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Secretary
Hon'ble Central Electricity Regulatory Commission
3rd & 4th Floor, Chanderlok Building,
36, Janpath,
New Delhi - 110001

16th September 2019

Sir,

Sub: Comments/ suggestions/ objections on Draft Central Electricity Regulatory Commission (Procedure, Terms and Conditions for grant of trading license and other related matters) Regulations, 2019 dated 24.07.2019 issued by the Central Electricity Regulatory Commission

Ref:

(1) Draft Central Electricity Regulatory Commission (Procedure, Terms and Conditions for grant of trading licence and other related matters) Regulations, 2019 dated 24.07.2017 issued by the Central Electricity Regulatory Commission ("**Draft Regulations**"), and Explanatory Memorandum thereto ("**EM**"); and

(2) Public notice dated 24.07.2019 given under Section 178(3) of the Electricity Act, 2003 read with the Electricity (Procedure for Previous Publication) Rules, 2005 inviting comments/ suggestions/ objections from the stakeholders and interested persons on the aforesaid Draft Regulations.

We would like to thank the Hon'ble Commission for providing us the opportunity to provide our comments/ suggestions/ objections on the Draft Regulations.

We would like to highlight some of the concerns that may be faced by an Electricity Trader under the proposed amendments, particularly Regulations 7 and 8 of the Draft Regulations. Statkraft Markets Private Limited ("**SMPL**") is a Category – I Trading Licensee, offering its products in the medium term and long-term segment. SMPL being an Electricity Trader will also be adversely affected by the Draft Regulations which propose to bring a change in the transactions under 'Open Position'. We have written to the Hon'ble Commission vide our letter dated 05th August 2019, seeking clarifications on specific concerns which the Hon'ble Commission is trying to address through these Draft Regulations which may be read as part and parcel of the present submissions.

1. Draft Regulations do not recognize the risks taken by the Electricity Trader

1.1. Electricity Traders are defined under Section 2(26) of the Electricity Act, 2003 (**Electricity Trader/Trader/Trading Licensee**). Traders play an important role in the

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market by reducing the seller's search costs for buyers, by providing market information and matching buyers and sellers. The proposed Draft Regulations do not recognize the risks born by an Electricity Trader while undertaking trading activities. As per the Electricity Act 2003, trading is defined under Section 2(71) as being:

> *"(71) "trading" means purchase of electricity for resale thereof and the expression "trade" shall be construed accordingly"*

1.2. Trading is recognized as a separate activity under the Electricity Act 2003 in sync with the overall framework of encouraging competition in all segments of the electricity industry. Electricity Traders, by virtue of purchase of electricity, own the title of the electricity purchased, before selling it to the consumer. Due to such trading activity, the Electricity Trader undertakes obligation of sale of electricity and consequently, the obligation of risk of delivery/offtake. As traders, the Trading Licensees are required to take default risk, late payment risk, contract dishonour risk, inflationary risk, inherent in the trading business. The Trading Licensee accordingly needs to be compensated for the said risks.

1.3. It is accordingly submitted that electricity trading takes place wherein there is a purchase and resale of electricity, resulting in the title of the electricity being transacted getting vested in the electricity trader. Due to transfer of such title, there is an element of risk of delivery/off-take of units of electricity that is assumed by the electricity trader in the very nature of transaction. Whereas a professional member other than the electricity trader, functioning as a broker will not have similar assumption of risk of delivery or off-take of the underlying units akin to an electricity trader. Such members negotiate/arrange contracts for the purchase or sale of electricity, on behalf of its principal on payment of commission or remuneration.

1.4. An Electricity Trader enters into transactions in/on 'Open Position', having two legs of transaction i.e. transaction with the seller and transaction with a buyer. An Electricity Trader has to/is bound to fulfil both parts of the transaction, regardless of any breach on one side. A broker on the other hand only acts as a facilitator, generally entering into back-to-back contracts with the seller and the buyer. The broker is exposed to financial risk only on breach of a contract.

1.5. As per the EM, the Draft Regulations propose to resolve the issue of risk under a contract with generators being passed on to the DISCOMS by the brokers through back to back contracts, and have suggested various amendments in trading margin in this regard. However, the Draft Regulations is discriminatory vis a vis traders, who assume varied risks and offer innovative products in the market by taking market risks.

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1.6. The price volatility of the market caused due to fluctuating demand and supply for the electricity, affects the consumers/buyer and exposes them to price risks, which are placated by Electricity Traders. Electricity Traders thus take market risk, credit risk, and regulatory risk arising out of obligation to deliver power to the consumers at the prevailing prices in the market.

1.7. The Draft Regulations do not recognize the risks undertaken by an Electricity Trader. Moreover, the Draft Regulations attempt to bring under the regulatory purview such transactions wherein either of the legs of the transactions i.e. transaction with the seller and transaction with the buyer, is a short-term transaction. By including such transactions under the regulatory ambit, the Draft Regulations propose to impose a cap and floor on the trading margin that can be earned by an Electricity Trader under long / medium term transactions with open position, failing to strike a balance between the risks taken by a Trader and the margin allowed for coverage of such risks.

2. Amendment to Definition of Short-Term Contracts (Regulation 7 of the Draft Regulations); Draft Regulations impose a price cap in non-observance to the market spirit

2.1. The Central Electricity Regulatory Commission (Fixation of Trading Margin) Regulations, 2010 ("**Trading Margin Regulations**") in its present form, are applicable to short term buy-short term sell contracts for the inter-state trading in electricity undertaken by a licensee. Regulation 3(1)(d) of the Trading Margin Regulations defines a "Short Term Buy - Short Term Sell contract" as "*a contract where the duration of the power purchase agreement and power sale agreement is less than one year*".

However, Regulation 7 of the Draft Regulations proposes the following amendment:

"*7. **Applicability of Trading Margin:***

Trading margin shall be applicable to the following types of contracts undertaken by the Trading Licensee:

(a) <u>Short term contracts (where period of the contract of the Trading Licensee with either or both the seller and the buyer is upto one year including transactions undertaken through power exchanges);</u>

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(b) *Long term contracts and medium term contracts (where period of the contract of the Trading Licensee with both the seller and the buyer is more than one year);*

... "

(Emphasis supplied)

2.2. It is respectfully submitted that earlier, short-term contracts referred to contracts wherein both legs of the transaction were less than one year. As per the proposed amendment, any transaction where even one of the contracts in the buy or sell side is up to one year, will be treated as short term contract.

2.3. It is respectfully submitted that the proposed amendment to the definition of short-term contracts, will have an adverse and debilitating effect on market innovation.

2.4. As per Regulation 8(c) of the Draft Regulations, the Trading Licensee can charge, for short term contracts and contracts through power exchanges, a minimum trading margin of zero (0.0) paise/kWh and a maximum trading margin of seven (7.0) paise/kWh. The Draft Regulations subject short-term transactions to a maximum trading margin of seven (7.0) paise/kWh whereas the risk taken by a Trader is much more.

2.5. In it is respectfully submitted that while prescribing the margin cap, the Hon'ble Commission took into consideration the traders' requirements of meeting expenses incurred to mitigate risks, expenses incurred towards Operations & Maintenance and return on net worth. The said consideration was implemented about 9 years back, which specifically excluded all transactions other than short term buy-short term sell, explicitly keeping the long term and medium-term transactions out of the purview of the proposed regulations.

2.6. It is humbly submitted that Clause 7 of the Statement of Reasons to the Trading Margin Regulations provided for no capping on trading margin of long-term contracts. This is because the Hon'ble Commission was of the view that where traders entered into long-term power purchase agreements ("**PPA**") of duration exceeding a year, the risks could not be completely mitigated through a trading margin. Further, since the long-term power procurement market was witnessing competitive forces at work, the Hon'ble Commission felt that the determination of an appropriate trading margin would be best left to market forces. While adopting such view, the Hon'ble Commission was of the opinion that the Trading Licensees would be required to be compensated for default

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risk, late payment risk, contract dishonour risk, operations and maintenance expenses and return on net worth.

2.7. It is further submitted that the cap of (7.0) paise/kWh, implemented 9 years ago, not only remains the same today but has also been imposed on long term and medium-term transactions as per the proposed Regulation 7 of the Draft Regulations. The margin so fixed does not take into consideration, inflationary tendencies wherein the WPI of approximately 9% since 2011-12. It is submitted that off-setting of inflationary trends is present in all other forms of tariff determined by this Hon'ble Commission. There is no rationale in disallowing any adjustments towards inflation for trading margin. The imposition of trading margins takes away the ability of an Electricity Trader to operate innovative market products, which ultimately help decrease the power procurement cost of the end consumer resulting in increased savings and security for the consumer.

2.8. It is humbly submitted that while the margin cap does not justify the risks taken by an Electricity Trader, it does not also recognize the instances/scenarios where the traders transact on negative margin.

2.9. A margin cap of (7.0) paise/kWh for short term transactions as per the Draft Regulations should not be imposed on long term/medium term transactions and similarly, a price floor of (0.0) paise/kWh should also be done away with in order to recognize the transactions undertaken by a trader and allow a trader to insulate its clients from the price volatility prevalent in the market.

3. Draft Regulations will have the effect of discouraging innovative products

3.1. One important benefit of competition among the Traders in the spirit of the Electricity Act 2003, is a boost to innovation. Competition among Traders spurs invention of new or better products, or more efficient processes, leading the Traders to invent new types of trading arrangements.

3.2. It is submitted that many consumers across different states avail open access by procuring electricity from sources other than the incumbent state utility/ DISCOM. One of the potential sources of procurement for consumers is through power exchanges. However, the challenge that many consumers face is that procurement through power exchanges can only be done either through day ahead market or term ahead market and hence, they have visibility of their cost of procurement for only the next day or next week. This makes it difficult for them to plan and budget costs for a longer term.

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3.3. An Electricity Trader has to take market risk and offer innovative products in the market to sustain competition. Various products are offered by Electricity Traders to the consumer to provide the consumers the certainty in their power procurement costs over a medium term (i.e. more than one year but less than three years) transaction. The fixed price product is in the form of a bilateral contract between the Electricity Trader and the consumer, where the Electricity Trader sources electricity either through the power exchange or through intra/ inter-state generators (conventional / renewable) directly. Such product structuring is done to meet medium term power requirements through careful planning of short-term purchases. Such transactions undertaken by an Electricity Trader by taking an Open Position is recognized under the Central Electricity Regulatory Commission (Power Market) Regulations, 2010 ("**Power Market Regulations**").

3.4. These Open Position transactions entail significant risk for the Electricity Trader/Trading Licensee who is exposed to the fluctuation in market prices

3.5. It is submitted that the fixed price offered by Electricity Traders enables consumers to save electricity costs relative to their state utility/ DISCOM tariff and protects them against price volatility in the market. Such products (including those offered by SMPL) are beneficial for consumers and can be applied successfully and on a sustained and commercially viable basis only if there is no cap on trading margin even where one leg of the transaction is short-term, while the other leg is medium-term. However, the Hon'ble Commission has not provided any rationale in the Draft Regulations and the EM thereto for bringing both legs of such transaction with open position within the purview of short-term contracts.

3.6. While we appreciate that vide the Draft Regulations, the Hon'ble Commission is endeavoring to bring about changes in the prevailing regulatory dispensation in the best interest of market development, it is humbly submitted that <u>the Hon'ble Commission has not provided any conclusive evidence of market failure/ mischief that is sought to be addressed by bringing at least one of the legs of the transaction undertaken through power exchanges within the purview of short term contracts</u>. It is pertinent to note that such regulatory intervention seems unjustified considering the fact that the "Report on Short-term Power Market in India: 2017-18" issued by the Hon'ble Commission notes that of the total electricity procured in India in the year 2017-18, the short-term power market only comprised 11%. The balance 89% of generation was procured mainly by distribution companies through long-term contracts and short-term intra-state transactions.

a) As per the CERC Market Power report the % share of top 5 traders was 76% in May-2019 with the top two traders grossing 57% Market Share. Further the HHI Index has increased to 0.256 in May-2019 up from 0.23 in 2009. This indicates a lack of

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competition in the power market and we are of the opinion that product innovation has to be fostered to allow competition to flourish so that it benefits the end customers.

3.7. The proposed amendment will have an adverse impact on the innovation of medium term contracts based on aggregation / segregation of contracts on the buy side or the sell side. The treatment of such contracts as short term contracts and thereby imposing a cap and floor on the trading margin will discourage Trading Licensees from offering medium term supply solutions as the margin of seven (7.0) paise/ kWh is not sufficient to cover the risks related to Open Position transactions in the medium term.

4. Draft Regulations and the EM thereto do not disclose the reasons for introducing amendments:

4.1. It is humbly submitted that the Hon'ble Commission has not provided the rationale for bringing transactions with open position wherein either the buying or selling leg of the transaction undertaken through power exchanges is up to one year, within the purview of short-term contracts. The proposed amendments in the Draft Regulations have the effect of significantly and drastically altering the rules of electricity trading. It has a grave impact on the business of Electricity Traders by completely altering the rules of the game. It is most respectfully submitted that unless the Draft Regulations and the EM clearly set out the objective or the rationale for the proposed amendment, the stakeholders will not be in a position to address effectively on the proposed change. The transparency in regulation making process requires the Hon'ble Commission to clearly spell out the reasons for altering the definition of short-term contracts, and thereby bringing within its purview, transactions that were earlier treated as medium term or long-term contracts. The present consultation process would remain a formality, unless the stakeholders are allowed an effective opportunity to know about and address the rationale of the Commission for introducing such wide ranging amendments.

4.2. In the absence of clearly defined basis or objective of the proposed amendment, it is not clear why the Hon'ble Commission has chosen to deviate from its earlier approach w.r.t. non-applicability of the definition of short term contracts to transactions with open position wherein either the buying or selling leg of the transaction undertaken through power exchanges is up to one year. It is also not clear as to why the Hon'ble Commission proposes to change its approach with respect to transactions with open position vis-à-vis applicability of cap on trading margin. Such drastic policy change without clearly formulated reasons would give rise to regulatory and business uncertainty.

4.3. It is respectfully submitted that SMPL had vide letter dated 05th August 2019, requested the Hon'ble Commission to disclose its reasoning, background information and assumptions on the basis of which the amendment in the Draft Regulations were

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formulated, for the benefit of all the stakeholders, and in order to enable them to provide effective and meaningful feedback on the Draft Regulations. We had even requested the Hon'ble Commission to provide the necessary details/ documents as an addendum to the EM accompanying the Draft Regulations; however, such information has not been furnished by the Hon'ble Commission.

4.4. SMPL seeks liberty to add to its present submissions as and when the basis and rationale for the proposed amendment is formally disclosed by the Hon'ble Commission.

5. Draft Regulations and EM do not disclose the basis, details or empirical studies for drawing assumptions based on which, Draft Regulations were formulated:

5.1. The Hon'ble Supreme Court of India, in para 91 of its judgment in ***Cellular Operators Association of India v. TRAI*, (2016) 7 SCC 703** ("**Call drop judgment**"), has observed the following:

> "*91. In Corpus Juris Secundum (March 2016 Update) it is stated:*
>
> "
>
> *Conclusory statements will not fulfill the administrative agency's duty to incorporate in adopted rules a concise general statement of their basis and purpose. The agency must articulate a satisfactory explanation for its action, including a rational connection between the facts it found and the choices it made. Under some circumstance, agencies must identify specific studies or data that they rely upon in arriving at their decision to adopt a rule...*"
>
> (Emphasis supplied)

5.2. Therefore, conclusions and assumptions made by the Hon'ble Commission for purposes of regulation-making, has to be explained based on facts, studies or data. It is submitted that all law-making has to conform to the fundamental tenets of transparency. One of the cornerstones of good regulatory practice is that it cannot be intuitive. Regulatory intervention in any form has to be based on empirical data/ evidence which warrants/ justifies such intervention.

5.3. It is respectfully submitted that the Hon'ble Commission has made several conclusive statements in the EM to the Draft Regulations relating to purported unfair market practices indulged in by certain Trading Licensees without any supporting details, material/ market survey/ data to substantiate such claims. Unless the Hon'ble Commission makes available to the stakeholders the supporting material/ studies on the

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basis of which such conclusive statements have been made, the stakeholders, including SMPL herein, will not be in a position to effectively address/ counter such statements or provide suggestions on the amendments based on such conclusions.

5.4. The attention of the Hon'ble Commission is specifically drawn to para 2.3.1 of the EM, which refers to certain malpractices that are being adopted by 'select Trading Licensees'. While these instances have been referred in relation to the addition of clause (23) of Regulation 9 of the Draft Regulations, we strongly feel that such concerns are not limited only to Regulation 9(23), but transcend into other parts of the Draft Regulations directly or indirectly, expressly or in an implied manner. Hence, it assumes utmost importance that the Hon'ble Commission discloses all relevant details of such alleged malpractice in support of its proposed amendment. It is presently not even clear whether the malpractice referred by the Hon'ble Commission is common in occurrence, or arises in some specific cases. Once the details are available, the stakeholders will be in a better position to respond to the suggestion of the Hon'ble Commission.

5.5. It is humbly submitted that even if the Hon'ble Commission is seeking to address the alleged malpractices of select Trading Licensees vide the Draft Regulations, such Draft Regulations should not be drafted in a manner so as to stifle the legitimate business model and interests of Trading Licensees such as SMPL herein. That may cause greater harm to the trading business than the intended benefit of the proposed remedy. The Draft Regulations seek to kill innovation for genuine Trading Licensees such as SMPL who have created different products under the current dispensation with respect to open position. In view of the above, the Hon'ble Commission is requested to kindly revisit the definition of "short term contracts" proposed in Regulation 7(a) of the Draft Regulations.

5.6. It is humbly submitted that in our letter dated 05th August 2019, we had highlighted the fact that the Hon'ble Commission has formulated the Draft Regulations on the basis of certain assumptions and that these assumptions have not being comprehensively dealt with or disclosed in the Draft Regulations or the EM thereto.

6. Compliance Requirements / 17 Contravention by Trading Licensee

6.1. We recommend Hon'ble Commission to monitor net worth and other financial compliances of Trading Licensees on an ongoing basis. We suggest that non-compliant licensees be barred from applying for Open Access for the duration of non-compliance.

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7. The proposal for Payment Security Mechanism under the Draft Regulations are discriminatory, counter-productive and do not address risks taken by Trading Licensees

7.1. Regulation 8 of the Draft Regulations provides for trading margin to be charged by Trading Licensees. Regulations 8(1)(c) and 8(1)(d) of the Draft Regulations provide the following:

> "*8. Trading Margin:*
>
> *(1) Trading Licensee shall comply with the trading margin as given below:*
>
> .
>
> .
>
> *(a) For short term contracts and contracts through power exchanges, the Trading Licensee shall charge a minimum trading margin of zero (0.0) paise/kWh and a maximum trading margin of seven (7.0) paise/kWh:*
>
> *Provided that in contracts where escrow arrangement or irrevocable, unconditional and revolving letter of credit as specified in clause 10 of regulation 9 is not provided by the Trading Licensee in favour of the seller, the Trading Licensee shall not charge any trading margin exceeding one (1.0) paise/kWh.*
>
> *(b) For long term contracts and medium term contracts, the trading margin would be decided mutually between the Trading Licensee and the seller:*
>
> *Provided that in contracts where escrow arrangement or irrevocable, unconditional and revolving letter of credit as specified in clause (10) of regulation 9 is not provided by the Trading Licensee in favour of seller, then the Trading Licensee shall not charge any trading margin exceeding one (1.0) paise/kWh.*
>
> .
>
> .
>
> ..."

(Emphasis supplied)

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Regulation 9(10) of the Draft Regulations provides the following:

"*9. **Obligations of the Trading Licensee***

The Trading Licensee shall be subject to the following obligations; namely: -

.

.

(10) The Trading Licensee shall make payment of dues upon the agreed due date to the seller for purchase of the agreed quantum of electricity through an escrow arrangement or irrevocable, unconditional and revolving letter of credit in favour of seller. Such escrow arrangement or irrevocable, unconditional and revolving letter of credit in favour of seller shall be equivalent to:

(a) two point one (2.1) times the average monthly bill amount (estimated average of monthly billing amounts for three months or actual monthly billing amount for preceding three months as the case may be) with a validity of one year for long term contracts;

(b) one point zero five (1.05) times of contract value for short term contracts.

.

..."

7.2. By treating Open Positions with contract for sale for less than a year as short term contracts, and thereby capping the trading margin, the Draft Regulations have created an onerous situation for the Trading Licensees who, in the event of non-offtake by DISCOMS, would be subject to trading margins if they try to sell the power through power exchange or short term bilateral contracts. The obligation of Trading Licensees under a long term contract to undertake offtake of power to mitigate loss for the generation company, is clearly inconsistent with the provisions of Regulations 8 and 9 of the Draft Regulations, which will subject the Trading Licensee to a capped margin of seven (7.0) paise/ kWh, if such power is sold through power exchange or short term bilateral contracts. The Trading Licensee clearly, has no option to resort to alternate disposal of power, unless the same is through a medium term or long term contract. The

same is detrimental to the interest of the sector, which is deprived of the availability of short-term power. This aspect needs to be considered by the Hon'ble Commission.

7.3. The Draft Regulations propose that the Trading Licensee shall ensure payment of dues upon the agreed due date to the seller through an escrow arrangement or irrevocable, unconditional and revolving letter of credit in favor of seller. For long-term contracts, where an escrow arrangement or irrevocable, unconditional and revolving letter of credit is not provided by Trading Licensee in favor of seller, then the Trading Licensee shall not charge any trading margin exceeding one (1.0) paise/kWh.

7.4. It is humbly submitted that the Hon'ble Commission has accorded undue importance to payment security mechanism to be provided by Trading Licensees under the Draft Regulations as such payment security mechanism does not safeguard against risks taken by a Trading Licensee under a long-term trading contract.

7.5. It is further submitted that creation of payment security mechanism/ escrow arrangement needs to be revisited by the Hon'ble Commission since in any case, liability of a Trading Licensee to pay the seller/ generator has to be correspondingly matched by its assets under the proposed liquidity ratio. There is no need for payment security mechanism in such a scenario.

7.6. The Hon'ble Commission has sought to de-risk only the generator without securing a similar protection for the Trading Licensee from the DISCOMS, thereby giving undue weightage to one party to the exclusion of the other which renders such provision manifestly arbitrary and discriminatory.

7.7. The Draft Regulations prohibit Trading Licensee from charging any trading margin exceeding 1 paisa/kWh in case payment security or escrow arrangement is not provided by a Trading Licensee in favor of a seller. This is a disproportionate and onerous restriction on the Trading Licensee. It is submitted that a trading margin of 1 paisa/kWh does not take care of the various risks taken by a Trading Licensee, especially in long-term contracts.

7.8. The Ministry of Power (**MoP**), vide its order dated 28.06.2019 issued directions regarding opening and maintaining the Payment Security Mechanism (**PSM**) under the PPAs by the Distribution Companies. The mandate for issuing and maintaining such PSM has been provided under the MoP order but leaving the flexibility to decide the quantum and period of such PSM, with the parties. The Hon'ble Commission thus should not impose an indiscriminate umbrella condition of 1:1 PSM maintenance.

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7.9. It is further submitted and reiterated that since the short-term power market only contributed towards 11% of the total electricity procured in India in the year 2017-18, the Hon'ble Commission should forbear from disincentivizing Trading Licensees by further capping their trading margin which could adversely affect the growth of short-term power market in India.

In light of the above, we seek your assistance in navigating the regulatory parameters and impediments to arrive at a solution that is conducive to the market and the stakeholders, and implore you to revisit Regulations 7 and 8 of the Draft Regulations in light of the issues detailed above.

We humbly request the Hon'ble Commission to consider the cause of genuine Trading Licensees such as SMPL wherein the product offered involves one short-term leg and one medium-term leg and carve out an exception in the Draft Regulations for such products.

We request this Hon'ble Commission for an opportunity of hearing to brief the Hon'ble Commission on various operational aspects of the Draft Regulations through detailed presentation.

We reserve our right to file additional documents and data in support of our contentions as detailed above, if requested by the Hon'ble Commission or if deemed to be appropriate and necessary by us in this regard.

This letter is without prejudice to our rights, remedies, and contentions as available in law.

Thanking you.

Yours sincerely,

STATKRAFT MARKETS PRIVATE LIMITED NEW DELHI

For Statkraft Markets Private Limited