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Central Electricity Regulatory Commission
New Delhi

Coram : Dr. Pramod Deo, Chairperson
Shri S.Jayaraman, Member
Shri V. S. Verma Member
Shri M. Deena Dayalan, Member

Date: 31st May 2010

In the matter of

Central Electricity Regulatory Commission (Procedure, Terms and Conditions for grant of trading licence and other related matters) (First Amendment) Regulations, 2010.

STATEMENT OF REASONS

1. The Commission in exercise of its power conferred under Section 178 of the Electricity Act, 2003 (hereinafter "the Act") had specified the Central Electricity Regulatory Commission (Procedure, Terms and Conditions for grant of trading licence and other related matters) Regulations, 2009 (hereinafter "2009 regulations"), repealing the Central Electricity Regulatory Commission (Procedure, Terms and Conditions for grant of trading licence and other related matters) Regulations, 2004. One of the important features of the 2009 regulations is reduction in the number of categories of trading licence from six categories to three categories and enhancement of the net-worth criteria,

2. The 2009 regulations came into force with effect from 24.2.2009 .An analysis of data of trading licences issued by the Commission since 2004-05 revealed that out of 44 licences issued, 6 licences have been surrendered. During 2009-10, as against the issue of only one licence, four licences have been surrendered. The data further reveals that 26 trading licensees have not carried out any trading transactions during the period from January to December 2009. It is observed that five Category-I traders (with net-worth requirement above Rs. 50 Crore) control about 85 % of market share in trading. It is also observed that minimum net-worth requirement of

Rs.5 Cr for Category III is acting as a high entry barrier for the new players to take trading licences. This is adversely affecting competition in the market and price discovery. It goes without saying that market functions efficiently when there are a large number players in the market .

3. With the promulgation of Central Electricity Regulatory Commission (Power Market) Regulations, 2010, the members of the Power Exchanges can undertake financial risk on behalf of their clients only as a trading licensee. In this case, the role of members of Power Exchange needs to be recognised. These members have acted as catalysts and have been instrumental in bringing small open access customers and captive power plants to the short term market. It is expected that small members of power exchange would be able to take advantage of the newly created category and join the mainstream by becoming trading licensees. This category of licensees are expected to act as new marketing channel, accommodate the marginal players in the market and to further penetrate the market.

4. Considering above scenario the Commission evolved a proposal to introduce a new category of trading licensees with lower net-worth requirement. The licence fee for this new category was proposed to be Rs. 2.50 lakh per annum. The Commission also decided to amend the ceiling on trade volume and net-worth requirement of existing categories of licensees. Accordingly, the Commission, in exercise of powers under Section 178 of the Act had published the draft amendment to the Central Electricity Regulatory Commission (Procedure, Terms and Conditions for grant of trading license and other related matters) Regulations, 2009 and had invited suggestions and comments from the stakeholders on the draft regulations through the public notice dated 8th April, 2010. The suggestions and comments have been received on the draft regulations from three stakeholders viz. M/s Manikaran Power Limited, Indian Energy Exchange and Tata Trading Power Company Limited.

5. Gist of the suggestions and objections received from the stakeholders is as under:

- (a) Transactions in day-ahead market of power exchanges are not 'trading' as construed in the Act and therefore the volume transacted through day-ahead and term-ahead markets of the power exchanges (PX) should not be included in the trading volume.
- (b) Small licence fees and annual fees for exchange members would encourage to take trading licences. The overheads for facilitating transactions through PX will be minimum and if the members' volume are added to trading volume, then the member will be required to pay higher fees to recover cost of maintaining high net-worth and licence fee. Stakeholders emphasised that trading volume and exchange volume should not be clubbed.
- (c) Separate limits may be prescribed for bilateral volumes and PX volumes.
- (d) Raising the ceiling of traded volume and bringing down net-worth requirement of Categories-II and III will increase market risk and introduction of a new category of licence (Category IV) will deteriorate market functioning.
- (e) Risk mitigating capability of Categories II, III and IV of trading licensees will not be sufficient and with existing trading margin it is very difficult to cover all risks in trading business.
- (f) Regulation 35 of Central Electricity Regulatory Commission (Power Market) Regulations, 2010 provides that PX with less than 20% market share for continuously two financial years falling after a period of two years of commencement of its operations shall close operations or merge with an existing PX within a period of next six months. In view of this provision, trading entities with low volume should not be permitted in a developed market and thus inviting more traders by lowering the net-worth requirement is in contradiction with the above provision.

(g) The trading business infrastructure expenses like operation, administrative and finance charges exceed the net-worth of Rs.1.00 crore specified for Category-IV.

(h) The proposed increase in trading volume of Category-II and III will increase their risk exposures vis-à-vis capital adequacy and liquidity requirement.

6. We have given our thoughtful consideration to the suggestions/ objections expressed by the stakeholders and our views/decisions thereon are enumerated in the succeeding paragraphs.

7. The Commission is of the view that markets function efficiently when there are a large number of market players leading to competition and price discovery. In the present scenario, only five Category-I licensees control 85 % of market share in bilateral trading. As only one licence has been granted during 2009-10, it appears to us that the minimum net-worth requirement of Rs.5 Cr for Category-III is acting as a high entry barrier for new players to enter the trading. We have therefore consciously decided to add a new Category-IV with net-worth of Rs.1.00 crore which can handle trade turnover up to 100 MUs.

8. With the notification of Central Electricity Regulatory Commission (Power Market) Regulations, 2010, the members of Power Exchange can undertake financial risk on behalf of their clients only as a trading licensees. These members have acted as catalysts and have been instrumental in bringing small open access customers and captive power plants in the short term market. It is expected that members of power exchange would be able to take advantage of the newly created category and join the mainstream by becoming trading licensee. The new category of licensees are expected to act as a new marketing channel, further penetrate the market and to accommodate the marginal players.

9. The Commission is of the view that net-worth requirement of Rs.25 Cr and Rs. 5 Cr and annual turnover of 500 MUs and 100 MUs for Category-II and III licensees

respectively have become an unviable business proposition for these licensees. This is corroborated from the fact that three licences have been surrendered in category III and one licence in Category-II. The Commission has, therefore, decided to reduce the net-worth requirement for Category-II from Rs.25 Cr to Rs.15 Cr. In order to make all the categories of trading licensees commercially viable, the net-worth requirement and trading volume limits have been re-aligned.

10. Although a large capital requirement in the form of net-worth reduces risk exposure, it increases the financial cost and reduces business viability for Category-II and III licensees. It makes them uncompetitive, especially considering that there is no limit on the volume to be traded by Category-I licensees. In any case, it is expected that the ultimate buyer/seller undertake their due diligence including capacity adequacy and risk coverage of electricity traders before using their services.

11. We are of the view that the net-worth of trading licensees should be linked to the open position of portfolio rather than the trade turnover since the outstanding open position is the true measure of portfolio risk. The net-worth is a capital adequacy requirement to cover any default by the clients of the trading licensee. However since the open position is difficult to monitor in the absence of real time IT connectivity with all trading licensees, the net-worth has been linked to the turnover of trading licensees. (Trading licensees presently report on a monthly basis, the price, volume and trading margin of transactions undertaken on various types of contracts and not open positions).

12. The increase in trade turnover does not necessarily increase the risk for the trader, as turnover increase can be achieved by rolling over the portfolio several times in a year. The average portfolio tenure is a function of contracts of various durations (weekly, fortnightly, monthly etc) in a trader's portfolio. Hence if the portfolio duration is of 3 months, the same can be rolled over four times in a year without a proportional increase in risk. However, the credit risk would increase if the

transaction is carried out for a larger number of clients. With the revision of trading margin from January 2010, it would be fair to assume that this risk is getting priced now. The increase in turnover on the new net-worth of different categories of trading licensees has also been considered from any change in systemic risk perspective. As the liquidity in the market (traders market and power exchange market) has been increasing, the liquidity risk for the trading licensees has decreased as the market is acting as an alternate mechanism to liquidate any open position in case of a default. Based on all the above, the annual turnovers for the different categories of licence have been revised upwards.

13. The Commission also does not see any merit in prescribing separate volume limits for bilateral trade and power exchange. Members of Power Exchanges with trading licences take the financial risk involved in the transactions. They are fully responsible for all transactions on behalf of their clients. Hence excluding the power exchange volume for net-worth calculation may not be prudent from risk management perspective.

14. As per the existing provisions in the 2009 Regulations, a trading licensee can undertake trading in electricity up to the maximum of 120 percent of the volume of trade authorized to the concerned category in exceptional circumstances. It has also been provided that the licensee may with the prior approval of the Commission and on such terms and conditions as the Commission may decide, exceed the specified limit of 120 percent in a year. Moreover, a trading licensee has the option to apply for the upgradation of its Category of trading licence by meeting the prescribed net-worth requirements. As such, the Commission is of the view that for the purpose of net-worth requirement, total volume of trade i.e. volume traded through power exchange and through bilateral transaction should be considered.

15. The Commission has noted that the overall market size is increasing. The monthly growth in short term market over the January – December 2009 period has been 3.54%. It is also observed that significant new capacities are being installed by the Independent Power Producers and Merchant Power Plants in the next few years.

Considering the imminent capacity addition, there is a strong case for a large pool of trading licensees to cater to the growing market in electricity. The proposed volume of electricity to be traded in a year by a Category II licensee is being increased from 500 MUs to 1500 MUs and that of Category III from 100 MUs to 500 MUs to provide them ample operational flexibility.

16. Though the volume of electricity to be traded by the existing categories of licensees has been revised upwards and net-worth downwards, the licence fee has not been proposed to be revised. This is expected to be beneficial to all the existing categories of trading licensees.

17 As regards suggestion of one of the stakeholders not to invite trading entities with low volumes by lowering the net-worth requirement in view of the provisions and spirit of Regulation 35 of Power Market Regulations, 2010, the Commission is of the view that the said regulation relates to market share of power exchanges which has been introduced to ensure that market liquidity does not split in numerous power exchanges since the primarily role of power exchange is to create benchmark day ahead price. No such consideration is necessary in the over the counter (OTC) market and hence creation of entry barriers is not necessary.

18. The existing licensees are not adversely affected by the proposed amendment to the trading licence regulations. Rather the proposed amendment is expected to increase their business scope with reduced net-worth requirement and increased ceiling of tradable volume. No change is envisaged for Category-I licensees as they are entitled to undertake any quantum of trading volume and free to expand their business. Of course, it is expected of the utilities dealing with the trading licensees to ensure that their commercial interests are fully protected through adequate risk management policies of their companies. The proposed changes are also expected to spurt new companies to take trading licences and bring in competition among the intermediaries. This will ultimately provide sufficient choice to generating companies and distribution licensees for selling and buying power.

19. In view of our discussion in the preceding paragraphs, we do not see any reason to modify any of the provisions of the draft regulations. Consequently, we direct the Secretary of the Commission to finalise the regulations and take steps to notify the same Official Gazette.

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