

RECOMMENDATIONS OF FORUM OF INDIAN REGULATORS ON TARIFF POLICY AS APPROVED IN THE 14TH GENERAL BODY MEETING

INTRODUCTION

Section 3 of the Electricity Act, 2003 states that the Central Government shall, from time to time, prepare the National Electricity Policy and Tariff Policy, in consultation with the State Governments and the Authority for development of the power system based on optimal utilisation of resources such as coal, natural gas, nuclear substances or materials, hydro and renewable sources of energy. Section 61 of the Act also directs the Appropriate Commissions to be guided by the National Tariff Policy while determining the terms and conditions of tariff. As per Section 79 (2) of the Act, the Central Commission shall advise the Central Government on the formulation of National Electricity Policy and Tariff Policy.

The Forum of Indian Regulators (FOIR) is in agreement with the need for a National tariff Policy as guidepost in determining broader sectoral issues.

The Discussion Paper has prescribed numbers/norms covering all the terms and conditions of tariff including project cost, return on equity, debt equity ratio, incentives, depreciation, level of availability for recovering of fixed charges, computation of surcharge for cross-subsidy in open access etc, leaving nothing for the regulator to apply his mind. Section 61 of the Act clearly mandates that it is the responsibility of the Appropriate Commission to specify the Terms and Conditions for determination of Tariff.

FOIR strongly opines that there is a need to distinguish between guiding principles and specification of norms. By prescribing the norms, the policy paper steps into the regulatory domain, which is not intended under the Act. Therefore, FOIR has prepared a set of guiding principles, which should be part of the National tariff policy, to be followed by the Appropriate Commission while laying down the terms and conditions for the determination of tariff, which are enclosed.

NATIONAL TARIFF POLICY

1 OBJECTIVES OF TARIFF POLICY

- 1.1 The objective of the Tariff Policy is to ensure reliable and quality power to the consumers at competitive rates. The Electricity Act 2003 (hereinafter referred as “the Act”) enjoins the Appropriate Commissions to encourage competition, efficiency, economical use of the resources, good performance and optimum investments to achieve the objects and the purpose of the Act.

Tariff Policy seeks to serve these objectives by:

- (a) Ensuring Financial viability of sector entities while protecting interests of consumers
- (b) Ensuring predictability in regulatory actions

2 UNDERLYING PRINCIPLES

Tariff Determination

- 2.1 For all the sub-sectors of electricity industry i.e. generation, transmission and distribution, the tariffs should be determined through a genuinely fair, open and transparent process. In case of Independent Power Producers (IPPs), the tariff should necessarily be determined through International competitive bidding. If the tariff is determined through a transparent process of bidding, then the Appropriate Commission may adopt that tariff. However, the Appropriate Commission has to see / review if the transparent procedure as detailed by Central Government guidelines is followed.
- 2.2 Where tariffs are determined taking costs into account, it may be ensured by the Appropriate Commission that the costs incurred are reasonable and as far as possible subject to verifiable and accepted standards.

Uniform Norms

- 2.3 Within a given sub-sector, the operating norms will be uniformly applied across all utilities e.g. in generation, operating norms will be uniformly applied across Central Sector generating companies, State Sector generating companies, IPPs, generation function within integrated SEBs or Licensees. Though uniform application of operating norms is desirable, it may be done with due regard to:

- (a) Technology;
- (b) Size/ capacity/ age of the assets;
- (c) Current level of efficiency and realistic transition time to reach efficient levels depending on the existing level of operations. It is desirable that this time frame should not exceed three to five years. However, the Appropriate Commission may decide on the actual time-frame based on the ground realities;

2.4 The Tariff Policy recognizes that application of uniform operating norms (and revisions thereto) could pose difficulties in the context of long-term agreements amongst sector entities. In this regard, it is to be noted that:

- In respect of long-term contracts, modifications through mutual discussions, pursuant to provisions of the relevant contract may be attempted and contracting parties could explore possibilities of reducing costs through mutual discussions

Peak and Off-peak tariffs

2.5 A differential tariff for peak and off-peak hours is necessary to promote demand side management. Appropriate Commission may take steps to encourage the distribution licensees to move towards separate peak and off-peak tariffs in a time-bound manner and also move towards time differentiated generation and transmission tariffs. To begin with, the Appropriate Commissions may look at “Time-of-the-day” tariffs for large consumers and gradually cover other major consumer classes in a time-bound manner.

The Appropriate Commission would specify the broad classification of consumers and time frame for implementation. While specifying differentiated tariffs, the Commission may also notify the periods for peak, off-peak and normal consumption.

Co-generation and Renewable sources of generation

2.6 Pursuant to provisions of section 86 (1) (e) of the Act, the Appropriate Commission may promote use of co-generation and generation from renewable sources. The Appropriate Commission may fix a minimum limit on quantity of purchase of energy from such sources taking into account availability of such resources in the State. The distribution licensee may procure energy from co-generation and renewable sources on the basis of competitive bidding among such generating agencies.

3 TARIFF AND FINANCIAL PRINCIPLES

Cost of Capital

- 3.1 The Appropriate Commission may determine the rate base for computing returns either considering debt and equity separately or in conjunction. However, in doing so factors that incentivise capital will be adequately considered.
- 3.2 The Appropriate Commission would need to provide a reasonable return to the investors and strike the right balance between the consumer's interest and the need to attract and sustain capital. In providing the returns, the interest on debt shall be benchmarked to the Prime Lending Rate (PLR) plus a debt margin to reflect the credit worthiness of the developer and the risk profile in the project. The return on equity will be linked to the RBI Bank Rate plus a margin for the investment risk in the power sector. In case of debt denominated in foreign currency, any impact of account of variation in exchange rates will be passed on as part of tariff.
- 3.3 The Appropriate Commission may provide post tax returns and shall ensure that tax only to the extent of the tax on return is provided as pass-through.

Depreciation

- 3.4 For the purpose of tariff determination, the rate of depreciation will be linked to the useful life of the asset. However, a higher rate of depreciation may be permitted by the Appropriate Commission, in case of inadequacy of cash for debt repayment.

Tariffs

- 3.5 While determining tariffs, the Appropriate Commission may apply principles that will reward performance and encourage efficiency and reduction of losses.
- 3.6 Appropriate Commissions may move towards **Multi-Year / Long Term Tariff Principles** to incentivise efficiency gains and T&D loss reduction. This will ensure predictability in regulatory actions as it provides certainty in the tariff setting process. The Appropriate Commission may also ensure that the benefits resulting from these efficiency gains are adequately shared with the consumers.

While laying Multi-year tariff principles, Appropriate Commission may also specify principles of risk sharing, definition of controllable and uncontrollable expenses for the utility, parameters and principles for incentives / dis-incentives, opening level of key parameters and customer service standards to be met by the utility.

- 3.7 As per Section 61 (g) of the Act, the tariff should progressively reflect the **cost of supply of electricity** and also reduce and eliminate cross-subsidies within the period specified by the Appropriate Commission.

- 3.8 Commission may adopt **Cost-to-Serve approach** while determining cost of supply for each category of consumers. If there are any data or implementation constraints, the Commission may adopt Average Cost for determining cost of supply. However, the Commissions should use Average cost to serve as an interim approach only and they need to initiate to move towards Cost-to-serve approach.
- 3.9 **Surcharge** to be levied on wheeling consumers be determined by the Appropriate Commission keeping in view the loss of cross-subsidy from the consumer or category of consumers who have opted for open access to take supply from a person other than the incumbent distribution licensee.

The Appropriate Commission may adopt a principle for computing surcharge, which shall compensate for the entire loss of cross subsidy for any given consumer category for which supply is given, as the Act clearly states that such surcharges shall be utilized to meet the requirements of current level of cross-subsidy. The entire loss of cross-subsidy need to paid to the incumbent distribution licensee.

- 3.10 Where a consumer avails himself of open access, the State Commission may determine the **additional surcharge** to meet the fixed costs of distribution licensee arising out of his obligation to supply and permit collection of such additional surcharge for the period the fixed cost remains stranded.

Pre-tax and Post-tax returns

- By providing post-tax returns, the Commission is giving an assured return to the investor, as the tax implications are a pass-through in the tariffs.
- If a principle of pre-tax returns is adopted, then the actual tax cannot be a pass-through. Pre-tax return implies that cost of tax need to be taken care by the investor itself and should not be passed on to the consumer.
- If the Commission feels appropriate that actual tax paid should be a pass-through, then it is better to adopt the principle of post-tax returns. There is a concern that during the transition period, the utilities may not pay tax because of losses but a component of tariff is being included in the revenue requirement and loaded on to the consumers. In this event, the Commission may evolve truing up mechanisms to plough back the expenditure on tax.
- Post-tax returns will not put any extra burden on the consumers as the Appropriate Commission need to ensure that the tax on return provided by the regulators alone will be a pass-through. Utilities may make higher profits through cost savings, efficiency gains etc and would be liable to pay higher taxes. Tax on these counts will not be loaded in the revenue requirement.