-----------------------------------|
|                                | <i>(Amounts in millions)</i>    |                                   |
| Balance at beginning of period | ₱24,729                         | ₱19,411                           |
| Provisions                     | 2,236                           | 5,331                             |
| Settlements                    | (33)                            | (13)                              |
| Balance at end of period       | ₱26,932                         | ₱24,729                           |

The balance of provisions substantially represents the amounts of claims related to a commercial contract which remains unresolved and local taxes being contested as discussed in Note 29, consistent with the limited disclosure as allowed in *PFRS*.

See Note 29 – *Contingencies and Legal Proceedings*.

## 20. Customers' Refund

This account represents the balance of the refund related to the *SC* decision promulgated on April 30, 2003, which has not yet been claimed by the customers.

In June 2003, the *ERC*, in the implementation of the *SC* decision, ordered *MERALCO* to refund to its customers an equivalent ₱0.167 per *kWh* for billings made from February 1994 to April 2003.

On February 7, 2011, the *ERC* approved *MERALCO*'s proposal for the extension of the *SC* refund process for five (5) years up to December 31, 2015, in view of difficulties encountered by the customers in meeting the necessary documentation requirements to claim a refund and by *MERALCO* in contacting or locating terminated customers entitled to the refund.

## 21. Notes Payable

Notes payable represent unsecured interest-bearing working capital loans obtained from various local banks. Annual interest rates ranged from 2.5% to 5.5% in 2014 and 1.5% to 3.9% in 2013 on peso-denominated loans.

Interest expense on notes payable amounted to ₱3 million and ₱39 million for the six months ended June 30, 2014 and 2013, respectively.

See Note 25 – *Expenses and Income*.

## 22. Trade Payables and Other Current Liabilities

This account consists of the following:

|                                      | Note      | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|--------------------------------------|-----------|---------------------------------|-----------------------------------|
| <i>(Amounts in millions)</i>         |           |                                 |                                   |
| Trade accounts payable               | 23 and 25 | <b>₱38,157</b>                  | ₱43,893                           |
| Output VAT - net                     |           | <b>7,010</b>                    | 5,508                             |
| Accrued expenses:                    |           |                                 |                                   |
| Employee benefits                    |           | <b>1,699</b>                    | 3,659                             |
| Taxes                                |           | <b>1,774</b>                    | 1,795                             |
| Interest                             |           | <b>36</b>                       | 269                               |
| Others                               |           | <b>864</b>                      | 876                               |
| Current portions of:                 |           |                                 |                                   |
| Bill deposits and related interests  | 18        | <b>7,425</b>                    | 6,130                             |
| Meter deposits and related interests | 18        | <b>505</b>                      | 2,119                             |
| Deferred lease income                |           | <b>710</b>                      | 726                               |
| Refundable service extension costs   |           | <b>1,614</b>                    | 1,615                             |
| Dividends payable on:                |           |                                 |                                   |
| Common stock                         | 15        | <b>75</b>                       | 91                                |
| Redeemable preferred stock           | 17        | <b>250</b>                      | 250                               |
| Universal charges payable            |           | <b>1,801</b>                    | 1,547                             |
| Refundable transmission charges      |           | <b>2,418</b>                    | 779                               |
| Reinsurance liability                |           | <b>43</b>                       | 215                               |
| Regulatory fees payable              |           | <b>325</b>                      | 205                               |
| Other current liabilities            |           | <b>1,336</b>                    | 4,215                             |
|                                      |           | <b>₱66,042</b>                  | ₱73,892                           |

### *Trade Accounts Payable*

Trade accounts payable mainly represent obligations to NPC/Power Sector Assets and Liabilities Management Corporation or *PSALM*, power generating companies, National Grid Corporation of the Philippines or *NGCP*, and Philippine Electricity Market Corporation or *PEMC*, for cost of power purchased and for cost of transmission. In addition, this account includes liabilities due to local and foreign suppliers for purchases of goods and services, which consist of transformers, poles, materials and supplies and, contracted services.

Trade payables are noninterest-bearing and are generally settled within the 15- to 60-day trade term. Other payables are noninterest-bearing and are due within six (6) months from incurrence.

See Note 23 – *Related Party Transactions* and Note 30 - *Significant Contracts and Commitments*.

#### *Refundable Service Extension Costs*

Article 14 of the *Magna Carta*, specifically, “Right to Extension of Lines and Facilities,” requires a customer requesting for an extension of lines and facilities beyond 30-meter service distance from the nearest voltage facilities of the *DU* to advance the cost of the project. The amended *DSOAR*, which became effective April 1, 2010 requires such advances from customers to be refunded at the rate of 75% of the distribution revenue generated from the extension lines and facilities until such amounts are fully refunded. The related asset forms part of the rate base only at the time a refund has been paid out. Customer advances are noninterest-bearing.

As at June 30, 2014 and December 31, 2013, the noncurrent portion of refundable service extension costs of ₱6,632 million and ₱5,782 million, respectively, is presented as “Refundable Service Extension Costs - net of current portion” account in the consolidated statements of financial position.

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### **23. Related Party Transactions**

The following summarizes the total amount of transactions, which have been provided and/or contracted by the *MERALCO Group* to/with related parties for the relevant financial year. The outstanding balances are unsecured, non-interest bearing and settled in cash.

#### *Pole Attachment Contracts with Philippine Long Distance Telephone Company or PLDT*

*MERALCO* has a Pole Attachment Contract with *PLDT* similar to third party pole attachment contracts of *MERALCO* with other telecommunication companies. Under the Pole Attachment Contract, *PLDT* shall use the contacted cable position exclusively for its telecommunication cable network facilities.

#### *Sale of Electricity under Various Service Contracts*

*MERALCO* sells electricity to related party shareholder groups such as *PLDT*, *Metro Pacific*, *JG Summit* and *SMC* and their respective subsidiaries, and affiliates for their facilities within *MERALCO*’s franchise area. The rates charged to related parties are the same *ERC*-mandated rates applicable to customers within the franchise area.

#### *Purchase of Telecommunication Services from PLDT and Subsidiaries*

The *MERALCO Group*’s primary telecommunications carriers are *PLDT* for its wireline and *SMART* and Digitel Mobile Philippines, Inc., for its wireless services. Such services are covered by standard service contracts between the telecommunications carriers and each legal entity within the *MERALCO Group*.

### *Purchase of Goods and Services*

In the ordinary course of business, the *MERALCO Group* purchases goods and services from its affiliates and sells power to such affiliates.

Following is the summary of related party transactions for the six months ended June 30, 2014 and 2013 and the outstanding balances as at June 30, 2014 and December 31, 2013:

| Category                                                              | Outstanding Receivable<br>(Liability)                         |        |                              |                                | Terms                          | Conditions                  |
|-----------------------------------------------------------------------|---------------------------------------------------------------|--------|------------------------------|--------------------------------|--------------------------------|-----------------------------|
|                                                                       | Amount of Transactions<br>For the Six Months Ended<br>June 30 |        |                              |                                |                                |                             |
|                                                                       | 2014                                                          | 2013   | June 30, 2014<br>(Unaudited) | December 31, 2013<br>(Audited) |                                |                             |
| (Amounts in millions)                                                 |                                                               |        |                              |                                |                                |                             |
| Sale of electricity:                                                  |                                                               |        |                              |                                |                                |                             |
| <i>PLDT Group</i>                                                     | ₱1,445                                                        | ₱1,464 | ₱292                         | ₱160                           | 10-day;<br>noninterest-bearing | Unsecured,<br>no impairment |
| <i>SMC Group</i>                                                      | 487                                                           | 513    | 35                           | 59                             | 10-day;<br>noninterest-bearing | Unsecured,<br>no impairment |
| <i>Metro Pacific Group</i>                                            | 185                                                           | 256    | 23                           | 15                             | 10-day;<br>noninterest-bearing | Unsecured,<br>no impairment |
| <i>JG Summit Group</i>                                                | 928                                                           | -      | 271                          | 293                            | 10-day;<br>noninterest-bearing | Unsecured,<br>no impairment |
| Purchases of IT services -<br><i>Indra Philippines</i>                | 149                                                           | 264    | (7)                          | (2)                            | 30-day;<br>noninterest-bearing | Unsecured                   |
| Purchases of meters and<br>devices - <i>GEPMICI</i>                   | 127                                                           | 138    | (11)                         | -                              | 30-day;<br>noninterest-bearing | Unsecured                   |
| Revenue from pole<br>attachment - <i>PLDT</i>                         | 244                                                           | 480    | 2                            | -                              | Advance payment                | Unsecured,<br>no impairment |
| Purchases of wireline and<br>wireless services -<br><i>PLDT Group</i> | 26                                                            | 13     | -                            | -                              | 30-day;<br>noninterest-bearing | Unsecured                   |
| Purchases of power:                                                   |                                                               |        |                              |                                |                                |                             |
| South Premiere Power<br>Corporation or <i>SPPC</i>                    | -                                                             | 17,904 | -                            | (2,893)                        | 30-day;<br>noninterest-bearing | Unsecured                   |
| San Miguel Energy<br>Corporation or <i>SMEC</i>                       | -                                                             | 6,901  | -                            | (951)                          | 30-day;<br>noninterest-bearing | Unsecured                   |

### *Advances to FPM Power*

On March 22, 2013, *FPM Power* availed a loan from *MPG Asia Limited* amounting to US\$110 million which is payable on demand. The loan is outstanding as at June 30, 2014.

### *Transaction with MERALCO Pension Fund*

*MERALCO Pension Fund* holds 6,000 common shares of *RP Energy* at ₱100 par value per share, with total carrying amount of ₱600,000 or an equivalent 3% equity interest in *RP Energy*. The fair value of *RP Energy*'s common shares cannot be reliably measured as these are not traded in the financial market. As at June 30, 2014, the fair value of the total assets being managed by *MERALCO Pension Fund* amounted to ₱35.1 billion.

See Note 26 – Long-Term Employee Benefits.

*Compensation of Key Management Personnel*

The compensation of key management personnel of the *MERALCO Group* by benefit type is as follows:

|                                                | Unaudited                           |      |                                       |      |
|------------------------------------------------|-------------------------------------|------|---------------------------------------|------|
|                                                | For the Six Months<br>Ended June 30 |      | For the Three Months<br>Ended June 30 |      |
|                                                | 2014                                | 2013 | 2014                                  | 2013 |
|                                                | <i>(Amounts in millions)</i>        |      |                                       |      |
| Short-term employee benefits                   | <b>₱315</b>                         | ₱317 | <b>₱190</b>                           | ₱104 |
| Long-term employee and retirement benefits     | <b>22</b>                           | 34   | <b>11</b>                             | 17   |
| Total compensation to key management personnel | <b>₱337</b>                         | ₱351 | <b>₱201</b>                           | ₱121 |

Each of the directors is entitled to a per diem of ₱120,000 for every *BOD* meeting attended. Each member of the Audit and Risk Management, Remuneration and Leadership Development, Finance, Governance and Nomination Committees is entitled to a fee of ₱20,000 for every committee meeting attended.

On March 22, 2013, the *BOD* approved the amendment of *MERALCO's* By-Laws which entitles all directors to a reasonable per diem for their attendance in meetings of the *BOD* and Board Committees plus an additional compensation provided, the total value of such additional compensation, in whatever form so given, shall not exceed one percent of the net income before tax of *MERALCO* during the preceding year.

Consistent with the foregoing, the *BOD* approved the increase in the compensation of all members of the *BOD* up to a maximum of pre-agreed amount per annum. The increase in compensation shall be through a stock grant based on a pre-approved number of shares for each director. The implementation of such plan was approved by the stockholders in the annual general meeting of stockholders on May 28, 2013.

There are no agreements between the *MERALCO Group* and any of its key management personnel providing for benefits upon termination of employment or retirement, except with respect to benefits provided under the pension and provident plans. The Pension Plan covers employees hired up to December 31, 2003 only. The Provident Plan, which is implemented on a voluntary basis, covers employees hired beginning January 1, 2004.

## 24. Revenues and Purchased Power

### *Sale of Electricity*

Electricity revenues account for 98% of the total revenues in 2014 and 2013. Following is the breakdown of electricity revenues:

|                                           | Unaudited                        |                 |                                    |                |
|-------------------------------------------|----------------------------------|-----------------|------------------------------------|----------------|
|                                           | For the Six Months Ended June 30 |                 | For the Three Months Ended June 30 |                |
|                                           | 2014                             | 2013            | 2014                               | 2013           |
|                                           | <i>(Amounts in millions)</i>     |                 |                                    |                |
| Generation charge                         | ₱77,287                          | ₱89,118         | ₱46,699                            | ₱48,671        |
| Transmission charge                       | 16,296                           | 14,265          | 8,520                              | 7,341          |
| System loss charge                        | 7,340                            | 8,334           | 4,500                              | 4,151          |
| Power Act Reduction adjustment            | —                                | (7)             | —                                  | (3)            |
| Interclass, lifeline subsidies and others | 117                              | 80              | 239                                | 146            |
| Distribution service charges              | 28,680                           | 27,907          | 15,717                             | 15,230         |
|                                           | <b>₱129,720</b>                  | <b>₱139,697</b> | <b>₱75,675</b>                     | <b>₱75,536</b> |

Distribution service revenue accounted for 22% and 20% of total electricity revenues for the six months ended June 30, 2014 and 2013 respectively. *VAT*, *LFT* and universal charges, which are also pass-through charges are billed and collected on behalf of the national and local governments and do not form part of total electricity revenues.

See Note 6 – Segment Information.

### *Purchased Power*

The details of purchased power are as follows:

|                     | Unaudited                        |                 |                                    |                |
|---------------------|----------------------------------|-----------------|------------------------------------|----------------|
|                     | For the Six Months Ended June 30 |                 | For the Three Months Ended June 30 |                |
|                     | 2014                             | 2013            | 2014                               | 2013           |
|                     | <i>(Amounts in millions)</i>     |                 |                                    |                |
| Generation charge   | ₱82,552                          | ₱96,289         | ₱49,576                            | ₱52,341        |
| Transmission charge | 17,721                           | 15,286          | 9,382                              | 7,645          |
|                     | <b>₱100,273</b>                  | <b>₱111,575</b> | <b>₱58,958</b>                     | <b>₱59,986</b> |

Purchased power costs are pass-through costs and are revenue-neutral to *MERALCO* and *CEDC*, as *DUs*.

Generation charge is inclusive of line rentals, market fees and must-run unit charges billed by *PEMC*.

Purchased power includes capacity fees, fixed operating fees and transmission line fees that are accounted for similar to a lease under Philippine Interpretation *IFRIC 4*, “*Determining whether an arrangement contains a lease*”. The total amounts billed by the suppliers presented as part of

“Purchased power” account in the interim consolidated statements of income are ₱21,428 million and ₱23,169 million for the six months ended June 30, 2014 and 2013, respectively. This also includes the actual *SL* incurred but no more than 8.5%. *MERALCO*’s actual 12 months moving average *SL* rates are 6.68% and 6.85% for the six months ended June 30, 2014 and 2013, respectively.

The details of purchased power follow:

|                                                                                                                            | Unaudited                    |          |                            |         |
|----------------------------------------------------------------------------------------------------------------------------|------------------------------|----------|----------------------------|---------|
|                                                                                                                            | For the Six Months Ended     |          | For the Three Months Ended |         |
|                                                                                                                            | June 30                      |          | June 30                    |         |
|                                                                                                                            | 2014                         | 2013     | 2014                       | 2013    |
|                                                                                                                            | <i>(Amounts in millions)</i> |          |                            |         |
| First Gas Power Corporation or <i>FGPC</i> and<br>FGP Corp. or <i>FGP</i>                                                  | ₱26,539                      | ₱27,511  | ₱13,185                    | ₱14,300 |
| <i>SPPC</i>                                                                                                                | 18,612                       | 17,902   | 9,911                      | 9,314   |
| <i>TransCo/NGCP</i>                                                                                                        | 17,607                       | 15,262   | 9,293                      | 7,620   |
| <i>PEMC/ WESM</i>                                                                                                          | (133)                        | 10,662   | 6,174                      | 7,612   |
| <i>SMEC</i>                                                                                                                | 7,297                        | 7,743    | 3,634                      | 3,922   |
| <i>QPPL</i>                                                                                                                | 7,342                        | 6,968    | 3,827                      | 3,591   |
| Masinloc Power Partners Co. Ltd. or <i>MPPCL</i>                                                                           | 6,765                        | 6,064    | 3,592                      | 3,179   |
| Therma Luzon, Inc. or <i>TLI</i>                                                                                           | 4,973                        | 6,889    | 2,178                      | 3,967   |
| Sem-Calaca Power Corporation or <i>Sem-Calaca</i>                                                                          | 4,518                        | 5,164    | 2,849                      | 2,776   |
| <i>NPC/PSALM (including NPC Successor<br/>Generating Companies or<br/>SGCs/Independent Power Plant<br/>Administrators)</i> | 2,422                        | 4,592    | 1,200                      | 2,326   |
| <i>AP Renewables</i>                                                                                                       | –                            | 1,795    | –                          | 772     |
| <i>Others</i>                                                                                                              | 4,331                        | 1,023    | 3,115                      | 607     |
|                                                                                                                            | ₱100,273                     | ₱111,575 | ₱58,958                    | ₱59,986 |

In March 2014, *MERALCO* received from *PEMC* a billing adjustment amounting to ₱9.3 billion for power purchases from *WESM* in December 2013 based on an order of the *ERC*, resulting in negative purchased power cost from *PEMC/WESM* for the six months ended June 30, 2014. Settlement of the *PEMC* billing adjustment is pending final advice from the *ERC*.

Generation and transmission cost over/under-recoveries occur as a result of the lag in the billing and recovery of generation and transmission costs from consumers. As at June 30, 2014 and December 31, 2013, the total transmission cost over-recoveries included in “Other noncurrent liabilities” account in the consolidated statements of financial position amounted to ₱6,732 million and ₱6,358 million, respectively.

## 25. Expenses and Income

### *Salaries, Wages and Employee Benefits*

|                                               |      | Unaudited                           |               |                                       |               |
|-----------------------------------------------|------|-------------------------------------|---------------|---------------------------------------|---------------|
|                                               |      | For the Six Months Ended<br>June 30 |               | For the Three Months Ended<br>June 30 |               |
|                                               | Note | 2014                                | 2013          | 2014                                  | 2013          |
| <i>(Amounts in millions)</i>                  |      |                                     |               |                                       |               |
| Salaries, wages and related employee benefits |      | <b>₱4,703</b>                       | <b>₱4,815</b> | <b>₱2,363</b>                         | <b>₱2,594</b> |
| Pension                                       | 26   | <b>625</b>                          | <b>624</b>    | <b>329</b>                            | <b>314</b>    |
| Other long-term post-employment benefits      | 26   | <b>58</b>                           | <b>138</b>    | <b>29</b>                             | <b>69</b>     |
|                                               |      | <b>₱5,386</b>                       | <b>₱5,577</b> | <b>₱2,721</b>                         | <b>₱2,977</b> |

### *Other Expenses*

|                              |      | Unaudited                           |               |                                       |             |
|------------------------------|------|-------------------------------------|---------------|---------------------------------------|-------------|
|                              |      | For the Six Months Ended<br>June 30 |               | For the Three Months Ended<br>June 30 |             |
|                              | Note | 2014                                | 2013          | 2014                                  | 2013        |
| <i>(Amounts in millions)</i> |      |                                     |               |                                       |             |
| Inventories                  | 13   | <b>₱432</b>                         | <b>₱366</b>   | <b>₱115</b>                           | <b>₱209</b> |
| Rent and utilities           |      | <b>352</b>                          | <b>335</b>    | <b>200</b>                            | <b>193</b>  |
| Transportation and travel    |      | <b>181</b>                          | <b>182</b>    | <b>97</b>                             | <b>111</b>  |
| Insurance                    |      | <b>167</b>                          | <b>130</b>    | <b>96</b>                             | <b>66</b>   |
| Advertising                  |      | <b>151</b>                          | <b>17</b>     | <b>122</b>                            | <b>—</b>    |
| Communication                | 23   | <b>40</b>                           | <b>38</b>     | <b>14</b>                             | <b>20</b>   |
| Others                       |      | <b>452</b>                          | <b>548</b>    | <b>315</b>                            | <b>336</b>  |
|                              |      | <b>₱1,775</b>                       | <b>₱1,616</b> | <b>₱959</b>                           | <b>₱935</b> |

### *Interest and Other Financial Charges*

|                                                                                                   |          | Unaudited                           |             |                                       |             |
|---------------------------------------------------------------------------------------------------|----------|-------------------------------------|-------------|---------------------------------------|-------------|
|                                                                                                   |          | For the Six Months Ended<br>June 30 |             | For the Three Months Ended<br>June 30 |             |
|                                                                                                   | Note     | 2014                                | 2013        | 2014                                  | 2013        |
| <i>(Amounts in millions)</i>                                                                      |          |                                     |             |                                       |             |
| Interest expense on interest-bearing long-term financial liabilities, net of interest capitalized | 7 and 17 | <b>₱690</b>                         | <b>₱509</b> | <b>₱347</b>                           | <b>₱246</b> |
| Interest expense on bill deposits                                                                 | 18       | <b>27</b>                           | <b>47</b>   | <b>13</b>                             | <b>24</b>   |
| Interest expense on notes payable                                                                 | 21       | <b>3</b>                            | <b>39</b>   | <b>2</b>                              | <b>21</b>   |
| Carrying charge on ERC-approved over-recoveries                                                   |          | <b>10</b>                           | <b>53</b>   | <b>10</b>                             | <b>28</b>   |
| Amortization of debt issuance costs                                                               | 17       | <b>32</b>                           | <b>9</b>    | <b>17</b>                             | <b>3</b>    |
| Others                                                                                            |          | <b>77</b>                           | <b>51</b>   | <b>15</b>                             | <b>13</b>   |
|                                                                                                   |          | <b>₱839</b>                         | <b>₱708</b> | <b>₱404</b>                           | <b>₱335</b> |

*Interest and Other Financial Income*

|                                                 | Unaudited                    |      |                            |      |
|-------------------------------------------------|------------------------------|------|----------------------------|------|
|                                                 | For the Six Months Ended     |      | For the Three Months Ended |      |
|                                                 | June 30                      |      | June 30                    |      |
|                                                 | 2014                         | 2013 | 2014                       | 2013 |
|                                                 | <i>(Amounts in millions)</i> |      |                            |      |
| Interest income on cash and cash equivalents    | ₱310                         | ₱662 | ₱172                       | ₱265 |
| Carrying costs on ERC-approved under-recoveries | 18                           | 15   | 5                          | 7    |
| Others                                          | 1                            | 55   | 1                          | 49   |
|                                                 | ₱329                         | ₱732 | ₱178                       | ₱321 |

**26. Long-term Employee Benefits**

Liabilities for long-term employee benefits consist of the following:

|                                          | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|------------------------------------------|---------------------------------|-----------------------------------|
|                                          | <i>(Amounts in millions)</i>    |                                   |
| Long-term incentives                     | ₱1,883                          | ₱1,205                            |
| Pension liability                        | 1,007                           | 1,186                             |
| Other long-term post-employment benefits | 1,850                           | 1,792                             |
|                                          | ₱4,740                          | ₱4,183                            |

*Retirement Plan*

The features of the *MERALCO Group's* defined benefit plans are discussed in *Note 4 – Significant Accounting Policies, Changes and Improvements*.

Actuarial valuations are prepared annually by the respective independent actuaries engaged by *MERALCO* and its subsidiaries.

*Expense recognized for defined benefit plans (included in "Salaries, wages and employee benefits" account)*

|                       | Unaudited                    |      |                            |      |
|-----------------------|------------------------------|------|----------------------------|------|
|                       | For the Six Months Ended     |      | For the Three Months Ended |      |
|                       | June 30                      |      | June 30                    |      |
|                       | 2014                         | 2013 | 2014                       | 2013 |
|                       | <i>(Amounts in millions)</i> |      |                            |      |
| Current service costs | ₱532                         | ₱521 | ₱272                       | ₱260 |
| Net interest costs    | 89                           | 101  | 55                         | 53   |
| Net pension expense   | ₱621                         | ₱622 | ₱327                       | ₱313 |

*Pension Liability*

|                            | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|----------------------------|---------------------------------|-----------------------------------|
|                            | <i>(Amounts in millions)</i>    |                                   |
| Defined benefit obligation | ₱36,094                         | ₱35,225                           |
| Fair value of plan assets  | (35,087)                        | (34,039)                          |
| Pension liability          | ₱1,007                          | ₱1,186                            |

Changes in the net pension liability are as follows:

|                                          | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|------------------------------------------|---------------------------------|-----------------------------------|
|                                          | <i>(Amounts in millions)</i>    |                                   |
| Pension liability at beginning of period | ₱1,186                          | ₱3,279                            |
| Net pension costs                        | 621                             | 1,171                             |
| Amounts recognized in <i>OCI</i>         | —                               | (278)                             |
| Contributions by employer                | (800)                           | (2,986)                           |
| Pension liability                        | ₱1,007                          | ₱1,186                            |

Changes in the present value of the defined benefit obligation are as follows:

|                                                   | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|---------------------------------------------------|---------------------------------|-----------------------------------|
|                                                   | <i>(Amounts in millions)</i>    |                                   |
| Defined benefit obligation at beginning of period | ₱35,225                         | ₱33,811                           |
| Interest costs                                    | 1,262                           | 1,999                             |
| Current service costs                             | 532                             | 1,041                             |
| Benefits paid                                     | (925)                           | (1,693)                           |
| Actuarial losses (gains) due to:                  |                                 |                                   |
| Changes in financial assumptions                  | —                               | 671                               |
| Experience adjustments                            | —                               | (604)                             |
| Defined benefit obligation at end of period       | ₱36,094                         | ₱35,225                           |

Changes in the fair value of plan assets are as follows:

|                                                                                                              | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|--------------------------------------------------------------------------------------------------------------|---------------------------------|-----------------------------------|
| <i>(Amounts in millions)</i>                                                                                 |                                 |                                   |
| Fair value of plan assets at beginning of period                                                             | <b>₱34,039</b>                  | ₱30,532                           |
| Benefits paid                                                                                                | <b>(925)</b>                    | (1,693)                           |
| Interest income                                                                                              | <b>765</b>                      | 1,869                             |
| Return on plan assets, excluding amount<br>included in net interest on the net defined<br>benefit obligation | <b>408</b>                      | 345                               |
| Contributions by employer                                                                                    | <b>800</b>                      | 2,986                             |
| Fair value of plan assets at end of period                                                                   | <b>₱35,087</b>                  | ₱34,039                           |

The Board of Trustees or *BOT*, which manages the retirement benefit fund, is chaired by the chairman of *MERALCO*, who is neither an executive nor a beneficiary. The other members of the *BOT* are (i) an independent member of the *BOD*; (ii) a member of the *BOD* who represents the largest shareholder group; (iii) an executive member of the *BOD*; (iv) two (2) senior executives; and (v) a non-executive, non-*BOD* member who represents another shareholder group, all of whom are non-beneficiaries of the Plan.

The Fund follows a generally conservative investment approach where investments are diversified to minimize risks but ensures an increase in value of the Fund assets. Substantially all of the funds of the Plan are managed by four (4) trustee banks whose common objective is to maximize the long-term expected return of plan assets. As approved by the *BOT*, the funds are invested in a guided proportion of fixed income instruments, cash investments and equities.

Net carrying amount and fair value of the assets of the fund as at June 30, 2014 and December 31, 2013 amounted to ₱35,087 million and ₱34,039 million, respectively. The major categories of plan assets are as follows:

|                                                     | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|-----------------------------------------------------|---------------------------------|-----------------------------------|
| <i>(Amount in millions)</i>                         |                                 |                                   |
| Cash and cash equivalents                           | <b>₱4,579</b>                   | ₱5,637                            |
| Investments quoted in active markets:               |                                 |                                   |
| Quoted equity investments                           |                                 |                                   |
| Holding firms                                       | <b>2,192</b>                    | 1,950                             |
| Electricity, energy, power and water                | <b>1,206</b>                    | 1,155                             |
| Food, beverages and tobacco                         | <b>992</b>                      | 908                               |
| Banks                                               | <b>663</b>                      | 713                               |
| Property                                            | <b>620</b>                      | 608                               |
| Telecommunication                                   | <b>780</b>                      | 607                               |
| Transportation services                             | <b>328</b>                      | 283                               |
| Construction, infrastructure and allied<br>services | <b>67</b>                       | 82                                |

|                           | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|---------------------------|---------------------------------|-----------------------------------|
|                           | (Amount in millions)            |                                   |
| Financial institution     | 75                              | 81                                |
| Gaming                    | 8                               | 75                                |
| Mining                    | 63                              | 66                                |
| Retail                    | 57                              | 44                                |
| Media                     | 30                              | 31                                |
| Hotel and leisure         | 37                              | 15                                |
| Others                    | 416                             | 325                               |
| Quoted debt investments   |                                 |                                   |
| Government securities     | 10,674                          | 11,385                            |
| “AAA” rated securities    | 9,665                           | 7,399                             |
| Unquoted investments      |                                 |                                   |
| Receivables               | 1,681                           | 1,721                             |
| Property                  | 954                             | 954                               |
| Fair value of plan assets | ₱35,087                         | ₱34,039                           |

Marketable equity securities, government securities, bonds and commercial notes are investments held by the trustee banks. The Fund does not have any direct equity interests in *MERALCO*.

*Other Long-term Post-employment Benefits (included as part of “Salaries, wages and employee benefits” account)*

|                       | Unaudited                           |      |                                       |      |
|-----------------------|-------------------------------------|------|---------------------------------------|------|
|                       | For the Six Months Ended<br>June 30 |      | For the Three Months Ended<br>June 30 |      |
|                       | 2014                                | 2013 | 2014                                  | 2013 |
|                       | (Amounts in millions)               |      |                                       |      |
| Interest costs        | ₱40                                 | ₱90  | ₱20                                   | ₱45  |
| Current service costs | 18                                  | 48   | 9                                     | 24   |
|                       | ₱58                                 | ₱138 | ₱29                                   | ₱69  |

*Other Long-term Post-employment Benefits Liability*

Changes in the present value of other long-term post-employment benefits liability are as follows:

|                                              | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|----------------------------------------------|---------------------------------|-----------------------------------|
|                                              | (Amounts in millions)           |                                   |
| Balance at beginning of period               | ₱1,792                          | ₱2,962                            |
| Interest costs                               | 40                              | 178                               |
| Current service costs                        | 18                              | 80                                |
| Benefits paid                                | —                               | (53)                              |
| Actuarial gains due to change in assumptions | —                               | (1,375)                           |
| Balance at end of period                     | ₱1,850                          | ₱1,792                            |

### *Actuarial Assumptions*

The principal assumptions used as at June 30, 2014 and December 31, 2013 in determining pension and other long-term post-employment benefits obligations are shown below:

|                                         | 2014       | 2013       |
|-----------------------------------------|------------|------------|
| Annual discount rate                    | 4.5%       | 4.5%       |
| Future range of annual salary increases | 6.0%–10.0% | 6.0%–10.0% |

### *Funding*

MERALCO contributes to the Fund from time to time such amounts of money required under accepted actuarial principles to maintain the Fund in a sound condition, subject to the provisions of the Plan.

The amount of the annual contributions to the Fund is determined through an annual valuation report performed by the actuary.

MERALCO expects to contribute ₱1,690 million to its defined benefit pension plan in 2014.

The following is the maturity profile of the undiscounted benefit obligation:

|                                  | (Amounts in millions) |
|----------------------------------|-----------------------|
| Less than one year               | ₱1,316                |
| More than one year to five years | 6,343                 |
| More than five years to 10 years | 6,453                 |
| More than 10 years to 15 years   | 6,992                 |
| More than 15 years to 20 years   | 6,891                 |
| More than 20 years               | 16,261                |

### *Risk*

The Fund is exposed to the following risks:

#### Credit Risk

The Fund's exposure to credit risk arises from its financial assets which comprise cash and cash equivalents, investments and rental receivable. The credit risk results from the possible default of the issuer of the financial instrument, with a maximum exposure equivalent to the carrying amount of the instruments.

The credit risk is minimized by ensuring that the exposure to the various chosen financial investment structures is limited primarily to government securities and bonds or notes duly recommended by the Trust Committees of the Fund of the appointed fund managers.

#### Share Price Risk

The Pension Fund's exposure to share price risk arises from the shares of stock it holds and being traded at the PSE. The price risk emanates from the volatility of the stock market.

The policy is to limit investment in shares of stock to blue chip issues or issues with good fair values or those trading at a discount to its net asset value so that in the event that market falls drastically, the Pension Fund may still consider to hold on to such investments until the market recovers.

By having a balanced composition of holdings in the equities portfolio, exposure to industry or sector-related risks is reduced. The mix of various equities in the portfolio reduces volatility and contributes to a more stable return over time. Equity investments are made within the parameters of the investment guidelines approved by the BOT. The BOT also meets periodically to review the investment portfolio based on financial market conditions. Share prices are also monitored regularly.

#### Liquidity Risk

Liquidity risk is the risk that the Pension Fund is unable to meet its payment obligations associated with its financial liabilities when they fall due and to replace funds when they are withdrawn. Liquidity risk is being managed to ensure that adequate fixed income and cash deposits are available to service the financial obligations of the Fund. The schedule of the maturities of fixed income investment assets are staggered by tenure or term. Policies are established to ensure that all financial obligations are met, wherein the timing of the maturities of fixed income investments are planned and matched to the due date of various obligations. Thus, for this investment class, maturities are classified into short-, medium- and long-term. A certain percentage of the portfolio is left in cash to manage liquidity and settle all currently maturing financial obligations.

#### *MERALCO Defined Contribution Provident Plan*

MERALCO has a contributory Provident Plan effective January 1, 2009, intended to be a Supplemental Retirement Benefit for employees hired after 2004, on a voluntary basis. Each qualified employee-member who opts to participate in the plan shall have the option to contribute up to a maximum of 25% of his base salary. MERALCO shall match the member's contribution up to the first 10% of the member's base salary. Upon resignation, the member shall be entitled to the total amount credited to his personal retirement account immediately preceding his actual retirement date, subject to provisions of the Provident Plan. MERALCO's contribution to the Provident Plan amounted to ₱4 million and ₱2 million for the six months ended June 30, 2014 and 2013, respectively.

#### *Consolidated Pension Benefit Cost (included in "Salaries, wages and employee benefits" account)*

|                                                  | Unaudited          |      |                      |      |
|--------------------------------------------------|--------------------|------|----------------------|------|
|                                                  | For the Six Months |      | For the Three Months |      |
|                                                  | Ended June 30      |      | Ended June 30        |      |
|                                                  | 2014               | 2013 | 2014                 | 2013 |
| <i>(Amounts in millions)</i>                     |                    |      |                      |      |
| Expense recognized for defined benefit plans     | ₱621               | ₱622 | ₱327                 | ₱313 |
| Expense recognized for defined contribution plan | 4                  | 2    | 2                    | 1    |
| Pension expense                                  | ₱625               | ₱624 | ₱329                 | ₱314 |

### Long-term Incentive Plan or LTIP

MERALCO's LTIP covers qualified executives and is based on MERALCO Group's achievement of specified level of consolidated core net income approved by the BOD and determined on an aggregate basis for a three year period as well as executives' attainment of a minimum level of performance rating. Executives invited to the plan must serve a minimum uninterrupted period to be entitled to any pay-out.

## 27. Financial Assets and Financial Liabilities

Financial assets consist of cash and cash equivalents and trade and nontrade receivables, which are generated directly from operations. The principal financial liabilities, other than derivatives, consist of bank loans, redeemable preferred shares, trade and nontrade payables, which are incurred to finance operations in the normal course of business. Accounting policies related to financial assets and financial liabilities are set out in *Note 4 – Significant Accounting Policies, Changes and Improvements*.

The following table sets forth the financial assets and financial liabilities as at June 30, 2014 and December 31, 2013:

|                                                                              | Loans<br>and<br>Receivables | Held-to-<br>maturity<br>Investments | Fair<br>Value<br>through<br>Profit<br>or Loss | Held-for-<br>trading | Available-<br>for-sale<br>Financial<br>Assets | Liabilities<br>Carried at<br>Amortized<br>Cost | Total<br>Financial<br>Assets and<br>Liabilities |
|------------------------------------------------------------------------------|-----------------------------|-------------------------------------|-----------------------------------------------|----------------------|-----------------------------------------------|------------------------------------------------|-------------------------------------------------|
| <i>(Amounts in millions)</i>                                                 |                             |                                     |                                               |                      |                                               |                                                |                                                 |
| <b>Assets as at June 30, 2014</b>                                            |                             |                                     |                                               |                      |                                               |                                                |                                                 |
| <i>Noncurrent</i>                                                            |                             |                                     |                                               |                      |                                               |                                                |                                                 |
| Other noncurrent assets                                                      | ₱578                        | ₱129                                | ₱–                                            | ₱–                   | ₱164                                          | ₱–                                             | ₱871                                            |
| <i>Current</i>                                                               |                             |                                     |                                               |                      |                                               |                                                |                                                 |
| Cash and cash equivalents                                                    | 67,053                      | –                                   | –                                             | –                    | –                                             | –                                              | 67,053                                          |
| Trade and other receivables - net                                            | 27,359                      | –                                   | –                                             | –                    | –                                             | –                                              | 27,359                                          |
| Advances to an associate                                                     | 4,801                       | –                                   | –                                             | –                    | –                                             | –                                              | 4,801                                           |
| <b>Total assets</b>                                                          | <b>99,791</b>               | <b>129</b>                          | <b>–</b>                                      | <b>–</b>             | <b>164</b>                                    | <b>–</b>                                       | <b>100,084</b>                                  |
| <b>Liabilities as at June 30, 2014</b>                                       |                             |                                     |                                               |                      |                                               |                                                |                                                 |
| <i>Noncurrent</i>                                                            |                             |                                     |                                               |                      |                                               |                                                |                                                 |
| Interest-bearing long-term financial liabilities -<br>net of current portion | –                           | –                                   | –                                             | –                    | –                                             | 27,579                                         | 27,579                                          |
| Customers' deposits - net of current portion                                 | –                           | –                                   | –                                             | –                    | –                                             | 20,275                                         | 20,275                                          |
| Refundable service extension costs - net of<br>current portion               | –                           | –                                   | –                                             | –                    | –                                             | 6,632                                          | 6,632                                           |
| <i>Current</i>                                                               |                             |                                     |                                               |                      |                                               |                                                |                                                 |
| Notes payable                                                                | –                           | –                                   | –                                             | –                    | –                                             | 368                                            | 368                                             |
| Trade payables and other current liabilities                                 | –                           | –                                   | –                                             | –                    | –                                             | 52,862                                         | 52,862                                          |
| Customers' refund                                                            | –                           | –                                   | –                                             | –                    | –                                             | 5,971                                          | 5,971                                           |
| Current portion of interest-bearing long-term<br>financial liabilities       | –                           | –                                   | –                                             | –                    | –                                             | 2,227                                          | 2,227                                           |
| <b>Total liabilities</b>                                                     | <b>–</b>                    | <b>–</b>                            | <b>–</b>                                      | <b>–</b>             | <b>–</b>                                      | <b>115,914</b>                                 | <b>115,914</b>                                  |
| <b>Net Assets (Liabilities)</b>                                              | <b>₱99,791</b>              | <b>₱129</b>                         | <b>₱–</b>                                     | <b>₱–</b>            | <b>₱164</b>                                   | <b>(₱115,914)</b>                              | <b>(₱15,830)</b>                                |

|                                                                              | Loans<br>and<br>Receivables | Held-to-<br>maturity<br>Investments | Fair<br>Value<br>through<br>Profit<br>or Loss | Held-for-<br>trading | Available-<br>for-sale<br>Financial<br>Assets | Liabilities<br>Carried at<br>Amortized<br>Cost | Total<br>Financial<br>Assets and<br>Liabilities |
|------------------------------------------------------------------------------|-----------------------------|-------------------------------------|-----------------------------------------------|----------------------|-----------------------------------------------|------------------------------------------------|-------------------------------------------------|
| <i>(Amounts in millions)</i>                                                 |                             |                                     |                                               |                      |                                               |                                                |                                                 |
| <b>Assets as at December 31, 2013</b>                                        |                             |                                     |                                               |                      |                                               |                                                |                                                 |
| <i>Noncurrent</i>                                                            |                             |                                     |                                               |                      |                                               |                                                |                                                 |
| Other noncurrent assets                                                      | P474                        | P129                                | P-                                            | P-                   | P161                                          | P-                                             | P764                                            |
| <i>Current</i>                                                               |                             |                                     |                                               |                      |                                               |                                                |                                                 |
| Cash and cash equivalents                                                    | 59,851                      | -                                   | -                                             | -                    | -                                             | -                                              | 59,851                                          |
| Trade and other receivables - net                                            | 28,543                      | -                                   | -                                             | -                    | -                                             | -                                              | 28,543                                          |
| Short-term investments                                                       | 4,841                       | -                                   | -                                             | -                    | -                                             | -                                              | 4,841                                           |
| Advances to an associate                                                     | 4,884                       | -                                   | -                                             | -                    | -                                             | -                                              | 4,884                                           |
| <b>Total assets</b>                                                          | <b>98,593</b>               | <b>129</b>                          | <b>-</b>                                      | <b>-</b>             | <b>161</b>                                    | <b>-</b>                                       | <b>98,883</b>                                   |
| <b>Liabilities as at December 31, 2013</b>                                   |                             |                                     |                                               |                      |                                               |                                                |                                                 |
| <i>Noncurrent</i>                                                            |                             |                                     |                                               |                      |                                               |                                                |                                                 |
| Interest-bearing long-term financial liabilities -<br>net of current portion | -                           | -                                   | -                                             | -                    | -                                             | 20,756                                         | 20,756                                          |
| Customers' deposits - net of current portion                                 | -                           | -                                   | -                                             | -                    | -                                             | 21,600                                         | 21,600                                          |
| Refundable service extension costs - net of<br>current portion               | -                           | -                                   | -                                             | -                    | -                                             | 5,782                                          | 5,782                                           |
| <i>Current</i>                                                               |                             |                                     |                                               |                      |                                               |                                                |                                                 |
| Notes payable                                                                | -                           | -                                   | -                                             | -                    | -                                             | 1,814                                          | 1,814                                           |
| Trade payables and other current liabilities                                 | -                           | -                                   | -                                             | -                    | -                                             | 57,113                                         | 57,113                                          |
| Customers' refund                                                            | -                           | -                                   | -                                             | -                    | -                                             | 6,013                                          | 6,013                                           |
| Current portion of interest-bearing long-term<br>financial liabilities       | -                           | -                                   | -                                             | -                    | -                                             | 11,021                                         | 11,021                                          |
| <b>Total liabilities</b>                                                     | <b>-</b>                    | <b>-</b>                            | <b>-</b>                                      | <b>-</b>             | <b>-</b>                                      | <b>124,099</b>                                 | <b>124,099</b>                                  |
| <b>Net Assets (Liabilities)</b>                                              | <b>P98,593</b>              | <b>P129</b>                         | <b>P-</b>                                     | <b>P-</b>            | <b>P161</b>                                   | <b>(P124,099)</b>                              | <b>(P25,216)</b>                                |

### *Fair Values*

The fair values of the financial assets and financial liabilities are prices that would be received to sell the financial assets or paid to transfer the financial liabilities in orderly transactions between market participants at the measurement date. Set out below is a comparison of carrying amounts and fair values of *MERALCO Group's* financial instruments as at June 30, 2014 and December 31, 2013.

|                                                   | 2014           |             | 2013           |             |
|---------------------------------------------------|----------------|-------------|----------------|-------------|
|                                                   | Carrying Value | Fair Value  | Carrying Value | Fair Value  |
| <i>(Amounts in millions)</i>                      |                |             |                |             |
| <b>Financial assets</b>                           |                |             |                |             |
| Loans and receivables -                           |                |             |                |             |
| Advances to a supplier                            | P578           | P609        | P474           | P522        |
| Available-for-sale financial assets               | 164            | 164         | 161            | 161         |
|                                                   | <b>P742</b>    | <b>P773</b> | <b>P635</b>    | <b>P683</b> |
| <b>Financial liabilities</b>                      |                |             |                |             |
| Financial liabilities carried at amortized cost - |                |             |                |             |
| Interest-bearing long-term financial liabilities  | P29,806        | P30,887     | P31,777        | P32,176     |

The following methods and assumptions were used to estimate the fair value of each class of financial instrument for which it is practicable to estimate such value:

*Cash and Cash Equivalents, Short-term Investments, Trade and Other Receivables, Advances to an Associate, Trade Payables and Other Current Liabilities and Notes Payable*

Due to the short-term nature of transactions, the fair values of these instruments approximate their carrying amounts as at reporting date.

*Advances to a Supplier*

The fair values of advances to a supplier were computed by discounting the instruments' expected future cash flows using the rates of 3.98% as at June 30, 2014 and 3.76% as at December 31, 2013.

*Bifurcated Foreign Currency Forward and Foreign Currency Forward*

The fair values of embedded currency forwards and freestanding currency forwards were calculated by reference to forward exchange market rates.

*AFS Investments*

The fair values were determined by reference to market bid quotes as at reporting date. The unquoted equity securities were carried at cost.

*Meter Deposits and Customers' Refund*

Meter deposits and customers' refund are due and demandable. Thus, the fair values of these instruments approximate their carrying amounts.

*Bill Deposits*

The carrying amount of bill deposits approximates their fair values as bill deposits are interest-bearing.

*Interest-bearing Long-term Financial Liabilities*

The fair values of interest-bearing long-term debt (except for redeemable preferred stock) were computed by discounting the instruments' expected future cash flows using the rates ranging from 1.20% to 4.55% as at June 30, 2014 and 0.52% to 4.29% as of December 31, 2013.

*Redeemable Preferred Stock*

The carrying amount of the preferred stock represents the fair value. Such preferred shares have been called and are payable anytime upon presentation by the shareholder of their certification. This is included under "Interest-bearing long-term financial liabilities" account.

*Refundable Service Extension Costs*

The fair values of refundable service extension costs cannot be reliably measured since the timing of related cash flows cannot be reasonably estimated and are accordingly measured at cost.

*Fair Value Hierarchy*

MERALCO uses the following hierarchy in determining and disclosing the fair value of financial instruments by valuation technique:

- Level 1: quoted (unadjusted) prices in active markets for identical assets or liabilities
- Level 2: other techniques where all inputs have a significant effect on the recorded fair value are observable, either directly or indirectly
- Level 3: techniques where inputs have a significant effect on the recorded fair value that are not based on observable market data

Below is the list of financial assets and financial liabilities that are classified using the fair value hierarchy:

|                                                  | June 30, 2014 (Unaudited)    |           |             |             | December 31, 2013 (Audited) |           |             |             |
|--------------------------------------------------|------------------------------|-----------|-------------|-------------|-----------------------------|-----------|-------------|-------------|
|                                                  | Level 1                      | Level 2   | Level 3     | Total       | Level 1                     | Level 2   | Level 3     | Total       |
|                                                  | <i>(Amounts in millions)</i> |           |             |             |                             |           |             |             |
| <b>Financial assets</b>                          |                              |           |             |             |                             |           |             |             |
| Advances to a supplier                           | P-                           | P-        | P609        | P609        | P-                          | P-        | P522        | P522        |
| <i>AFS</i> investments                           | 130                          | -         | 34          | 164         | 124                         | -         | 37          | 161         |
|                                                  | <b>P130</b>                  | <b>P-</b> | <b>P643</b> | <b>P773</b> | <b>P124</b>                 | <b>P-</b> | <b>P559</b> | <b>P683</b> |
| <b>Financial liabilities</b>                     |                              |           |             |             |                             |           |             |             |
| Interest-bearing long-term financial liabilities | P-                           | P-        | P30,887     | P30,887     | P-                          | P-        | P32,176     | P32,176     |

For the six months ended June 30, 2014 and 2013, there were no transfers between Level 1 and Level 2 fair value measurements, and no transfers into and out of Level 3 fair value measurements.

#### *Financial Risk Management Objectives and Policies*

The main risks arising from the financial instruments are interest rate risk, foreign currency risk, commodity price risk, credit risk and liquidity risk. The importance of managing these risks has significantly increased in light of the considerable change and volatility in the Philippine and international financial markets. The *BOD* reviews and approves policies for managing each of these risks. Management monitors the market price risk arising from all financial instruments. The policies for managing these risks are as follows:

#### *Interest Rate Risk*

The *MERALCO Group's* exposure to the changes in market interest rates relate primarily to the long-term interest-bearing financial liabilities.

The *MERALCO Group's* policy is to manage its interest rate risk exposure using a mix of fixed and variable rate debts. The strategy, which yields a reasonably lower effective cost based on market conditions, is adopted. Refinancing of fixed rate loans may also be undertaken to manage interest cost. Approximately 91% and 90% of the borrowings bear fixed rate of interest as at June 30, 2014 and December 31, 2013, respectively.

The following table sets out the maturity profile of the financial instruments that are exposed to interest rate risk (exclusive of debt issuance costs):

|                              | Within<br>1 Year | Over 1–2<br>Years | Over 2–3<br>Years | Over 3–4<br>Years | Over 4–5<br>Years | More<br>than 5<br>Years | Total  |
|------------------------------|------------------|-------------------|-------------------|-------------------|-------------------|-------------------------|--------|
| <i>(Amounts in millions)</i> |                  |                   |                   |                   |                   |                         |        |
| June 30, 2014 (Unaudited)    | ₱312             | ₱26               | ₱2,425            | ₱–                | ₱–                | ₱–                      | ₱2,763 |
| December 31, 2013 (Audited)  | 612              | 13                | 13                | 12                | 2,425             | –                       | 3,075  |

Floating interest rate of bank loans is repriced at intervals of less than one year. The other financial liabilities of *MERALCO Group* that are not included in the foregoing have fixed interest rate and are therefore not subject to interest rate risk.

The following table demonstrates the sensitivity to a reasonably possible change in interest rates, with all other variables held constant, of *MERALCO's* profit before tax as at June 30, 2014 and December 31, 2014 through the impact on floating rate borrowings. There is no other impact on *MERALCO's* equity other than those already affecting the consolidated statement of income.

|                                        | 2014                                      |                                   | 2013                                      |                                   |
|----------------------------------------|-------------------------------------------|-----------------------------------|-------------------------------------------|-----------------------------------|
|                                        | Increase<br>(Decrease) in<br>Basis Points | Effect on<br>Profit<br>before Tax | Increase<br>(Decrease) in<br>Basis Points | Effect on<br>Profit<br>before Tax |
| <i>(Amounts in millions)</i>           |                                           |                                   |                                           |                                   |
| Floating rate loans from various banks | +100<br>(100)                             | (₱28)<br>28                       | +100<br>(100)                             | (₱31)<br>31                       |

Interest expense of floating rate loans for the year is computed by taking into account actual principal movements, based on management's best estimate of a +/-100 basis points change in interest rates. There has been no change in the methods and assumptions used by the management in the above analysis.

#### *Foreign Currency Risk*

The revaluation of any of foreign currency-denominated financial assets and financial liabilities as a result of the appreciation or depreciation of the Philippine peso is recognized as foreign exchange gains or losses as at the end of each reporting year. The extent of foreign exchange gains or losses is largely dependent on the amount of foreign currency-denominated financial instruments. While an insignificant percentage of the *MERALCO Group's* revenues and liabilities is denominated in U.S. dollars, a substantial portion of the *MERALCO Group's* capital expenditures for electricity capital projects and a portion of the operating expenses are denominated in foreign currencies, mostly in U.S. dollars. As such, a strengthening or weakening of the Philippine peso against the U.S. dollar will decrease or increase in Philippine peso terms, the principal amount of the *MERALCO Group's* foreign currency-denominated liabilities and the related interest expense, foreign currency-denominated capital expenditures and operating expenses as well as U.S. dollar-denominated revenues.

The following table shows the consolidated foreign currency-denominated financial assets and financial liabilities as at June 30, 2014 and December 31, 2013, translated to Philippine peso at ₱43.65 and ₱44.395 to US\$1, respectively.

|                                      | June 30, 2014 (Unaudited) |                 | December 31, 2013 (Audited) |                 |
|--------------------------------------|---------------------------|-----------------|-----------------------------|-----------------|
|                                      | U.S. Dollar               | Peso Equivalent | U.S. Dollar                 | Peso Equivalent |
| <i>(Amounts in millions)</i>         |                           |                 |                             |                 |
| Financial assets:                    |                           |                 |                             |                 |
| Cash and cash equivalents            | \$215                     | ₱9,375          | \$65                        | ₱2,864          |
| Trade and other receivables          | 4                         | 167             | 3                           | 148             |
| Advances to an associate             | 110                       | 4,801           | 110                         | 4,884           |
| Advance payments to a supplier       | 13                        | 575             | 11                          | 474             |
|                                      | 342                       | 14,918          | 189                         | 8,370           |
| Financial liabilities -              |                           |                 |                             |                 |
| Trade payables and other liabilities | (191)                     | (8,339)         | (46)                        | (2,043)         |
|                                      | \$151                     | ₱6,579          | \$143                       | ₱6,327          |

All of *MERALCO*'s long-term financial liabilities are denominated in Philippine peso. However, an insignificant portion of its trade payables are denominated in *U.S.* dollar. Thus, the impact of ₱1 movement of the Philippine Peso against the *U.S.* dollar will not have a significant impact on *MERALCO*'s obligations. Further, *PBR* assumes a forecast level of foreign currency movements in its calculation of the regulatory asset base and expenditures. *PBR* also allows for adjustment of the rates *MERALCO* charges should there be significant deviations in the foreign exchange forecast from what is actually realized.

The following table demonstrates the sensitivity to a reasonably possible change in the *U.S.* dollar exchange rate vis-a-vis the peso, with all other variables held constant, of the *MERALCO Group*'s income before income tax for the six months ended June 30, 2014 and 2013 (due to changes in the fair value of financial assets and financial liabilities). There is no other impact on *MERALCO*'s equity other than those already affecting the profit and loss.

|                                                 | 2014                                                              |                                                                     | 2013                                                              |                                                                     |
|-------------------------------------------------|-------------------------------------------------------------------|---------------------------------------------------------------------|-------------------------------------------------------------------|---------------------------------------------------------------------|
|                                                 | Appreciation<br>(Depreciation)<br>of U.S. Dollar<br><i>(In %)</i> | Effect on<br>Income<br>before Income<br>Tax<br><i>(In millions)</i> | Appreciation<br>(Depreciation)<br>of U.S. Dollar<br><i>(In %)</i> | Effect on<br>Income<br>before Income<br>Tax<br><i>(In millions)</i> |
| <i>U.S.</i> dollar-denominated financial assets | +5                                                                | ₱329                                                                | +5                                                                | ₱317                                                                |
| and financial liabilities                       | -5                                                                | (329)                                                               | -5                                                                | (317)                                                               |

Foreign exchange gain or loss for the year is computed based on management's best estimate of a +/-5 percent change in the closing Philippine peso to *U.S.* dollar conversion rate using the year-end balances of *U.S.* dollar-denominated cash and cash equivalents, receivables and liabilities. There has been no change in the methods and assumptions used by management in the foregoing analysis.

#### *Commodity Price Risk*

Commodity price risk is the risk that the fair value or cash flows of a financial instrument will fluctuate because of changes in commodity prices. The exposure of *MERALCO* and *CEDC* to price risk is minimal. The cost of fuel is part of *MERALCO*'s and *CEDC*'s generation costs that are recoverable through the generation charge in the billings to customers.

### *Credit Risk*

Credit risk is the risk that the *MERALCO Group* is exposed to as a result of its customers, clients or counterparties failing to discharge their contracted obligations. The *MERALCO Group* manages and controls credit risk by setting limits on the amount of risk that it is willing to accept for individual counterparties and by monitoring exposures in relation to such limits.

*MERALCO* as a franchise holder serving public interest cannot refuse customer connection. To mitigate risk, the *DSOAR* allows *MERALCO* to collect bill deposit equivalent to one month's consumption to secure credit. Also, as a policy, disconnection notices are sent three days after the bill due date and disconnections are carried out beginning on the third day after receipt of disconnection notice.

The *MERALCO* subsidiaries trade only with recognized, creditworthy third parties. It is the *MERALCO Group's* policy that all customers who wish to trade on credit terms are subject to credit verification procedures. In addition, receivables are monitored on an ongoing basis to reduce exposure to bad debt.

With respect to placements of cash with financial institutions, these institutions are subject to the *MERALCO Group's* accreditation evaluation based on liquidity and solvency ratios and on the bank's credit rating. The *MERALCO Group* transacts derivatives only with similarly accredited financial institutions. In addition, the *MERALCO Group's* deposit accounts in banks are insured by the Philippine Deposit Insurance Corporation up to ₱500,000 per bank account.

Credit risk on other financial assets, which include cash and cash equivalents, trade and other receivables, short-term investments and certain derivative instruments, arises from the potential default of the counterparty.

Finally, credit quality review procedures are in place to provide regular identification of changes in the creditworthiness of counterparties. Counterparty limits are established and reviewed periodically based on latest available financial information of counterparties, credit ratings and liquidity. The *MERALCO Group's* credit quality review process allows it to assess any potential loss as a result of the risks to which it may be exposed and to take corrective actions.

There are no significant concentrations of credit risk within the *MERALCO Group*.

The table below shows the maximum exposure to credit risk for the components of the consolidated statements of financial position as at June 30, 2014 and December 31, 2013. The maximum exposure is equivalent to the nominal amount of the accounts.

|                                                                              | Gross Maximum Exposure          |                                   |
|------------------------------------------------------------------------------|---------------------------------|-----------------------------------|
|                                                                              | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
| <i>(Amounts in millions)</i>                                                 |                                 |                                   |
| Cash and cash equivalents:                                                   |                                 |                                   |
| Cash in banks                                                                | ₱4,713                          | ₱4,994                            |
| Cash equivalents                                                             | 62,340                          | 54,722                            |
| Trade and other receivables:                                                 |                                 |                                   |
| Billed electricity                                                           | 21,819                          | 24,312                            |
| Service contracts                                                            | 1,683                           | 1,310                             |
| Insurance receivable                                                         | 81                              | 453                               |
| Cost of estimated earnings in excess of billings<br>on uncompleted contracts | 692                             | 455                               |
| Nontrade receivables                                                         | 3,084                           | 2,013                             |
| Other current assets:                                                        |                                 |                                   |
| Short-term investments                                                       | —                               | 4,841                             |
| Advances to an associate                                                     | 4,801                           | 4,884                             |
| Other noncurrent assets:                                                     |                                 |                                   |
| Advance payments to suppliers                                                | 578                             | 474                               |
| HTM investments                                                              | 129                             | 129                               |
|                                                                              | <b>₱99,920</b>                  | <b>₱98,587</b>                    |

The credit quality of financial assets is managed by *MERALCO* using “High Grade,” “Standard Grade” and “Sub-standard Grade” for accounts, which are neither impaired nor past due as internal credit ratings. The following tables show the credit quality by asset class:

|                                                                           | June 30, 2014 (Unaudited)     |                |                    |                           |                           | Total           |
|---------------------------------------------------------------------------|-------------------------------|----------------|--------------------|---------------------------|---------------------------|-----------------|
|                                                                           | Neither Past Due nor Impaired |                |                    | Past Due but not Impaired | Impaired Financial Assets |                 |
|                                                                           | High Grade                    | Standard Grade | Sub-standard Grade |                           |                           |                 |
| <i>(Amounts in millions)</i>                                              |                               |                |                    |                           |                           |                 |
| Cash in banks and cash equivalents                                        | ₱67,053                       | ₱—             | ₱—                 | ₱—                        | ₱—                        | ₱67,053         |
| Trade and other receivables:                                              |                               |                |                    |                           |                           |                 |
| Billed electricity                                                        | 4,420                         | 2,635          | 9,861              | 4,903                     | 3,239                     | 25,058          |
| Service contracts                                                         | 1,588                         | —              | —                  | 95                        | 203                       | 1,886           |
| Insurance receivable                                                      | —                             | —              | 52                 | 29                        | —                         | 81              |
| Cost of estimated earnings in excess of billings on uncompleted contracts | 692                           | —              | —                  | —                         | —                         | 692             |
| Nontrade receivables                                                      | 2,323                         | 121            | 218                | 422                       | 2                         | 3,086           |
| Other current assets:                                                     |                               |                |                    |                           |                           |                 |
| Advances to an associate                                                  | —                             | 4,801          | —                  | —                         | —                         | 4,801           |
| Other noncurrent assets                                                   | —                             | —              | 707                | —                         | —                         | 707             |
|                                                                           | <b>₱76,076</b>                | <b>₱7,557</b>  | <b>₱10,838</b>     | <b>₱5,449</b>             | <b>₱3,444</b>             | <b>₱103,364</b> |

| December 31, 2013 (Audited)                                               |                               |                |                    |                           |                           |          |
|---------------------------------------------------------------------------|-------------------------------|----------------|--------------------|---------------------------|---------------------------|----------|
|                                                                           | Neither Past Due nor Impaired |                |                    | Past Due but not Impaired | Impaired Financial Assets | Total    |
|                                                                           | High Grade                    | Standard Grade | Sub-standard Grade |                           |                           |          |
| (Amounts in millions)                                                     |                               |                |                    |                           |                           |          |
| Cash in banks and cash equivalents                                        | ₱59,716                       | ₱—             | ₱—                 | ₱—                        | ₱—                        | ₱59,716  |
| Trade and other receivables:                                              |                               |                |                    |                           |                           |          |
| Billed electricity                                                        | 6,048                         | 3,583          | 9,064              | 5,616                     | 2,970                     | 27,281   |
| Service contracts                                                         | 1,118                         | —              | —                  | 192                       | 180                       | 1,490    |
| Insurance receivable                                                      | 33                            | —              | 304                | 116                       | —                         | 453      |
| Cost of estimated earnings in excess of billings on uncompleted contracts | 455                           | —              | —                  | —                         | —                         | 455      |
| Nontrade receivables                                                      | 1,883                         | 8              | 20                 | 103                       | 2                         | 2,016    |
| Other current assets:                                                     |                               |                |                    |                           |                           |          |
| Short-term investments                                                    | 4,841                         | —              | —                  | —                         | —                         | 4,841    |
| Advances to an associate                                                  | —                             | 4,884          | —                  | —                         | —                         | 4,884    |
| Other noncurrent assets                                                   | —                             | —              | 603                | —                         | —                         | 603      |
|                                                                           | ₱74,094                       | ₱8,475         | ₱9,991             | ₱6,027                    | ₱3,152                    | ₱101,739 |

Credit ratings are determined as follows:

- “High Grade”

‘High’ grade financial assets include “cash in banks and cash equivalents and derivative assets to counterparties with good credit rating or bank standing. Consequently, credit risk is minimal. These counterparties include large prime financial institutions, large industrial companies and commercial establishments, and government agencies. For trade receivables, these consist of current month’s billings (less than 30 days) that are expected to be collected within 10 days from the time bills are delivered.

- “Standard Grade”

‘Standard’ grade financial assets include trade receivables that consist of current month’s billings (less than 30 days) that are expected to be collected before due date (10 to 14 days after bill date).

- “Sub-standard Grade”

‘Sub-standard’ grade financial assets include trade receivables that consist of current month’s billings, which are not expected to be collected within 60 days.

The following table shows the aging analysis of financial assets as at June 30, 2014 and December 31, 2013:

| June 30, 2014 (Unaudited)                                                     |                                        |                           |               |                 |                                 |          |
|-------------------------------------------------------------------------------|----------------------------------------|---------------------------|---------------|-----------------|---------------------------------|----------|
|                                                                               | Neither<br>Past Due<br>nor<br>Impaired | Past Due But Not Impaired |               |                 | Impaired<br>Financial<br>Assets | Total    |
|                                                                               |                                        | 31-60<br>Days             | 61-90<br>Days | Over<br>90 Days |                                 |          |
| (Amounts in millions)                                                         |                                        |                           |               |                 |                                 |          |
| Cash and cash equivalents:                                                    |                                        |                           |               |                 |                                 |          |
| Cash equivalents                                                              | P4,713                                 | P-                        | P-            | P-              | P-                              | P4,713   |
| Cash in banks                                                                 | 62,340                                 | -                         | -             | -               | -                               | 62,340   |
| Trade and other receivables:                                                  |                                        |                           |               |                 |                                 |          |
| Trade:                                                                        |                                        |                           |               |                 |                                 |          |
| Billed electricity                                                            | 16,916                                 | 1,098                     | 339           | 3,466           | 3,239                           | 25,058   |
| Service contracts                                                             | 1,588                                  | -                         | -             | 95              | 203                             | 1,886    |
| Insurance receivable                                                          | 52                                     | 3                         | 3             | 23              | -                               | 81       |
| Cost and estimated earnings in excess of<br>billings on uncompleted contracts | 692                                    | -                         | -             | -               | -                               | 692      |
| Nontrade receivables                                                          | 2,662                                  | 15                        | 137           | 270             | 2                               | 3,086    |
| Other current assets:                                                         |                                        |                           |               |                 |                                 |          |
| Advances to associate                                                         | 4,801                                  | -                         | -             | -               | -                               | 4,801    |
| Other noncurrent assets:                                                      |                                        |                           |               |                 |                                 |          |
| Advance payments to a supplier                                                | 578                                    | -                         | -             | -               | -                               | 578      |
| HTM investments                                                               | 129                                    | -                         | -             | -               | -                               | 129      |
|                                                                               | P94,471                                | P1,116                    | P479          | P3,854          | P3,444                          | P103,364 |
| December 31, 2013 (Audited)                                                   |                                        |                           |               |                 |                                 |          |
|                                                                               | Neither<br>Past Due<br>nor<br>Impaired | Past Due But Not Impaired |               |                 | Impaired<br>Financial<br>Assets | Total    |
|                                                                               |                                        | 31-60<br>Days             | 61-90<br>Days | Over<br>90 Days |                                 |          |
| (Amounts in millions)                                                         |                                        |                           |               |                 |                                 |          |
| Cash and cash equivalents:                                                    |                                        |                           |               |                 |                                 |          |
| Cash equivalents                                                              | P54,722                                | P-                        | P-            | P-              | P-                              | P54,722  |
| Cash in banks                                                                 | 4,994                                  | -                         | -             | -               | -                               | 4,994    |
| Trade and other receivables:                                                  |                                        |                           |               |                 |                                 |          |
| Trade:                                                                        |                                        |                           |               |                 |                                 |          |
| Billed electricity                                                            | 18,695                                 | 2,068                     | 504           | 3,044           | 2,970                           | 27,281   |
| Service contracts                                                             | 1,118                                  | -                         | -             | 192             | 180                             | 1,490    |
| Insurance receivable                                                          | 337                                    | 5                         | 9             | 102             | -                               | 453      |
| Cost and estimated earnings in excess of<br>billings on uncompleted contracts | 455                                    | -                         | -             | -               | -                               | 455      |
| Nontrade receivables                                                          | 1,911                                  | 22                        | 5             | 76              | 2                               | 2,016    |
| Other current assets:                                                         |                                        |                           |               |                 |                                 |          |
| Short-term investments                                                        | 4,841                                  | -                         | -             | -               | -                               | 4,841    |
| Advances to associate                                                         | 4,884                                  | -                         | -             | -               | -                               | 4,884    |
| Other noncurrent assets:                                                      |                                        |                           |               |                 |                                 |          |
| Advance payments to a supplier                                                | 474                                    | -                         | -             | -               | -                               | 474      |
| HTM investments                                                               | 129                                    | -                         | -             | -               | -                               | 129      |
|                                                                               | P92,560                                | P2,095                    | P518          | P3,414          | P3,152                          | P101,739 |

### Liquidity Risk

Liquidity risk is the risk that the *MERALCO Group* will be unable to meet its payment obligations when these fall due. The *MERALCO Group* manages this risk through monitoring of cash flows in consideration of future payment of obligations and the collection of its trade receivables. The *MERALCO Group* also ensures that there are sufficient, available and approved working capital lines that it can draw from at any time.

The *MERALCO Group* maintains an adequate amount of cash and cash equivalents and government securities, which may be readily converted to cash in any unforeseen interruption of its cash

collections. The *MERALCO Group* also maintains accounts with several relationship banks to avoid significant concentration of funds with one institution.

The following table sets out the maturity profile of the financial liabilities based on contractual undiscounted payments plus future interest:

| June 30, 2014 (Unaudited)                         |                       |                     |                   |                      |                 |
|---------------------------------------------------|-----------------------|---------------------|-------------------|----------------------|-----------------|
|                                                   | Less than<br>3 Months | Over 3–12<br>Months | Over 1–5<br>Years | More than<br>5 Years | Total           |
| <i>(Amounts in millions)</i>                      |                       |                     |                   |                      |                 |
| Notes payable                                     | ₱368                  | ₱–                  | ₱–                | ₱–                   | ₱368            |
| Trade payables and other current liabilities      | 43,319                | –                   | –                 | –                    | 43,319          |
| Customers' refund                                 | 5,971                 | –                   | –                 | –                    | 5,971           |
| Interest-bearing long-term financial liabilities: |                       |                     |                   |                      |                 |
| Floating rate borrowings                          | 22                    | 343                 | 2,612             | –                    | 2,977           |
| Fixed rate borrowings                             | 81                    | 597                 | 2,790             | 6,115                | 9,583           |
| Bonds payable                                     | 211                   | 633                 | 4,222             | 20,452               | 25,518          |
| Redeemable preferred stock                        | 1,554                 | –                   | –                 | –                    | 1,554           |
| Customers' deposits                               | 3,919                 | 4,011               | 4,728             | 15,547               | 28,205          |
| Refundable service extension costs                | –                     | 1,614               | 2,957             | 3,675                | 8,246           |
| <b>Total undiscounted financial liabilities</b>   | <b>₱55,445</b>        | <b>₱7,198</b>       | <b>₱17,309</b>    | <b>₱45,789</b>       | <b>₱125,741</b> |

  

| December 31, 2013 (Audited)                       |                       |                     |                |                      |                 |
|---------------------------------------------------|-----------------------|---------------------|----------------|----------------------|-----------------|
|                                                   | Less than<br>3 Months | Over 3–12<br>Months | Over 1–5 Years | More than<br>5 Years | Total           |
| <i>(Amounts in millions)</i>                      |                       |                     |                |                      |                 |
| Notes payable                                     | ₱1,814                | ₱–                  | ₱–             | ₱–                   | ₱1,814          |
| Trade payables and other current liabilities      | 47,018                | 231                 | –              | –                    | 47,249          |
| Customers' refund                                 | 6,013                 | –                   | –              | –                    | 6,013           |
| Interest-bearing long-term financial liabilities: |                       |                     |                |                      |                 |
| Floating rate borrowings                          | 14                    | 601                 | 2,592          | –                    | 3,207           |
| Fixed rate borrowings                             | 3,975                 | 5,057               | –              | –                    | 9,032           |
| Bonds payable                                     | 211                   | 645                 | 3,427          | 21,716               | 25,999          |
| Redeemable preferred stock                        | 1,562                 | –                   | –              | –                    | 1,562           |
| Customers' deposits                               | 3,179                 | 5,070               | 4,151          | 17,449               | 29,849          |
| Refundable service extension costs                | –                     | 1,615               | 2,772          | 3,010                | 7,397           |
| <b>Total undiscounted financial liabilities</b>   | <b>₱63,786</b>        | <b>₱13,219</b>      | <b>₱12,942</b> | <b>₱42,175</b>       | <b>₱132,122</b> |

The maturity profile of bill deposits is not determinable since the timing of each refund is linked to the cessation of service, which is not reasonably predictable. However, *MERALCO* estimates that the amount of bill deposits (including related interest) of ₱7,425 million will be refunded within the year. This is shown as part of "Trade payables and other current liabilities" account in the consolidated statement of financial position as at June 30, 2014.

### *Capital Management*

The primary objective of the *MERALCO Group's* capital management is to enhance shareholder value. The capital structure is reviewed with the end view of achieving a competitive cost of capital and at the same time ensuring that returns on, and of, capital are consistent with the levels approved by its regulators for its core distribution business.

The capital structure optimization plan is complemented by efforts to improve capital efficiency to increase yields on invested capital. This entails efforts to improve the efficiency of capital assets, working capital and non-core assets.

The *MERALCO Group* monitors capital using debt to equity ratio, which is gross debt divided by equity attributable to the holders of the parent. The *MERALCO Group* considers long-term debt, redeemable preferred stock and notes payable as debt.

|                                                               | June 30,<br>2014<br>(Six months -<br>Unaudited) | December 31,<br>2013<br>(One year -<br>Audited) |
|---------------------------------------------------------------|-------------------------------------------------|-------------------------------------------------|
| <i>(Amounts in millions,<br/>except debt to equity ratio)</i> |                                                 |                                                 |
| Long-term debt                                                | <b>₱28,252</b>                                  | ₱30,215                                         |
| Redeemable preferred stock                                    | <b>1,554</b>                                    | 1,562                                           |
| Notes payable                                                 | <b>368</b>                                      | 1,814                                           |
| Debt (a)                                                      | <b>30,174</b>                                   | 33,591                                          |
| Equity attributable to the holders of the parent (b)          | <b>77,409</b>                                   | 75,162                                          |
| Debt to equity ratio (a)/(b)                                  | <b>0.39</b>                                     | 0.45                                            |

## 28. Income Taxes and Local Franchise Taxes

### *Income Taxes*

The components of net deferred tax assets (liabilities) as at June 30, 2014 and December 31, 2013 are as follows:

|                                                                       | Note | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|-----------------------------------------------------------------------|------|---------------------------------|-----------------------------------|
| <i>(Amounts in millions)</i>                                          |      |                                 |                                   |
| Deferred tax assets:                                                  |      |                                 |                                   |
| Provisions for various claims                                         | 19   | <b>₱14,218</b>                  | ₱12,682                           |
| Accrued employee benefits                                             |      | <b>1,073</b>                    | 899                               |
| Unfunded pension cost and unamortized past service cost               |      | <b>373</b>                      | 480                               |
| Allowance for doubtful accounts                                       | 12   | <b>971</b>                      | 945                               |
| Allowance for excess of cost over net realizable value of inventories | 13   | <b>61</b>                       | 61                                |
| Others                                                                |      | <b>408</b>                      | 324                               |
|                                                                       |      | <b>17,104</b>                   | 15,391                            |
| Deferred tax liabilities:                                             |      |                                 |                                   |
| Revaluation increment in utility plant and others                     | 15   | <b>7,351</b>                    | 7,389                             |
| Depreciation method differential                                      |      | <b>1,005</b>                    | 1,082                             |
| Capitalized interest                                                  |      | <b>739</b>                      | 744                               |
| Capitalized duties and taxes deducted in advance                      |      | <b>645</b>                      | 651                               |
| Net book value of capitalized/realized foreign exchange losses        |      | <b>17</b>                       | 22                                |
| Others                                                                |      | <b>132</b>                      | 123                               |
|                                                                       |      | <b>9,889</b>                    | 10,011                            |
|                                                                       |      | <b>₱7,215</b>                   | ₱5,380                            |

Provision for income tax consists of:

|          | Unaudited                           |        |                                       |        |
|----------|-------------------------------------|--------|---------------------------------------|--------|
|          | For the Six Months Ended<br>June 30 |        | For the Three Months Ended<br>June 30 |        |
|          | 2014                                | 2013   | 2014                                  | 2013   |
|          | <i>(Amounts in millions)</i>        |        |                                       |        |
| Current  | ₱6,012                              | ₱4,625 | ₱3,400                                | ₱2,069 |
| Deferred | (1,798)                             | (817)  | (932)                                 | 103    |
|          | ₱4,214                              | ₱3,808 | ₱2,468                                | ₱2,172 |

A reconciliation between the provision for (benefit from) income tax computed at statutory income tax rate of 30% for the six months ended June 30, 2014 and 2013, and provision for (benefit from) income tax as shown in the consolidated statements of income is as follows:

|                                                       | Unaudited                                  |        |
|-------------------------------------------------------|--------------------------------------------|--------|
|                                                       | For the Six Months Period<br>Ended June 30 |        |
|                                                       | 2014                                       | 2013   |
|                                                       | <i>(Amounts in millions)</i>               |        |
| Income tax computed at statutory tax rate of:         | ₱4,167                                     | ₱3,985 |
| Income tax effects of:                                |                                            |        |
| Interest income subjected to lower final tax rate     | (89)                                       | (193)  |
| Nondeductible interest expense                        | 37                                         | 80     |
| Nontaxable income                                     | (5)                                        | (35)   |
| Equity in net losses of associates and joint ventures | 16                                         | —      |
| Others                                                | 88                                         | (29)   |
|                                                       | 47                                         | (177)  |
|                                                       | ₱4,214                                     | ₱3,808 |

On December 18, 2009, the BIR issued Revenue Regulation, or RR No. 16-2008, which implemented the provisions of RA No. 9504 on Optional Standard Deductions or OSD. Such regulation allows both individual and corporate taxpayers to use OSD in computing their taxable income. For corporations, they may elect to adopt standard deduction in an amount not exceeding 40% of gross income in lieu of the allowed itemized deductions.

The temporary difference for which deferred tax assets have not been recognized pertains to the tax effect of net operating loss carryover amounting ₱998 million and ₱701 million as at June 30, 2014 and December 31, 2013, respectively.

*NOLCO* totaling to ₱998 million may be claimed as deduction against taxable income as follows:

| Date Incurred     | Expiry Date       | Amount        |
|-------------------|-------------------|---------------|
|                   |                   | (In millions) |
| December 31, 2011 | December 31, 2014 | ₱106          |
| December 31, 2012 | December 31, 2015 | 193           |
| December 31, 2013 | December 31, 2016 | 402           |
| June 30, 2014     | June 30, 2017     | 297           |
|                   |                   | <b>₱998</b>   |

### *LFT*

Consistent with the decisions of the *ERC*, *LFT* is a recoverable charge of the *DU* in the particular province or city imposing and collecting the *LFT*. It is presented as a separate line item in the customer's bill and computed as a percentage of the sum of generation, transmission, distribution services and related system loss charges.

The Implementing Rules and Regulations issued by the *ERC* provide that local franchise taxes shall be paid only on its distribution wheeling and captive market supply revenues. Pending the promulgation of guidelines from the relevant government agencies, *MERALCO* is paying *LFT* based on the sum of the foregoing charges in the customers' bill.

## 29. Contingencies and Legal Proceedings

### *Overpayment of Income Tax related to SC Refund*

With the decision of the *SC* for *MERALCO* to refund ₱0.167 per *kWh* to cover customers during the billing period February 1994 to May 2003, *MERALCO* overpaid income tax in the amount of ₱7,107 million for taxable years 1994 to 1998 and 2000 to 2001. Accordingly, *MERALCO* filed a claim on November 27, 2003 for the recovery of such excess income taxes paid. After examination of the books of *MERALCO* for the covered periods, the *BIR* determined that *MERALCO* had in fact overpaid income taxes in the amount of ₱6,690 million. However, the *BIR* also maintained that *MERALCO* is entitled to a refund amount of only ₱894 million, which pertains to taxable year 2001, claiming that the period for filing a claim had prescribed in respect of the difference between *MERALCO*'s overpayment and the refund amount *MERALCO* is entitled to.

The *BIR* then approved the refund of ₱894 million for issuance of tax credit certificates or *TCCs*, proportionate to the actual refund of claims to utility customers. The *BIR* initially issued *TCCs* amounting to ₱317 million corresponding to actual refund to customers as at August 31, 2005. In May 2014, the *BIR* issued additional *TCCs* amounting to ₱396 million corresponding to actual refund to customers as at December 31, 2012.

As at June 30, 2014 and December 31, 2013, the amount of unissued *TCCs* amounting to ₱182 million and ₱577 million, respectively, refund entitlement is presented as part of "Other noncurrent assets" account in the consolidated statements of financial position.

See *Note 10 – Other Noncurrent Assets*.

*MERALCO* filed a Petition with the Court of Tax Appeals or *CTA*, assailing the denial by the *BIR* of its income tax refund claim of ₱5,796 million for the years 1994 - 1998 and 2000, arising from the *SC* decision (net of ₱894 million as approved by the *BIR* for taxable year 2001). In a decision dated December 6, 2010, the *CTA*'s Second Division granted *MERALCO*'s claim and ordered the *BIR* to refund or to issue tax credit certificate in favor of *MERALCO* in the amount of ₱5,796 million in proportion to the tax withheld on the total amount that has been actually given or credited to its customers.

On appeal by the *BIR* to the *CTA En Banc*, *MERALCO*'s petition was dismissed on the ground of prescription in the Decision of the *CTA En Banc* dated May 8, 2012. On Motion for Reconsideration by *MERALCO* of the said dismissal, the *CTA En Banc* partly granted *MERALCO*'s motion and issued an Amended Decision dated November 13, 2012, ruling that *MERALCO*'s claim was not yet barred by prescription and remanding the case back to the *CTA* Second Division for further reception of evidence.

The *BIR* filed a Motion for Reconsideration of the above Amended Decision, while *MERALCO* filed its Motion for Partial Reconsideration or Clarification of Amended Decision. Both parties filed their respective Comments to the said motions, and these were submitted for resolution at the *CTA En Banc*.

In a Resolution promulgated on May 22, 2013, the *CTA* denied the said motions of the *BIR* and *MERALCO*, and the *CTA* Second Division was ordered to receive evidence and rebuttal evidence relating to *MERALCO*'s level of refund to customers, pertaining to the excess charges it made in taxable years 1994-1998 and 2000, but corresponding to the amount of ₱5,796 million, as already determined by the said court.

On July 12, 2013, the *BIR* appealed the *CTA En Banc*'s Amended Decision dated November 13, 2012 and Resolution dated May 22, 2013 via Petition for Review with the *SC*.

#### *Overpayment of Income Tax Related to Change in Tax Basis*

On February 4, 2008, the *SC* denied with finality a motion for reconsideration filed by the Commissioner of Internal Revenue or *CIR*, against *MERALCO*, with respect to the issue on excess income tax paid by the latter. The *SC* affirmed a *CA* decision and ordered the *CIR* to refund or issue a *TCC* in favor of *MERALCO* for ₱107 million representing overpaid income taxes for taxable years 1987 and 1988. The overpayment is in accordance with the effectivity of Executive Order No. 72, which subjected *MERALCO* to regular corporate income tax instead of 2% franchise tax based on gross receipts it was previously liable for. On February 5, 2013, *MERALCO* filed a Motion for Issuance of a Writ of Execution with the *CTA* to enforce the judgment of the *SC*. On February 14, 2013, the *CTA* promulgated a Resolution ordering the *CIR* and the *OSG* to comment on the Motion filed by *MERALCO*. On March 14, 2013, the *CTA* promulgated a Resolution granting the Motion of

*MERALCO* and directed the issuance of corresponding Writ of Execution. In March 2014, *MERALCO* received the ₱107 million *TCC* from the *BIR*.

#### *LFT Assessments of Municipalities*

Certain municipalities have served assessment notices on *MERALCO* for *LFT*. As provided in the Local Government Code or *LGC*, only cities and provincial governments may impose taxes on establishments doing business in their localities. On the basis of the foregoing, *MERALCO* and its legal counsel believe that *MERALCO* is not subject or liable for such assessments.

#### *Real Property Tax or RPT Assessments*

Several Local Government Units or *LGUs*, assessed *MERALCO* for deficiency *RPTs* on certain assets of *MERALCO*. The assets include electric poles, wires, insulators, and transformers, collectively referred to as *TWIP*. Of these *LGUs*, one has secured a favorable decision from the *CA*. Such decision was appealed by *MERALCO* to the *SC* for the benefit of *MERALCO* customers, where it is now submitted for resolution. The cases of the other *LGUs* are pending with their respective administrative bodies or government offices.

*MERALCO* also filed a case against the City of Manila before Regional Trial Court – Pasig branch or *RTC-Pasig*, to enjoin the collection of *RPT* on *MERALCO*'s *TWIP* and nullify *RPT* assessments made thereon based on the argument that these are not within the ambit of the definition of real property under the *LGC*. The case is set for mediation after the City of Manila filed its comments on *MERALCO*'s petition.

In the event that the assessment is sustained by the *SC* and payment is warranted or appropriate, *MERALCO* will file for the recovery of any resulting *RPT* payments from customers in the relevant *LGU* through a separate application with the *ERC*.

#### *Mediation with NPC*

The *NPC* embarked on a Power Development Program or *PDP*, which consisted of contracting generating capacities and the construction of its own, as well as private sector, generating plants, following a crippling power supply crisis. To address the concerns of the creditors of *NPC*, namely, Asian Development Bank and the World Bank, the Department of Energy or *DOE* required that *MERALCO* enter into a long-term supply contract with the *NPC*.

Accordingly, on November 21, 1994, *MERALCO* entered into a 10-year Contract for Sale of Electricity or *CSE*, with *NPC* to commence on January 1, 1995. The *CSE* and the rates and amounts charged to *MERALCO* therein, were approved by the *BOD* of *NPC* and the then Energy Regulatory Board, respectively.

Separately, the *DOE* further asked *MERALCO* to provide a market for half of the output of the Camago–Malampaya gas field to enable its development and production of natural gas, which was to generate significant revenues for the Philippine Government and equally significant foreign exchange savings for the country to the extent of the fuel imports, which the domestic volume of natural gas will displace.

*MERALCO*'s actual purchases from *NPC* exceeded the contract level in the first seven years of the *CSE*. However, the 1997 Asian crisis resulted in a significant curtailment of energy demand.

While the events were beyond the control of *MERALCO*, *NPC* did not honor *MERALCO*'s good faith notification of its off-take volumes. A dispute ensued and both parties agreed to enter into mediation.

The mediation resulted in the signing of a Settlement Agreement or *SA*, between the parties on July 15, 2003. The *SA* was approved by the respective *BODs* of *NPC* and *MERALCO*. The net settlement amount of ₱14,320 million was agreed upon by *NPC* and *MERALCO* and manifested before the *ERC* through a Joint Compliance dated January 19, 2006. The implementation of the *SA* is subject to the approval of *ERC*.

Subsequently, the Office of the Solicitor General or *OSG* filed a "Motion for Leave to Intervene with Motion to Admit Attached Opposition to the Joint Application and Settlement Agreement between *NPC* and *MERALCO*." As a result, *MERALCO* sought judicial clarification with the *RTC-Pasig*. Pre-trials were set which *MERALCO* complied with and attended. However, the *OSG* refused to participate in the pre-trial and opted to seek a *TRO* from the *CA*.

In a Resolution dated December 1, 2010, the *CA* issued a *TRO* against *RTC-Pasig*, *MERALCO* and *NPC* restraining the respondents from further proceeding with the case. Subsequently, in a Resolution dated February 3, 2011, the *CA* issued a writ of preliminary injunction enjoining the *RTC-Pasig* from conducting further proceedings pending resolution of the Petition. In a Decision dated October 14, 2011, the *CA* resolved to deny the Petition filed by the *OSG* and lifted the injunction previously issued. The said Decision likewise held that the *RTC-Pasig* committed no error in finding the *OSG* in default due to its failure to participate in the proceedings. The *RTC-Pasig* was thus ordered to proceed to hear the case *ex-parte*, as against the *OSG*, and with dispatch. The *OSG* filed a motion for reconsideration which was denied by the *CA* in its Resolution dated April 25, 2012. The *OSG* filed a Petition for Review on Certiorari with the *SC*. In a Resolution dated July 25, 2012, the *SC* required *MERALCO* to file a Comment. *MERALCO*'s Comment was filed on October 29, 2012. The *SC* then issued a Resolution dated November 26, 2012 requiring the *OSG* to file a Reply. On February 19, 2013, the *OSG* filed a motion for extension to file a consolidated reply.

On January 22, 2014, *MERALCO* received a Notice of Judgment from the *SC* stating that a Decision dated December 11, 2013 was rendered by the First Division of the *SC* denying the Petition for Review on Certiorari by the *OSG* and affirming the decision promulgated by the *CA* on October 14, 2011.

With the dismissal of the petition filed by the *OSG* with the *CA*, *MERALCO* filed a motion for the reception of its evidence *ex-parte* with the *RTC-Pasig* pursuant to the ruling of the *CA*. In a Decision dated May 29, 2012, the *RTC-Pasig* declared the *SA*, independent of the pass-through for the settlement amount which is reserved for the *ERC*, valid and binding. The *OSG* has filed a Notice of Appeal with the *RTC-Pasig* on June 19, 2012. After both parties filed their respective appeal briefs, the *CA* rendered a Decision dated April 15, 2014 denying the appeal and affirming the *RTC* Decision, which declared the Settlement Agreement as valid and binding. The *OSG* filed a Petition for Review with the *SC*. As of June 30, 2014, *MERALCO* is preparing its comment to the petition.

*Sucat-Araneta-Balintawak Transmission Line*

The Sucat-Araneta-Balintawak transmission line is a two-part transmission line, which completed the 230kV-line loop within Metro Manila. The two main parts are the Araneta to Balintawak leg and the Sucat to Araneta leg, which cuts through Dasmariñas Village, Makati City.

On March 10, 2000, certain residents along Tamarind Road, Dasmariñas Village, Makati City or plaintiffs, filed a case against *NPC* with the *RTC-Makati*, enjoining *NPC* from further installing high voltage cables near the plaintiffs' homes and from energizing and transmitting high voltage electric current through said cables because of the alleged health risks and danger posed by the same. Following its initial status quo Order issued on March 13, 2000, *RTC-Makati* granted on April 3, 2000 the preliminary injunction sought for by the plaintiffs. The decision was affirmed by the *SC* on March 23, 2006, which effectively reversing a decision of the *CA* to the contrary. The *RTC-Makati* subsequently issued a writ of execution based on the order of the *SC*. *MERALCO*, in its capacity as an intervenor, was constrained to file an Omnibus Motion to maintain status quo because of the significant effect of a de-energization of the Sucat-Araneta line to the public and economy. Shutdown of the 230-kV line will result in widespread and rotating brownouts within *MERALCO*'s franchise area with certain power plants unable to run at their full capacities.

On September 8, 2009, the *RTC-Makati* granted the motions for intervention filed by intervenors *MERALCO* and *NGCP* and dissolved the Writ of Preliminary Injunction issued, upon the posting of the respective counter bonds by defendant *NPC*, intervenors *MERALCO* and *NGCP*, subject to the condition that *NPC* and intervenors pay all damages, which the plaintiffs may incur as a result of the Writ of Preliminary Injunction.

Thereafter, the plaintiffs questioned the *RTC-Makati* order before the *CA*. As at June 30, 2014, this case remains pending for resolution in the *CA*.

Moreover, in its Order dated February 5, 2013, the *RTC-Makati* granted plaintiffs' motion and directed the re-raffle of the case to another court after the judicial dispute resolution failed.

*Petition for Dispute Resolution against PEMC, TransCo, NPC and PSALM*

On September 9, 2008, *MERALCO* filed a Petition for Dispute Resolution, against *PEMC*, *TransCo*, *NPC* and *PSALM* with the *ERC* as a result of the congestion in the transmission system of *TransCo* arising from the outages of the San Jose-Tayabas 500kV Line 2 on June 22, 2008, and the 500kV 600 Mega volt-ampere Transformer Bank No. 2 of *TransCo*'s San Jose, Bulacan substation on July 11, 2008. The Petition seeks to, among others, direct *PEMC* to adopt the *NPC-TOU* rate or the new price determined through the price substitution methodology of *PEMC* as approved by the *ERC*, as basis for its billing during the period of the congestion and direct *NPC* and *PSALM* to refund the transmission line loss components of the line rentals associated with *NPC/PSALM* bilateral transactions from the start of *WESM* operation on June 26, 2006.

In a Decision dated March 10, 2010, the *ERC* granted *MERALCO*'s petition and ruled that there is double charging of the Transmission Line Costs billed to *MERALCO* by *NPC* for the *TSC* quantities to the extent of 2.98% loss factor, since the start of the *TSC* in November 2006. Thus, *NPC* was directed to refund/collect line rental adjustment to/from *MERALCO*. In the meantime, the *ERC* issued an Order on May 4, 2011 directing *PEMC* to submit an alternative methodology for the

segregation of line rental into congestion cost and line losses from the start of the *WESM*. *PEMC* has filed its compliance submitting its alternative methodology.

On September 8, 2011, *MERALCO* received a copy of *PEMC*'s compliance to *ERC*'s directive and on November 11, 2011, *MERALCO* filed a counter-proposal which effectively simplifies *PEMC*'s proposal.

On November 11, 2011, *MERALCO* filed its Motion to Implement the Decision dated March 10, 2010 by immediately effecting the refund/collection of line rental adjustments to consumers. On December 21, 2011, *PSALM* filed its comment on *MERALCO*'s said Motion. Then, in an Order dated January 24, 2012, the *ERC* directed *PEMC*, *Transco* and *NPC* to submit their respective comments on *MERALCO*'s motion within five days from receipt.

In an Order of the *ERC* dated June 21, 2012, *MERALCO* was directed to submit its computation of the amount of the double charging of line loss on a per month basis from June 26, 2006 up to June 2012. On July 4, 2012, *MERALCO* filed its Compliance to the said Order. Thereafter, the *ERC* issued an Order directing the parties to comment on *MERALCO*'s submissions.

In an Order dated March 4, 2013, the *ERC* approved the methodology proposed by *MERALCO* and *PEMC* in computing the double charged amount on line losses by deducting 2.98% from the *NPC-TOU* amount. Accordingly, the *ERC* determined that the computed double charge amount to be collected from *NPC* is ₱5.2 billion, covering the period November 2006 to August 2012 until actual cessation of the collection of the 2.98% line loss charge in the *NPC-TOU* rates imposed on *MERALCO*, while the amount to be collected from the *SGCs* is ₱4.7 billion. Additionally, *MERALCO* was directed to file a petition against the following *SGCs*: *MPPCL*, Aboitiz Power Renewables, Inc. or *APRI*, *TLI*, *SMEC* and *SCPC*, within thirty (30) days from receipt thereof, to recover the line loss collected by them. *MERALCO* filed a motion for clarification with the *ERC* regarding the directives contained in the March 4, 2013 Order. On April 30, 2013 and May 8, 2013, *PSALM* and *NPC*, respectively, filed motions seeking reconsideration of the March 4, 2013 Order.

In an Order dated July 1, 2013, the *ERC* issued the following clarifications/resolutions: 1) *SPPC* should be included as one of the *SGCs* against whom a petition for dispute resolution should be filed by *MERALCO*; 2) Amount to be refunded by *NPC* is not only ₱5.2 billion but also the subsequent payments it received from *MERALCO* beyond August 2012 until the actual cessation of the collection of the 2.98% line loss charge in its *TOU* rates and Petition to be filed by *MERALCO* against the *SGCs* should not only be for the recovery of the amount of ₱4.7 billion but also the subsequent payments beyond August 2012 until the actual cessation of the collection of the 2.98% line loss charge in its *TOU* rates. ; 3) "SCPC Ilijan" pertains to *SPPC* instead. Thus, the refundable amount of ₱706 million pertaining to "SCPC Ilijan" should be added to *SPPC*'s refundable amount of ₱1.1 billion; 4) Grant the "Motion for Extension" filed by *MERALCO* which was directed to file a petition against the following *SGCs*: *MPPCL*, *APRI*, *TLI*, *SMEC*, *Sem-Calaca* and *SPPC*, otherwise, it shall be the one liable to refund the subject amount to its customers; and 5) deny the respective "Motions for Reconsideration" filed by *NPC* and *PSALM*.

On September 12, 2013, *MERALCO* filed a Manifestation with Motion with the *ERC* seeking approval of its proposal to offset the amount of ₱74 million against some of its monthly remittances to *PSALM*. *PSALM* and *NPC* filed their comments *ad cautelam* on *MERALCO*'s Manifestation and Motion. *MERALCO* is awaiting the resolution of the *ERC* on its Manifestation and Motion. On

November 4, 2013, *MERALCO* filed its Reply. *MERALCO* is awaiting the resolution of the *ERC* on its Manifestation and Motion.

On October 24, 2013, *MERALCO* received *PSALM*'s Petition for Review on Certiorari with the *CA* (With Urgent *TRO* and/or Writ of Preliminary Mandatory Injunction Applications) questioning the March 4, 2013 and July 1, 2013 Orders of the *ERC*. *MERALCO* filed a *Comment with Opposition to the Application for Temporary Restraining Order or Writ of Preliminary Injunction* dated January 30, 2014. *PEMC* filed a *Comment and Opposition [Re: Petition for Certiorari (with Urgent Temporary Restraining Order and/or Writ of Preliminary Mandatory Injunction)]* dated January 6, 2014. On June 4, 2014, *SC* issued a Resolution declaring that *PSALM* is deemed to have waived the filing of a Reply to the comment and opposition of *MERALCO* and *PEMC* and directing the parties to submit their simultaneous memoranda within fifteen (15) days from notice. As of June 30, 2014, *MERALCO* has filed its memorandum and is awaiting further action by the *SC* on this matter.

*Petition for Dispute Resolution Against SPPC, MPPCL, APRI, TLI, SMEC and Sem-Calaca*

On August 29, 2013, *MERALCO* filed a Petition for Dispute Resolution against *SPPC, MPPCL, APRI, TLI, SMEC* and *Sem-Calaca*. Said Petition seeks the following: a) Refund of the 2.98% transmission line losses in the amount of ₱5.4 billion from said *SGCs*; and 2) approval of *MERALCO*'s proposal to correspondingly refund to its customers the aforementioned line loss amounts, as and when the same are received from the *SGCs*, until such time that the said over-recoveries are fully refunded, by way of automatic deduction of the amount of refund from the computed monthly generation rate. On September 20, 2013, *MERALCO* received the *SGCs*' Joint Motion to Dismiss. On October 7, 2013, *MERALCO* filed its Comment on the said Joint Motion. On October 8, 2013, *MERALCO* received the *SGCs* Manifestation and Motion. On October 14, 2013, *MERALCO* filed its Opposition thereto. On October 24, 2013, *MERALCO* received the *SGC*'s Reply to its Comment. On October 29, 2013, *MERALCO* filed its Rejoinder. As of June 30, 2014, *MERALCO* is awaiting the resolution of the *ERC* of the motion to dismiss.

*PSALM versus PEMC and MERALCO*

Due to the unusually large increases in *WESM* prices during the 3<sup>rd</sup> and 4<sup>th</sup> months of the *WESM* operations, *MERALCO* raised concerns with the *PEMC* to investigate whether *WESM* rules were breached or if anti-competitive behavior had occurred.

While resolutions were initially issued by the *PEMC* directing adjustments of *WESM* settlement amounts, a series of exchanges and appeals with the *ERC* ensued. *ERC*'s decision directing the *WESM* settlement price for the 3<sup>rd</sup> and 4<sup>th</sup> billing months to be *NPC-TOU* rates prompted *PSALM* to file a Motion for Reconsideration with the *CA*, which was denied on November 6, 2009. In December 2009, *PSALM* filed a Petition for Review on Certiorari with the *SC*.

As at June 30, 2014, *PSALM*'s Petition for Review is pending resolution by the *SC*.

*Petition for Dispute Resolution with NPC on Premium Charges*

On June 2, 2009, *MERALCO* filed a Petition for Dispute Resolution against *NPC* and *PSALM* with respect to *NPC*'s imposition of premium charges for the alleged excess energy it supplied to *MERALCO* covering the billing periods May 2005 to June 2006. The premium charges amounting to

₱315 million during the May-June 2005 billing periods have been paid but are the subject of a protest by *MERALCO*, and premium charges of ₱318 million during the November 2005, February 2006 and April to June 2006 billing periods are being disputed and withheld by *MERALCO*. *MERALCO* believes that there is no basis for the imposition of the premium charges. The hearings on this case have been completed and *MERALCO* is now awaiting the resolution of the *ERC* on the petition.

*SC Temporary Restraining Order on MERALCO's December 2013 Billing Rate Increase*

On December 9, 2013, the *ERC* gave clearance to the request of *MERALCO* to implement a staggered collection over three (3) months covering the December 2013 billing month for the increase in generation charge and other bill components such as *VAT*, *LFT*, transmission charge, and *SL* charge, which reflected a total increase of ₱4.15 per *kWh* for a 200-*kWh* residential consumer. The generation costs for the November 2013 supply month increased significantly because of the use of the more expensive liquid fuel or bio-diesel by the natural gas-fired power plants that were affected by the Malampaya Gas Field or *Malampaya*, shutdown from November 11 to December 10, 2013. This was compounded by the aberrant spike in the *WESM*, charges on account of the scheduled and extended shutdowns, and the forced outages, of several base load power plants, as well as the non-compliance with *WESM* Rules by certain plants resulting in significant power generation capacities not being offered and dispatched.

The Department of Justice commenced an investigation while the House of Representatives and the Senate conducted separate hearings to determine the underlying reasons for the price increase, including any possible collusion among the power firms. In the meantime, *MERALCO* proceeded with billing its captive customers with the *ERC* approval.

On December 19, 2013, several party-list representatives of the House of Representatives filed a Petition against *MERALCO*, *ERC* and the *DOE* before the *SC*, questioning the *ERC* clearance granted to *MERALCO* to charge the ₱4.15 per *kWh* price increase, alleging the lack of hearing and due process. It also sought for the declaration of the unconstitutionality of the *EPIRA*, which essentially declared the generation and supply sectors competitive and open, and not considered public utilities. A similar petition was filed by a consumer group and several private homeowners associations challenging also the legality of the *AGRA* that the *ERC* had promulgated. Both petitions prayed for the issuance of *TRO*, and a Writ of Preliminary Injunction.

On December 23, 2013, the *SC* consolidated the two (2) Petitions and granted the application for *TRO* effective immediately and for a period of sixty (60) days, which effectively enjoined the *ERC* and *MERALCO* from implementing the ₱4.15 per *kWh* price increase. The *SC* also ordered *MERALCO*, *ERC* and *DOE* to file their respective comments to the Petitions. Oral Arguments were conducted on January 21, 2014, February 4, 2014 and February 11, 2014. Thereafter, the *SC* ordered all the Parties to the consolidated Petitions to file their respective Memorandum on or before February 26, 2014 after which the Petitions will be deemed submitted for resolution of the *SC*. *MERALCO* complied with said directive and filed its Memorandum on said date.

On February 18, 2014, acting on the motion filed by the Petitioners, the *SC* extended for another 60 days or until April 22, 2014, the *TRO* that it originally issued against *MERALCO* and *ERC* last December 23, 2013. The *TRO* was also similarly applied to the generating companies, specifically *MPPCL*, *SMEC*, *SPPC*, *FGPC*, and the *NGCP*, and the *PEMC* (the administrator of *WESM* and

market operator) who were all enjoined from collecting from *MERALCO* the deferred amounts representing the ₱4.15 per *kWh* price increase for the November 2013 supply month.

In the meantime, on January 30, 2014, *MERALCO* filed an Omnibus Motion with Manifestation with the *ERC* for the latter to direct *PEMC* to conduct a re-run or re-calculation of the *WESM* prices for the supply months of November to December 2013. Subsequently, on February 17, 2014, *MERALCO* filed with the *ERC* an Application for the recovery of deferred generation costs for the December 2013 supply month praying that it be allowed to recover the same over a six (6)-month period.

On March 3, 2014, the *ERC* issued an Order voiding the Luzon *WESM* prices during the November and December 2013 supply months on the basis of the preliminary findings of its Investigating Unit that these are not reasonable, rational and competitive and imposing the use of regulated rates for the said period. *PEMC* was given seven (7) days upon receipt of the Order to calculate these regulated prices and implement the same in the revised *WESM* bills of the concerned. *PEMC*'s recalculated power bills for the supply month of December 2013 resulted in a net reduction of the December 2013 supply month bill of the *WESM* by ₱9,274 million. Due to the pendency of the *TRO*, no adjustment was made to the *WESM* bill of *MERALCO* for the November 2013 supply month. The timing of amounts to be credited to *MERALCO* is dependent on the reimbursement of *PEMC* from associated generator companies. However, several generating companies, including *MPPCL*, *SNAP*, Team Energy, *Pan-Asia*, and *SMEC*, have filed motions for reconsideration questioning the Order dated March 3, 2014. *MERALCO* has filed a consolidated comment to these motions for reconsideration. The *ERC* has yet to resolve these motions.

In view of the pendency of the various submissions before the Commission and mindful of the complexities in the implementation of *ERC*'s Order dated March 3, 2014, the *ERC* directed *PEMC* to provide the market participants an additional period of 45 days to comply with the settlement of their respective adjusted *WESM* bills. In an Order dated May 9, 2014, the parties were then given an additional non-extendible period of 30 days from receipt of the Order within which to settle their *WESM* bills. However, in an Order dated June 6, 2014 and acting on an intervention filed by Angeles Electric Corporation, the *ERC* deemed it appropriate to hold in abeyance the settlement of *PEMC*'s adjusted *WESM* bills by the market participants.

On April 22, 2014, the *SC* extended indefinitely the *TRO* issued on December 23, 2013 and February 18, 2014 and directed generating companies not to collect from *MERALCO*. The *SC* has yet to resolve the various petitions filed against *MERALCO*.

#### *Interim Pre-Emptive Mitigating Measure in the WESM*

On May 5, 2014, the *ERC* issued Resolution No 8, Series of 2014, setting an interim pre-emptive mitigating measure in the *WESM*, which established a price threshold in the *WESM* applied over a seventy-two (72) hour period, which is determined through rolling averaged Generated Weighted Average Price or *GWAP* of ₱8,186 per *MWh*. Also, a secondary cap amounting to ₱6,245 per *MWh* is imposed upon a breach of the threshold, or *Secondary Cap mechanism*. Such interim measure was put in place to mitigate sustained high prices in the *WESM* during the May and June 2014 supply months. On June 16, 2014, the *ERC* issued another resolution extending the effectivity of the pre-emptive mitigating measure for forty-five (45) days from expiration or until August 9, 2014. A public consultation and a subsequent focus group discussion relative to the said mitigating measure

were held on July 23 and 25, 2014, respectively. The *ERC* has taken cognizance of the need to establish permanent mitigating measures in order to mitigate the impact of extreme price volatilities and excessive levels of prices in the *WESM* to discourage manipulative acts therein. In its Resolution No. 14, Series of 2014 dated August 5, 2014, the *ERC* resolves (1) to adopt a permanent pre-emptive mitigating measure that will be applied in the *WESM*; (2) to direct all interested stakeholders to submit their proposed measures within twenty (20) days from effectivity of such Resolution; and (3) to extend the effectivity of the *Secondary Cap mechanism* for a period of one hundred twenty (120) days from August 10, 2014 or until the establishment by the *ERC* of a permanent pre-emptive mitigating measure in the *WESM*, whichever comes earlier.

#### *Others*

Management and its internal and external counsels believe that the probable resolution of these issues will not materially affect the *MERALCO Group's* financial position and results of operations.

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### 30. Significant Contracts and Commitments

#### *NPC*

*MERALCO* and *NPC* entered into a Transition Supply Contract or *TSC*, effective the earlier of five years from November 16, 2006 up to December 25, 2011 or one year after the introduction of Open Access, should *RCOA* be in place within the five-year contract period. Two addenda for additional contracted volumes were signed, the most recent being in 2010. The adjusted contracted volume was for a total of more than 40,000 *GWh* up to 2011.

On December 26, 2011, the *TSC* with *NPC* was extended until December 25, 2012 or three months after the implementation of the *RCOA*, whichever comes first.

As a result of the extension of the *TSC*, the Customer Choice Program or *CCP*, which is a joint program of *NPC* and *MERALCO* aimed at providing *NPC* time-of-use or *TOU*, benefits to qualified customers, has also been extended to be co-terminus with the *TSC*. The *CCP* expired on December 25, 2012.

With respect to the *TSC*, *MERALCO*, *NPC* and *PSALM* then executed a Memorandum of Agreement or *MOA* which further extended the *TSC* until June 25, 2013.

On June 26, 2013, *MERALCO's TSC* with *NPC* was terminated.

#### *Assignment of TSC Volume to SGCs*

From 2008 to 2009, *NPC* privatized a number of its generating assets and Independent Power Plants or *IPP* contracts in favor of the successful bidders. As a result, the contracted energy volume under the original *TSC* between *MERALCO* and *NPC* was assigned by *NPC* to the respective new owners and *IPPs*. Following are the privatized plants and *IPP* contracts:

| Year | Power Plant                                                                 | Successor Owner/IPPAs | % of Total Volume |
|------|-----------------------------------------------------------------------------|-----------------------|-------------------|
| 2008 | Masinloc coal-fired power plant – 600 MW                                    | MPPCL                 | 21.3              |
| 2009 | Tiwi-Makban geothermal power plants – 289 MW                                | APRI                  | 8.1               |
|      | Pagbilao power plant – 735 MW                                               | TLI                   | 25.0              |
|      | Sual coal-fired power plant – 1,000 MW                                      | SMEC                  | 8.6               |
|      | Coal-fired Calaca power plant – 600 MW                                      | Sem-Calaca            | 10.4              |
| 2010 | Combined cycle gas turbine, natural gas-fired Ilijan power plant – 1,200 MW | SPPC                  | 15.2              |

*NPC/PSALM* remained the contracting party of record for the supply of power to *MERALCO*. Payments of the contracted volume are made based on the billing instructions from *NPC/PSALM* received by *MERALCO*.

#### *PSAs with Privatized Plants and IPPAs*

*MERALCO* entered into separate *PSAs* with *SPPC*, *Sem-Calaca* and *MPPCL* on December 12, 20 and 21, 2011, respectively. Also, separate *PSAs* with *TLI* and *SMEC* were executed on February 29 and June 26, 2012, respectively. These *PSAs* are for a period of seven years, extendable for three years upon agreement of the parties. Thereafter, applications for approval of the *PSAs* were filed with the *ERC*.

On March 16, 2012, *MPower* signed a separate *PSA* with *MPPCL* for 30MW of contracted capacity from the Masinloc coal-fired power plant in Zambales for seven years, extendable for three years upon agreement of the parties.

On April 26, 2012, the *MERALCO BOD* approved the *PSA* with Pangea Green Energy Philippines, Inc., or *PGEP*, a biogas power plant located in Payatas, Quezon City using methane gas extracted from the Payatas Landfill as its fuel. Its plant has a total nominal generating capacity of 1,236 kW.

In separate Decisions dated December 17, 2012, the *ERC* approved with modifications the *PSAs* of *MERALCO* with *SPPC*, *Sem-Calaca*, *MPPCL*, *TLI* and *SMEC*.

Motions for Reconsideration were filed regarding the *ERC* decisions on the *PSAs* with *SPPC*, *Sem-Calaca* and *SMEC*. *MERALCO* is awaiting the decision of the *ERC* on the *SPPC* and *Sem-Calaca* Motions for Reconsideration. In an Order dated December 16, 2013, the *ERC* denied the Motion for Partial Reconsideration on the *PSA* with *SMEC*. Both *MERALCO* and *SMEC* have filed separation motions with respect to such order and now await *ERC* resolution thereof.

On December 27, 2012, *MERALCO* executed the *PSAs* with *TLI* and *APRI* to cover the volume needed by *MERALCO* during the six-month transition period before the start of the commercial operations of *RCOA*. Under the *PSAs* with *TLI* and *APRI*, *MERALCO* will procure power from *TLI* and *APRI* from the expiration of the *TSC* until June 25, 2013 conditioned upon *ERC* approval. The said *PSAs* had been submitted to the *ERC* for approval on January 2, 2013. However, *MERALCO* filed Motions to Withdraw the said *PSAs*, considering that the *TSC* was extended up to June 25, 2013. The *ERC* granted said Motions in separate Orders.

Under the *PSAs*, fixed capacity fees and fixed operating maintenance fees are recognized monthly based on their contracted capacities. The annual projection of these payments is shown in the table below:

| Year | Contracted Capacity  | Fixed Payment Amount |
|------|----------------------|----------------------|
|      | <i>(In Megawatt)</i> | <i>(In million)</i>  |
| 2014 | 3,049                | ₱35,593              |
| 2015 | 3,084                | 37,775               |
| 2016 | 3,114                | 39,865               |
| 2017 | 3,114                | 39,574               |
| 2018 | 2,880                | 39,198               |
| 2019 | 2,460                | 33,864               |

#### *FGPC and FGP*

In compliance with the DOE's program to create a market for Camago-Malampaya gas field and enable its development, *MERALCO* was committed to contract 1,500-MW of the 2,700 MW output of the Malampaya gas field.

Accordingly, *MERALCO* entered into separate 25-year *PPAs* with *FGPC* (March 14, 1995) and *FGP* (July 22, 1999) for a minimum number of *kWh* of the net electrical output of the Sta. Rita and San Lorenzo power plants, respectively, from the start of their commercial operations. The *PPA* with *FGPC* terminates on August 17, 2025, while that of *FGP* ends on October 1, 2027.

On January 7, 2004, *MERALCO*, *FGP* and *FGPC* signed an Amendment to their respective *PPAs*. The negotiations resulted in certain new conditions including the assumption of *FGP* and *FGPC* of community taxes at current tax rate, and subject to certain conditions increasing the discounts on excess generation, payment of higher penalties for non-performance up to a capped amount, recovery of accumulated deemed delivered energy until 2011 resulting in the non-charging of *MERALCO* of excess generation charge for such energy delivered beyond the contracted amount but within a 90% capacity quota. The amended terms under the respective *PPAs* of *FGP* and *FGPC* were approved by the *ERC* on May 31, 2006.

Under the respective *PPAs* of *FGP* and *FGPC*, the fixed capacity fees and fixed operating and maintenance fees are recognized monthly based on the actual Net Dependable Capacity tested and proven, which is usually conducted on a semi-annual basis.

#### *QPPL*

*MERALCO* entered into a *PPA* with *QPPL* on August 12, 1994, which was subsequently amended on December 1, 1996. Under the terms of the amended *PPA*, *MERALCO* is committed to purchase a specified volume of electric power and energy from *QPPL*, subject to certain terms and conditions. The *PPA* is for a period of 25 years from the start of commercial operations up to July 12, 2025.

In a Letter Agreement signed on February 21, 2008, the amount billable by *QPPL* included a transmission line charge reduction in lieu of a previous rebate program. The Letter Agreement also provides that *MERALCO* make advances to *QPPL* of US\$2.85 million per annum for 10 years beginning 2008 to assist *QPPL* in consideration of the difference between the transmission line charge specified in the *TLA* and the *ERC*-approved transmission line charge in March 2003. *QPPL* shall repay *MERALCO* the same amount at the end of the 10-year period in equal annual payments

without adjustment. However, if *MERALCO* is able to dispatch *QPPL* at a plant capacity factor of no less than 86% in any particular year, *MERALCO* shall not be required to pay US\$2.85 million in that year. This arrangement did not have any impact on the rates to be charged to consumers and hence, did not require any amendment in the *PPA*, as approved by *ERC*.

See Note 10 – Other Noncurrent Assets.

#### *Committed Energy Volume to be Purchased*

The following are forecasted purchases/payments to *FGPC*, *FGP* and *QPPL* corresponding to the Minimum Energy Quantity or *MEQ*, provisions of the contracts. The forecasted fixed payments include capacity charge and fixed operation and maintenance cost escalated using the US and Philippine Consumer Price Index or *CPI*.

| Year      | Minimum Energy<br>Quantity (MEQ)<br><i>(In Million Kilowatt-Hours)</i> | Equivalent Amount<br><i>(In millions)</i> |
|-----------|------------------------------------------------------------------------|-------------------------------------------|
| 2014      | 14,955                                                                 | ₱21,476                                   |
| 2015      | 14,955                                                                 | 21,577                                    |
| 2016      | 14,855                                                                 | 21,592                                    |
| 2017      | 14,855                                                                 | 21,817                                    |
| 2018      | 14,855                                                                 | 22,011                                    |
| 2019-2025 | 103,984                                                                | 159,967                                   |

#### *Montalban Methane Power Corporation or MMPC*

*MMPC* operates an 8 *MW* (designed capacity of 11 *MW*) renewable energy generating facility, which utilizes landfill gas.

On May 13, 2009, *MERALCO* filed an application for the approval of the *CSE* with *MMPC* with the *ERC*. On June 9, 2009, *ERC* issued an order dated June 1, 2009 provisionally approving the *CSE* subject to the following conditions: (i) any amendments to the *CSE* shall be filed with the *ERC* for approval and the implementation shall be prospective; and (ii) in the event the rates approved are higher than the final rates, the amount corresponding to the excess shall be refunded by *MERALCO* to its customers by crediting the same in their electric bills.

On June 11, 2009, *MMPC* began delivering energy to *MERALCO* under a two year *CSE*. The *CSE* is a “take and pay” arrangement, without a minimum energy volume. Energy is billed to *MERALCO* on an hourly basis at the *ERC*- approved *NPC TOU* rate plus certain pre-agreed cost components. Being an embedded renewable energy generator, purchases from *MMPC* are *VAT* zero-rated and energy deliveries from *MMPC* are exempt from power delivery service charge.

After a series of negotiations, on May 23, 2011, *MERALCO* and *MMPC* signed a Letter Agreement extending the *CSE*. Said Agreement likewise contained minor amendments to the *CSE* that were intended to benefit the consumers. On June 3, 2011, *MERALCO* filed a Manifestation with Motion with the *ERC* seeking the approval of the Letter Agreement, pursuant to the condition contained in the *ERC* Order dated June 1, 2009. On February 19, 2013, the *ERC* issued its Decision approving the application as well as the Letter Agreement. On June 6, 2013, *MERALCO* and *MMPC* signed a Letter Agreement extending the *CSE* for three (3) months from June 11, 2013 to September 11, 2013, and, thereafter, for a series of three (3)-month terms under the same terms and conditions. On

June 11, 2013, *MERALCO* filed a Manifestation with Motion with the *ERC* seeking approval of the June 6, 2013 Letter Agreement.

On June 2, 2014, *MERALCO* filed a new application with the *ERC* for approval of its new *PSA* with *MMPC*, executed by the parties on April 16, 2014, which has a term of two (2) years from *ERC* approval. Similar to the previous *CSE*, said *PSA* is a “take and pay” arrangement. On June 11, 2014, *MERALCO* received *MMPC*’s motion to join *MERALCO* as co-applicant in the case. Upon approval by the *ERC* of the new *PSA*, the same shall replace the previous *CSE* executed between *MMPC* and *MERALCO*. *MERALCO* filed its Formal Offer of Evidence on July 23, 2014. The *ERC* conducted its last hearing on the application on August 5, 2014 and gave *MMPC* a period of fifteen (15) days from said hearing, or until August 20, 2014, within which to file its Formal Offer of Evidence.

*Philippine Power and Development Company or PPDC*

*PPDC* operates three (3) run-of-river hydro power plants, namely: (1) Palakpakin, a 448 *kW* hydro power plant located at Brgy. Prinza, Calauan, Laguna; (2) Calibato, a 75 *kW* Calibato hydro power plant located at Brgy. Sto. Angel, San Pablo City, Laguna; and (3) Balugbog, a 528 *kW* hydro power plant located at Brgy. Palina, Nagcarlan Laguna.

On June 2, 2014, *MERALCO* filed an application with the *ERC* for approval of its *PSA* with *PPDC*. Said *PSA* is a “take and pay” arrangement and *MERALCO* shall accept all the energy deliveries of *MMPC* as measured by the latter’s billing meter. The *ERC* has yet to schedule the initial hearing for said application.

*BEI*

*MERALCO* signed a *CSE* with *BEI* on November 12, 2010. *BEI* owns and operates a 4*MW* renewable energy generation facility powered by landfill gas in San Pedro, Laguna.

The terms of the *CSE* with *BEI* are similar to that signed with *MMPC*. Purchases from *BEI*, an embedded renewable energy generator, are *VAT* zero-rated and exempt from power delivery service charge. *MERALCO* filed an application for the approval of the *CSE* with the *ERC*, for the provisional implementation of the contract on December 15, 2010. In an order dated January 31, 2011, the *ERC* provisionally approved the said application which extended the implementation indefinitely. The said case is pending decision by the *ERC*.

After a series of negotiations, *MERALCO* and *BEI* signed the Letter Agreements dated March 1, 2013 and March 5, 2013, extending the *CSE* between said parties for another two (2) years from March 16, 2013, or until March 16, 2015. On June 13, 2013, *MERALCO* filed a Manifestation with Motion date seeking *ERC*’s approval of said extension. In its Order dated September 30, 2013, the *ERC* denied said Manifestation and Motion. On October 11, 2013, *MERALCO* filed a motion with the *ERC* seeking reconsideration of it September 30, 2013. In its Order December 9, 2013, the *ERC* reversed its previous ruling and allowed the *CSE* to be extended until March 16, 2015.

*Therma Mobile, Inc. or TMO*

On March 4, 2013, *MERALCO* signed an Interconnection Agreement with *Therma Mobile Inc. or TMO* for their 243 *MW* generating facility at the Navotas Fish Port Complex, Navotas City, which is

an interconnection at *MERALCO's* Grace Park - Malabon 115kV line. *TMO* is thus an embedded generator. *TMO* shall construct at its own cost, operate and maintain the 115kV line connecting its generating facility to *MERALCO's* system.

On September 27, 2013, *MERALCO* signed a *PSA* with *TMO* for the output of the barge-mounted, bunker oil-fired diesel engines moored at the Fishport Complex in Navotas, Manila. On November 4, 2013.

San Buenaventura Power Ltd. Co. or *SBPL*

On May 30, 2014, *MERALCO* signed a long-term *PSA* for a 455 *MW* (net) capacity and electrical output with *SBPL*.

*SBPL* will be constructing the first supercritical highly fuel efficient, reliable and environmental friendly pulverized coal-fired power plant in the country. The *PSA* will be subject to the approval of the *ERC*.

*Interim Power Supply Agreement (IPSA)*

On April 2, 2014, *MERALCO* signed two separate *IPSAs* with the wholly owned subsidiaries of Global Business Power Corporation or *GBPC*, namely: (1) Panay Power Corp. for a 27 *MW* firm output from its 72-*MW* diesel-fired power plant in Brgy. Ingore, La Paz, Iloilo City; and (2) Toledo Power Co. for a 28 *MW* firm and 9 *MW* non-firm output from its 40-*MW* diesel-fired power plant in Carmen, Toledo City. Both *IPSAs* became immediately effective upon execution and shall expire on June 30, 2014.

On July 10, 2014, *ERC* approved the extension of the *IPSA* with Panay Power Corp. and Toledo Power Co. until October 31, 2014.

On April 3, 2014, *MERALCO* signed an *IPSA* with 1590 Energy Corp. for the 140 *MW* output from the Bauang power plant – a 225-*MW* diesel-fired power plant in Bauang, La Union. On April 8, 2014, *MERALCO* signed an *IPSA* with PanAsia Energy Inc. for the 270 *MW* output from the Limay Combined Cycle Power Plant – a 540-*MW* diesel power facility at Brgy. Luz, Limay, Bataan. Both *IPSAs* becomes effective upon the Final Approval of the *ERC* and shall expire on June 30, 2014.

On June 30, 2014, *ERC* approved the extension of the *IPSA* with 1590 Energy Corp until October 31, 2014.

The *IPSAs* may also be extended upon mutual agreement of the parties.

*Interconnection Agreement with Alternergy Philippine Holdings Corporation or Alternergy*

On March 1, 2012, *MERALCO* signed an Interconnection Agreement with *Alternergy* for their 90*MW* Wind Farm Renewable Energy plant in Pililla, Rizal, which is an interconnection at *MERALCO's* Malaya-Teresa 115kV line, *Alternergy* is thus an embedded generator. *Alternergy* shall construct at its own cost, operate and maintain the 115kV line connecting its generating facility to *MERALCO's* system.

*Interconnection Agreement with Maibarara Geothermal, Inc. or MGI*

On December 6, 2012, *MERALCO* signed an Interconnection Agreement with *MGI* for their 20MW (with max capacity of 40 MW) Geothermal Facility plant in Sto. Tomas, Batangas, which is an interconnection at *MERALCO*'s FPIP - Los Banos 115kV line. *MGI* is thus an embedded generator. *MGI* shall construct at its own cost, operate and maintain the 115kV line connecting its generating facility to *MERALCO*'s system.

*Technical Services Agreement with Integrated Energy Distribution and Marketing (IEDM)*

*MERALCO* provides technical expertise into the operations of Yola Electricity Distribution Company and Ibadan Electricity Distribution Company in Nigeria. In consideration, *MERALCO* receives fixed monthly fees, subject to adjustment annually in accordance with the provisions of the Technical Services Agreement.

*Technical Services Agreement with Comstech Integration Alliance, Inc. or Comstech*

On February 12, 2014, *MERALCO* signed a Technical Service Agreement with *Comstech* whereby *MERALCO* shall provide technical services to support *Comstech* in operating the business of Pampanga Electric Cooperative II or *PELCO II*.

*Comstech* earned the vote of the majority of *PELCO II* membership to be the investment and management partner in electricity and distribution of *PELCO II*.

*Concession Agreement with Philippine Economic Zone Authority or PEZA*

On May 26, 2014, *MERALCO* and *PEZA* entered into a concession agreement whereby *MERALCO* has been contracted to operate the distribution system of Cavite Economic Zone or *CEZ* beginning May 6, 2014.

### 31. Earnings Per Share Attributable to Equity Holders of the Parent

Basic and diluted earnings per share are calculated as follows:

|                                                             | Unaudited                |        |                            |        |
|-------------------------------------------------------------|--------------------------|--------|----------------------------|--------|
|                                                             | For the Six Months Ended |        | For the Three Months Ended |        |
|                                                             | June 30                  |        | June 30                    |        |
|                                                             | 2014                     | 2013   | 2014                       | 2013   |
| <i>(In millions, except per share data)</i>                 |                          |        |                            |        |
| Net income attributable to equity holders of the Parent (a) | <b>₱9,637</b>            | ₱9,441 | <b>₱5,629</b>              | ₱5,417 |
| Weighted average common shares outstanding (b)              | <b>1,127</b>             | 1,127  | <b>1,127</b>               | 1,127  |
| Per Share Amounts:                                          |                          |        |                            |        |
| Basic and diluted earnings per share (a/b)                  | <b>₱8.55</b>             | ₱8.38  | <b>₱4.99</b>               | ₱4.81  |

Basic and diluted earnings per share amounts are calculated by dividing net income for the year attributable to common shareholders of the parent by the weighted average number of common shares outstanding during the year. There are no potential dilutive common shares in 2014 and 2013.

There are no other transactions involving common shares or potential common shares between the reporting date and the date of completion of these unaudited interim consolidated financial statements.

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### 32. Other Matters

#### *Revised SL Caps*

On December 8, 2008, the *ERC* promulgated a resolution providing for a lower maximum rate of *SL* (technical and non-technical) that a utility can pass on to its customers. The revised *SL* cap is 8.5% for private utilities, effective January 2010 billing. This is one percentage point lower than the *SL* cap of 9.5% provided under *RA* No. 7832. The actual volume of electricity used by *MERALCO* (administrative loss) is treated as part of the operation and maintenance expense beginning July 2011. The manner by which the utility is rewarded for its efforts in *SL* reduction is addressed by the *ERC* in the *PIS* under *PBR*.

On December 8, 2009, *MERALCO* filed a Petition to amend the said Resolution with an urgent prayer for the immediate suspension of the implementation of the new *SL* cap of 8.5% starting January 2010. The proposed amendment is aimed at making the Resolution consistent with the provisions of *RA* No. 9136 and *RA* No. 7832, by increasing the *SL* cap to not less than 9%. The hearing on the Petition was conducted on November 18, 2010. Thereafter, *MERALCO* was directed to submit its *FOE*. *MERALCO* has submitted its *FOE* and is awaiting *ERC* decision on this Petition.

#### *Benefit Sharing Scheme to Lower System Loss*

On January 26, 2011, *MERALCO*, together with Private Electric Power Operators Association, Inc. or *PEPOA* and Philippine Rural Electric Cooperative Association or *PHILRECA*, filed a joint petition to the *ERC* to initiate rule-making to adopt the *Proposed Guidelines for the Implementation of an Incentive Scheme to Lower the System Losses of Private Distribution Utilities and Electric Cooperatives to Level Below the System Loss Cap, for the Benefit of End-Users*. This was aimed to encourage the *DUs* to reduce system loss levels below the cap set by the *ERC* and benefit the end-users through lower system loss charges. Public hearings were conducted and completed on June 15, 2011.

On December 11, 2012, the *ERC* posted on its website the second draft of the *Rules to Govern the Implementation of a Benefit Sharing to Lower the System Losses of Electric Distribution Utilities*. The salient points of the second draft rules include calculation of System Loss Charge using the prevailing system loss cap or the lowest consecutive five year average system loss, whichever is lower, and an equitable sharing (50-50) of incentives between the customer and the *DU* on the savings which is the difference between the lower of this system loss level and the *DU*'s actual system loss. Any system loss reward from the *PIS* under the *RDWR* for private *DUs* shall be offset from the rewards the *DU* will receive from this Benefit-Sharing scheme, except when the net benefit from this scheme is less than the *PIS* rewards of the *DU*, in which case the *DU* will retain the

rewards under the *PIS* and forego its share under this Benefit-Sharing Scheme. The foregone share of the *DU* shall be added to the End-user share correspondingly. As at June 30, 2014, *MERALCO* and *PEPOA* are awaiting the action of the *ERC* on this matter.

#### *Retail Competition*

On September 27, 2012, the *DOE* and the *ERC* issued a joint statement setting the initial *RCOA* implementation on December 26, 2012. The joint statement clarified that the *RCOA* commencement is on a phase-in and partial implementation of the program, with the first six (6) months of *RCOA* implementation (December 26, 2012 – June 25, 2013) allotted as the Transition Period to allow all concerned parties to undertake their respective preparations to operationalize the mechanism for *RCOA*. An initial *RCOA* Commercial Operation using an interim IT system was set to start on June 26, 2013.

On December 17, 2012, the *ERC* issued Resolution No. 16 series of 2012 adopting the Transitory Rules for the implementation of *RCOA*. The resolution provides the detailed responsibilities of industry participants during the *RCOA* transition period.

On January 9, 2013, the *DOE* issued Department Circular, "Promulgating the Retail Rules for the Integration of Retail Competition and Open Access in the Wholesale Electricity Spot Market", to provide rules for the integration of retail competition in the operations and governance processes of the *WESM*, the management of the transactions of Suppliers and Contestable Customers, and the operations of the Central Registration Body.

On March 26, 2013, *PEMC* began the *RCOA* Trial Operations Program, a nine-week test period participated in by the various entities and service providers of *RCOA*.

On June 19, 2013, the *ERC* issued a resolution adopting the Supplemental Rules to the Transitory Rules for the implementation of *RCOA*. The resolution seeks to prevent contestable customers who have yet to execute a Retail Supply Contract or *RSC*, with a *RES* from being disconnected or transferred to *SOLR* service upon the commencement of initial commercial operations of *RCOA*. Qualified contestable customers who fail to enter into a *RSC* with a *RES* shall be deemed to stay with their current *DU* until December 26, 2013 or until such time that it is able to find a *RES* provided that they inform the *DU*.

In accordance with the *ERC*'s "Transitory Rules for the Initial Implementation of Open Access and Retail Competition", commercial operations of *RCOA* began on June 26, 2013. As at June 30, 2014, there are about 811 contestable customers in *MERALCO*'s franchise area and 327 have already switched to their respective *RES*s.

#### *Philippine Export Zone Authority or PEZA – ERC Jurisdiction*

On September 13, 2007, *PEZA* issued "Guidelines in the Registration of Electric Power Generation Facilities/Utilities/Entities Operating Inside the Ecozones" and "Guidelines for the Supply of Electric Power in Ecozones." Under these Guidelines, *PEZA* effectively bestowed upon itself franchising and regulatory powers in Ecozones operating within the legislative franchise areas of *DUs* which are under the legislatively-authorized regulatory jurisdiction of the *ERC*. The Guidelines are the subject of an injunction case filed by the *DUs* at the *RTC-Pasig*.

In support of the government's objective of providing lower cost to Ecozone locators, *MERALCO* entered into a *MOA* with *NPC* on September 17, 2007 for the provision of special Ecozone rates to high load factor *PEZA*-accredited industries. The *ERC* authorized the immediate implementation of the Ecozone Rate Program or *ERP*. The program expired in December 2012.

The *ERP* was initially scheduled to expire by December 25, 2011 but was extended twice and was terminated on December 25, 2012.

In January 2013, *MERALCO* entered into a tripartite agreement with *PEZA* and Trans-Asia Oil and Energy Development Corporation for the sale of power to *CEZ* and its locators beginning January 26, 2013.

As an alternative to the *ERP*, *MERALCO* filed an application for the implementation of Peak/Off-Peak (POP) Program. On December 17, 2012, the *ERC* provisionally approved the application and *MERALCO* started implementing the program on February 1, 2013.

#### *Purchase of Subtransmission Assets or STAs*

On April 17, 2012, *MERALCO* and *TransCo* filed a joint application for the approval of the Batch 4 contract to sell with the *ERC*. On April 22, 2013, the *ERC* issued a Decision on *MERALCO*'s joint application for the acquisition of the Batch 4 contract to sell. On June 21, 2013, *MERALCO* filed a motion for partial reconsideration regarding the exclusion of certain facilities for acquisition.

On May 22, 2014, *MERALCO* received an *ERC* Order dated May 5, 2014, wherein the *ERC* denied *MERALCO*'s motion for partial reconsideration. On June 5, 2014, *MERALCO* filed a clarificatory motion and a motion for reconsideration of the May 5, 2014, *ERC* Order, which was denied by the *ERC* through an Order dated June 16, 2014.

On December 12, 2011, *MERALCO* signed various agreements for the acquisition of certain sub-transmission assets of *TransCo* within the *MERALCO* franchise area for its sole account, as well as with a consortium with Batangas II Electric Cooperative, Inc., or *BATELEC II* and First Bay Power Corporation. On September 18, 2012, an amended consortium agreement was executed between *MERALCO* and *FBPC*. On October 17, 2012, *MERALCO* signed two separate amended consortium agreements with *BATELEC II*, and with *FBPC* and *BATELEC II*. These amended consortium agreements superseded the ones signed on December 12, 2011. On December 27 and 28, 2012, the Contract to Sell and Consortium Agreements, respectively, covering these sub-transmission assets were filed with the *ERC* for approval.

The applications for approval of the Consortium Agreement between *MERALCO* and *BATELEC II* and the Contract to Sell among *TRANSCO*, *MERALCO* and *BATELEC II* are submitted for resolution of the *ERC*.

#### *MERALCO's POP Program*

On November 15, 2012, *MERALCO* filed an application with the *ERC* for the approval of its revised Time of Use or *TOU* rates program, also known as the *POP* Program. The *POP* is a rate program being offered by *MERALCO* to customers whose load characteristics can benefit from *TOU* rates as well as to those that can shift their loads from peak to off-peak hours. The proposed revised *POP*

Rate aims to provide better savings to avalees by providing them with a *TOU* program that has a wider pricing difference between peak and off-peak rates.

In an Order dated December 17, 2012, the *ERC* provisionally approved the *POP* Program. *MERALCO* started implementing the program on February 1, 2013.

#### *Feed-in-Tariff (FIT)*

Pursuant to Republic Act No. 9513, or the Renewable Energy Act of 2008 or *RE* Act, the *ERC* issued Resolution No. 16, Series of 2010, Adopting the Feed-in-Tariff or *FIT* Rules, on July 23, 2010. As defined under the *FIT* Rules, the *FIT* system is as a renewable energy policy that offers a guaranteed payment on a fixed rate per kilowatt-hour for electricity from wind, solar, ocean, hydropower and biomass energy sources.

On May 16, 2011, the National Renewable Energy Board or *NREB* filed its Petition to Initiate Rule Making for the Adoption of *FIT*. The Petition proposed a specific *FIT* Rate for each emerging renewable resource. On July 27, 2012, after undergoing several public consultations and public hearings, the *ERC* approved *FIT* Rates that are significantly lower than the rates applied by the *NREB*.

To fund the *FIT* payments to eligible *RE* developers, a *FIT*-Allowance charge will be imposed on all end-users. The *FIT*-Allowance will be established by the *ERC* upon petition by the *TransCo*, which had been designated as the *FIT* Fund Administrator. The *FIT*-Allowance Petition will go through the process of public hearings and consultations.

On February 5, 2014, the *ERC* released the *FIT*-Allowance Disbursement and Collection Guidelines to supplement the *FIT* Rules. This set of guidelines will govern how the *FIT*-Allowance will be calculated using the formulae provided. It will also outline the process of billing and collecting the *FIT*-Allowance from the electricity consumers, the remittance to a specified fund, the disbursement from the *FIT*-Allowance fund and the payment to eligible *RE* developers.

#### *Net Metering Program*

The *RE* Act mandates the *DUs* to provide the mechanism for the “physical connection and commercial arrangements necessary to ensure the success of the *RE* programs”, specifically the Net Metering Program. The *RE* Act defines Net Metering as “a system, appropriate for distributed generation, in which a distribution grid user has a two-way connection to the grid and is only charged for his net electricity consumption and is credited for any overall contribution to the electricity grid”. By their nature, net metering installations will be small (less than 100 *kW*) and will likely be adopted by the households and small business end-users of *DUs*.

On September 4, 2012, the *ERC* released the first draft of the Proposed Net Metering Rules. The proposed rules will govern the implementation of the Net Metering program for *RE* sources. On September 21, 2012, the *ERC* conducted the first public consultation on the proposed rules.

After consultations with stakeholders, the *ERC* issued on July 3, 2013 its Resolution No. 09, Series of 2013, entitled, “A Resolution Adopting the Rules enabling the Net Metering Program for Renewable Energy”. The rules will govern the *DUs*’ implementation of the Net Metering program. Included in the Rules are the Interconnection Standards that shall provide technical guidance to

address engineering, electric system reliability, and safety concerns for net metering interconnections. The final pricing methodology, however, will be addressed in another set of rules and will be endorsed to the *ERC* in due course. In the meantime, the distribution utilities' blended generation cost equivalent to the generation charge, shall be used as the preliminary reference price in the net metering agreement. The rules took effect on July 24, 2013. As at June 30, 2014, *MERALCO* has already energized twelve Net Metering customers, the country's first participants to the net metering program.

#### Interruptible Load Program or *ILP*

In an *ERC* Order dated April 11, 2014, the *ERC* approved with modification *MERALCO*'s request that it be allowed to adopt and implement the "Rules to Govern the Interruptible Load Program of Distribution Utilities" promulgated under Resolution No. 08, Series of 2010, as amended by Resolution No. 08, Series of 2013.

On May 16, 2014, *MERALCO* called on its Interruptible Load Program ("*ILP*") with eligible commercial customers, such as malls and condominium buildings.

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### 33. Event After the Reporting Date

On July 28, 2014, the *BOD* declared an interim dividend and a special cash dividend totaling ₱5.91 per share to all shareholders of record as at August 25, 2014, payable on September 18, 2014.