

CENTRAL ELECTRICITY REGULATORY COMMISSION

Sub: Statutory advice to Central Government regarding Tariff Policy

1. Introduction

- 1.1 The Electricity Act, 2003 (except Section 121) has come into force with effect from 10th June, 2003. Ministry of Power, Government of India, vide its letter No.23/20/2001-R&R dated 18.7.2003 has invoked the provision under Section 79(2)(i) of the Act, and has sought the statutory advice of the Central Electricity Regulatory Commission on the formulation of the Tariff Policy.
- 1.2 CERC's statutory advice is contained in the following paragraphs.
- 1.3 In extending this statutory advice, CERC is aware that the Electricity Act, 2003 aims at taking measures conducive to development of electricity industry, promoting competition, protecting interest of consumers and supply of electricity to all areas, rationalising electricity tariff, ensuring transparent policies regarding subsidies, etc. CERC is also aware that the Constitution of India places "Electricity" in the Concurrent List (Entry 38, List III of Schedule VII), and recognises the Centre and the States as equal partners in the promotion of electricity industry.

2. Legal Provision regarding Tariff Policy:

- 2.1 Section 3 of the Electricity Act, 2003 mandates that the Central Government shall prepare a tariff policy. The procedure for preparation of the policy as well as the parameters thereof are clearly defined at Section 3(1) of the Act and is reproduced below:

3.(1) 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.

2.2 It is clear from the above provision of law that the Central Government is obliged to prepare the Tariff Policy **in consultation with the State Governments and the Authority**. The law does not mandate any other consultation by the Central Government, and to that extent, such other consultations may be considered extraneous and not material.

2.3 The above provision of the Act also clearly lays down the ambit and the boundary of the Tariff Policy, by mandating that such policy shall be **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**. The Tariff Policy has to be within the four corners of the law, and should conform to the parameters prescribed.

2.4 The Act mandates that the Central Electricity Regulatory Commission (CERC) shall advise the Government on the Tariff Policy, by laying down as follows:

79(2) The Central Commission shall advise the Central Government on all or any of the following matters, namely:

(i) ***formulation of National Electricity Policy and tariff policy;***

2.5 In terms of the Act, CERC is the only authority recognised by law which is vested with the statutory responsibility to advise the Central Government

on the Tariff Policy. The authority of the CERC in the matter of advising the Central Government on Tariff Policy extends much beyond mere consultation, and its statutory advice is expected to be accepted by the Central Government.

3. Parameters of Tariff Policy:

- 3.1 CERC would like to advise Government that the Tariff Policy should conform to the parameters laid down in Section 3(1) of the Act. The Policy should aim at the development of power system based on optimum utilisation of alternative resources, and should be a document that enables the country to have a balanced mix of available resources for such development. The Policy document should be a brief and concise Vision Paper. It should focus on creating a vibrant power sector for ensuring reliable and quality power to the consumers at competitive rates. It should stress the need for promoting economy, efficiency, and competition, for determination of tariff through a transparent procedure, for competitive bidding for IPPs, for a tariff mechanism to provide the optimum balance between consumer interest and investment in the power sector, for prescribing time frame for separation of CTU and load dispatch functions to enable non discriminatory open access, for transparency in subsidy related issues, for multi-year tariff, for incentivising efficiency gains and better performance, for transparent determination of prudence of investment for tariff purposes, for flexibility between the concepts of return in equity and return on investment, for movement away from cost-plus regime, etc. It should uphold the independence and authority of the Regulatory Commissions for specifying the Terms and Conditions of Tariff, and for discharging such other functions as are mandated under the Act.
- 3.2 The Policy Document should not be an instrument for micro-management of the tariff setting procedure or of the regulatory framework, since this is not mandated under the Act.

- 3.3 In June 2002, Ministry of Power had circulated an earlier Draft of the Tariff Policy, after discussion with Central Utilities, State Electricity Boards and the CEA. The reasons why this draft has been discarded by Ministry of Power are not known. The Commission would advise that this draft may be used as the base document, and may be modified as necessary.

4. Exclusive jurisdiction of Regulator to specify Terms and Conditions of Tariff:

- 4.1 Regulatory Commissions in the Centre as well as in most of the States were established under the erstwhile Electricity Regulatory Commissions Act 1998, which interalia mandated that appropriate Commission “shall determine by regulations the Terms and Conditions for fixation of Tariff” (Section 28 & 29).
- 4.2 Prior to the establishment of the Regulatory Commissions, tariff fixation was in the domain of the Central and State Governments. Government used to determine the Terms and Conditions of Tariff for Generating Companies in terms of Section 43A(2) of the Electricity (Supply) Act 1948, which is reproduced below:

The tariff for the sale of electricity by a Generating Company to the Board shall be determined in accordance with the norms regarding operation and the Plant Load Factor as may be laid down by the authority and in accordance with the rates of depreciation and reasonable return and such other factors as may be determined, from time to time, by the Central Government, by notification in the Official Gazette:

Provided that the terms, conditions and tariff for such sale shall, in respect of a Generating Company, wholly or partly owned by the Central Government, be such as may be determined by the Central Government and in respect of a Generating Company wholly or partly owned by one or more state Governments be such

as may be determined, from time to time, by the government or governments concerned.

Under this provision, financial norms like depreciation, reasonable return etc. were determined by the Central Government, while operational norms and Plant Load Factor were determined by the Central Electricity Authority.

- 4.3 With effect from 15th May 1999, Section 43A(2) was omitted in respect of generating companies owned or controlled by the Central Government and generating companies having a composite scheme for generation and sale in more than one state. Accordingly, the powers to fix financial terms and conditions (earlier with Government) and to fix technical terms and conditions (earlier with CEA) were passed on to the Regulator. Section 43A(2) has been omitted for many States also.
- 4.4 In respect of Licensees, tariff was determined in accordance with Schedule VI of the Act of 1948. The ERC Act of 1998 diluted Schedule VI by mandating that the Commissions could depart from these provisions for reasons to be recorded in writing (Section 30). The Electricity Act of 2003 does away with Schedule VI altogether.
- 4.5 Various judicial pronouncements have upheld that the Commission concerned is the sole authority to determine tariff and for framing regulations for terms and conditions of tariff.
- 4.6 From the above historical analysis, it will be clear that it has been the endeavor of Parliament, the Judiciary as well as the Executive to distance Government from Regulatory activity, to uphold the independence of the Regulatory framework, and to repose confidence in its impartiality and transparency in the discharge of its statutory responsibility. In fact, the Electricity Act, 2003 recognises the further maturing of the Regulatory system by vesting it with greater responsibility in matters related to licensing, open access, gradual removal of cross subsidy, market development, promotion of competition, economy, and efficiency, etc. There is no provision anywhere in the Electricity Act, 2003 which restores

back to Government the authority to specify terms and conditions of tariff which was available to it under Section 43A(2) and Schedule VI of the erstwhile Electricity (Supply) Act 1948.

5. CERC's Tariff Regulation: 2001-2004: -

- 5.1 In exercise of the power vested in it by law, CERC notified the Terms and Conditions of Tariff for the period 1st April 2001 to 31st March 2004, after a detailed, transparent consultation process lasting more than one year. Since this was based on Cost-plus approach, CERC devised its objective methodology for determining the prudence of capital cost for tariff purposes. CERC also determined the numbers/norms for the six elements of fixed charges (interest on loan, depreciation, operation & maintenance, return on equity, interest on working capital and income tax) and operational norms for variable charges (station heat rate, secondary fuel oil consumption, auxiliary energy consumption, target availability, etc.) CERC's regulation on the Terms and Conditions of Tariff for the above period was notified in the Gazette of India (Extraordinary) dated March 26, 2001 and was duly laid on the Table of the Parliament. This document is available on CERC's Website: www.cercind.org

6. CERC's Tariff Regulation for the period beginning April 1, 2004:

- 6.1 Section 61 of the Electricity Act, 2003 mandates that "the appropriate Commission shall, subject to the provisions of this Act, specify the terms and conditions for the determination of Tariff". In exercise of this responsibility, CERC is currently in the process of formulating the Terms and Conditions for determination of tariff for the period beginning April 1, 2004, through a transparent procedure of giving due consideration to inputs from all stakeholders. A Discussion Paper for this purpose has been prepared in June 2003, and comments have been solicited from all

stakeholders. The Discussion Paper is available on the Website of the CERC www.cercind.org

6.2 Concurrently CERC is in the process of finalising its Regulations for transmission license, trading license, open access in inter-state transmission and distribution etc. All these documents are expected to be notified within the next six months.

7. Discussion Paper of Ministry of Power:

7.1 CERC's attention has been drawn to the document entitled "Preliminary Discussion Paper on Tariff Policy (prepared with the assistance of CRISIL)" which has recently been posted in the Website of Ministry of Power. CERC would like to make the following observations in this regard:

- (i) It appears that Ministry of Power had constituted a Committee with Secretary Power, Chairman CEA and CRISIL as Members for preparing the Discussion Paper. Section 3 of the Act mandates that the document shall be prepared in consultation with State Governments, but this has not been done. The document can hardly be termed as Discussion Paper, since it clearly states the mind of the Ministry of Power (with the assistance of CRISIL), on every issue of tariff setting, and does not throw up any choice or alternatives for discussion and debate. The underlying spirit of the mandated consultation process is to ensure that the Paper is developed in conjunction with the State Governments, and not to seek the comments of the State Governments on a Paper which already gives out the mind of the Central Government.
- (ii) It is clear that the Consultant, namely CRISIL, had not understood the parameters of Tariff Policy as laid down in Section 3(1) of the Act. The Draft Document goes far beyond this mandate for

“development of the power system based on optimal utilisation of resources.....” The Consultant appears to be unduly preoccupied with eliminating all regulatory discretion, rather than with the formulation of a Vision Paper for the Power Sector. It also appears to be an attempt to restore to the Central Government the authority given under the Section 43(A)2 and Schedule VI of the erstwhile Electricity (Supply) Act of 1948. We would sincerely like to believe that this was not the mandate given to its Consultant by the Ministry of Power, since the Act has clearly done away with such provision. 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. 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. However, the draft document has itself specified these Terms and Conditions. Any such attempt to vest in the Central Government the authority to prescribe terms and conditions, methodologies and principles of tariff determination will be violative of the provisions of law, since powers vested upon the Regulators by the Parliament and upheld through judicial pronouncements, cannot be taken away through a policy instrument.

- (iii) It is curious to note that most of the new methodologies and numbers included in the Discussion Paper are loaded in favour of the Central Public Sector Utilities. For example, the Central Commission follows its own prudence norms for determining the project cost for tariff purposes, while the paper lays down that the project cost as approved by the appropriate authority shall form the basis of tariff setting for Government owned projects. The commission has prescribed a straight-line method of depreciation

combined with advance against depreciation for repayment of loan obligations, while the Paper provides that the rate as per Schedule XIV of the Companies Act 1956 shall be taken for tariff purposes also, although the Companies Act is applicable for accounting purposes only. The Commission has prescribed recovery of full fixed charges at 80% target availability while the Paper proposes such full recovery at 75%. The Commission has prescribed incentives beyond 77% PLF @ 50% of the fixed charges subject to a maximum of 21.5ps per kWh while the Paper relates the incentives to the return on equity. CERC has prescribed the Terms and Conditions of Tariff after an open consultation process of more than 12 months. The reasons for modification of these numbers is not understood, particularly since there has not been any detailed consultation. This will lead to increase in tariff which will affect the States and the consumers. CERC would like to remind the Ministry of Power that some CPSUs have appealed to the Hon'ble Courts in the matter. It may be highly inappropriate for the Central Government to provide these reliefs to the CPSUs through the Tariff Policy when the matter is still in the jurisdiction of the Courts.

- (iv) On the issue of long-term Agreements, both the ERC Act, 1998 and the Electricity Act, 2003 are silent. The Paper suggests modifications through "mutual discussion" between contracting parties. The jurisdiction of Regulators vis-à-vis PPAs, in the meanwhile, has come up before various Courts, and appropriate Orders have been issued. The Commission considers it ill advised to put something so expressly in the policy document, which the Legislature have not done while framing the law.
- (v) The Draft Discussion Paper makes it clear that the Tariff Policy will be uniformly applicable all over the country. Apart from the fact that this will take away the discretion available with the State Governments and Regulators, such a proposition does not appear

to take into consideration the dynamics of the power sector and the differing ground realities. Given the diversity in economic development, power sector reforms, as well as of technology, vintage, fuel, size, etc., it will be extremely difficult to enforce this through one document. It is in recognition of this diversity that law prescribes not only the Central Regulator but also Regulators in every State who would have flexibility to deal with States specific issues. The Electricity Act, 2003 mandates the required level of uniformity by prescribing that the SERCs will be guided by the principles and methodologies specified by the Central Commission for determination of tariff applicable to generating companies and transmission licensees [Section 61 (a)]. The Act also provides for an institutional mechanism in the form of a Forum of Regulators [Section 166(2)] through which the objective of harmonisation and uniformity can be achieved more effectively.

- (vi) With regard to Distribution, the Discussion paper proposes use of the concept of AT&C losses, wherever feasible, as a measure of efficiency, instead of T&D losses. AT&C Losses are a combination of two efficiency parameters, i.e., distribution system losses and collection efficiency. The concept of AT&C Losses arose because of non-availability of trust-worthy data. Improving the quality of data alone can mitigate the risk of data uncertainty, and not the using of AT&C Loss concept.

Under the existing conditions of data uncertainty, price cap regulation may only compound existing distortions. The time frame is a State-specific issue and should be left to the State Commissions to decide.

All bad debts cannot be treated as automatic pass through since these would place the burden of bad debt on regular paying customers. Normative provisions would need to be used. Similarly, computation of net-worth and interest on working capital

have various connotations which cannot be captured in a simple formula. These issues should be left to the appropriate Commission.

It is not understood as to how the Consultant concluded that the open access surcharge for consumers shall not be more than 50% of the difference between the average tariff and the average cost of supply. The Electricity Act, 2003 clearly provides for determination of wheeling charge, surcharge and additional surcharge by the appropriate Commission in view of State-wise divergences. Hence these should be left to the Regulatory Commissions.

8. Conclusion:

- 8.1 The observations in the foregoing paragraphs would make it clear that the Preliminary Discussion Paper on Tariff Policy (prepared with the assistance of CRISIL) posted on the Website of the Ministry of Power goes far beyond the mandate of Section 3 of the Act. The Central Commission would therefore advise the Central Government to prepare the Tariff Policy within the scope and ambit of the Act and following the prescribed consultation procedure. We have indicated the broad contours of the Tariff Policy at paragraph 3 of this document.
- 8.2 This advice under Section 79(2) of the Act is being tendered on the basis of the information available to us in the Discussion Paper. Ministry of Power may please forward to us the Draft Tariff Policy as and when prepared, for statutory advice of the Central Commission before its finalisation.
- 8.3 The Commission would be willing to prepare such draft of the Tariff Policy, if necessary.
- 8.4 The Commission would expect the Central Government to accept the statutory advice given in this document.

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