Aquamarine

Chairman, Central Electricity Regulatory Commission (CERC)
3rd and 4th Floor, Chanderlok Building,
36, Janpath, New Delhi - 110001

Subject: **Stakeholder Comments on Draft CERC Staff Paper on Market Coupling.**

Dear Sir,

I am writing this in response to the call for comment on the above-mentioned staff paper.

I am Guy Spier, Founder and Managing Partner of Aquamarine Fund, which manages assets worth approximately $350 million. Of this, a significant portion is invested in India, including the power sector and the power exchange.

My investing journey in India began nearly two decades ago. Over the years, I've consistently allocated part of my fund's assets to the Indian market, driven by my admiration for the country's dynamism and the intelligence of its populace.

Under the leadership of Honorable Prime Minister Narendra Modi, initiatives like the General Sales Tax, Demonetization, and the Real Estate Regulatory Act have showcased India's immense potential. I am proud to be a supplier of capital and liquidity to India's capital markets as they develop.

The Indian electricity sector in particular is critical to all of India's future plans, as the rest of the Indian economy relies on it. Thankfully, the Ministry of Power - under the guidance of Mr. R.K. Singh and the prior leadership of Mr. Piyush Goya - has made incredible strides. Today, 40% of India's electricity capacity is sourced from renewables, a remarkable achievement. The realization of a 'one grid, one market' by India is a feat that even Europe and the US have not accomplished.

Although my education was in the UK (Oxford University) and the US (Harvard Business School), I feel a deep connection to India. Early in my career, I met Mohnish Pabrai, who gave me Mahatma Gandhi's autobiography. I was inspired to discover that his struggle for India's independence started in Pietermaritzburg, South Africa - the town where I was born. Gandhi's autobiography and his incredible honesty also inspired my book, *The Education of A Value Investor*.

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Because of this connection, I'm filled with pride when I witness India's progress as a country – especially in areas where it leapfrogs the West.

But it is still very early in the innings for India and there is a very long way to go before the country achieves its destiny of parity with the West. There is always the danger that India's progress might be derailed. This has happened in the past and could happen again. As we are seeing with China currently, a high-growth path to prosperity should not be taken for granted. Given the centrality of the Indian energy sector, disruption – or even merely uncertainty – could derail India's growth and its path to prosperity for all. The stakes could not be higher.

With this in mind, it is absolutely vital for key policymakers – the Ministry of Power and the CERC – to build on their success and avoid taking steps that may jeopardize this stupendous progress. Those with public responsibility to build on and deliver on past successes should be on guard against steps that, although taken with the best intentions, may turn out to be negative – or perhaps even disastrous – for the sector.

Concerns

Unfortunately, I have noticed that India's enormous success in its energy sector has led to a desire, at least amongst some participants, to tinker with a system that is working.

New Entrants

When it comes to licensing new entrants, the power exchange business already had two competitors, which compares well with other markets. For example, when it comes to equity trading in India, there are two exchanges – the Bombay Stock Exchange and the National Stock Exchange. These provide the country with two stable and reliable players, which drives innovation and inward investment.

But when it comes to the energy sector, the CERC has approved a third competitor – even though the energy market is far less mature than equity trading. Presumably, the goal was to foster competition. Instead, it has fractured liquidity and has fostered uncertainty and confusion. It has forced existing electricity market participants to divert resources from innovation and product development.

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I urge members of the CERC to consider their evaluation of outcomes in electricity trading in a dynamic, rather than in a static framework. The question is not what is happening today, but how the industry develops. From my experience talking to electricity and energy traders both inside and outside India, the introduction of a new competitor, with no visibility of additional volumes, has already dampened trading activity. Energy investors outside of India have already indicated to me that they have put India on the back burner when it comes to energy trading – because of the uncertainty created by the new entrant.

In other words, it's not market structure and outcomes from the static perspective of today that counts, but what unfolds. Members of the CERC should consider that during the time that the
Indian market has been grappling with new regulations, the European Energy Exchange, EEX has started trading energy contracts in Japan. This sort of innovation only happens because places like Japan and Europe have regulatory certainty.

From one perspective, it may seem that tinkering with the rules should not be of great concern, but international experience shows that regulatory certainty attracts market participants who bring with them capital and liquidity. It is those broad and deeply liquid energy markets that allow new players to make the large new investments that India needs to continue to grow. However, that does not and will not happen without a stable regulatory framework.

Every successful country I have studied has not encouraged new entrants into a space that is functioning well and is developing rapidly. All over the world, exchanges specialize and become experts in particular area. For example, the New York Stock Exchange specializes in equity trading for listed companies. The Chicago Mercantile Exchange (CME) leads when it comes to gold, silver, crude oil, and natural gas derivatives, and the Intercontinental Exchange (ICE) dominates in coffee and sugar derivatives.

My submission and respectful suggestion to the CERC is not to make any more changes and to refocus on the multi-exchange model that was envisaged by the Electricity Act of 2003. To put it more bluntly, the CERC should focus on creating stability and certainty for market participants rather than risk destabilizing a functioning market by introducing radical changes. To do so is at best a massive distraction for the industry.

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Market Coupling

When it comes to market coupling in the Indian context, the meddling with something that already works might be taken to a whole new and, with respect, dangerous level.

It starts with a profound misunderstanding of the term and seems to be promulgated by the CERC itself. In Europe, market coupling pertains to integrating electricity markets across countries. In Europe, the term emphatically does not mean forcing all exchanges to become brokers and having the Government step into a commercial role to become the sole entity that discovers market price.

But somehow, the term has been misconstrued in India as 'one market maker'.

Thus we have in India a remarkable situation where the MoP and unfortunately by consequence the CERC – which should be congratulating themselves with great pride on having achieved something that Europe has not achieved – are instead thinking up on new grand plans that would begin to reverse many of the gains India has achieved in the energy sector.

For the CERC to get any closer to implementing a rule on market coupling would be to snatch defeat from the jaws of victory. For a government body like the CERC to mandate changes in the trading venue for such a key commodity as electricity would undoubtedly lead to severe confusion and market disruptions in energy markets. Moreover, it would exercise a chilling effect on participants in the energy sector.

That starts with investors. Investors in the sector such as the Aquamarine fund and others like it will have relied on the exchange license having a validity of 25 years. Investors will have taken comfort in the understanding that, provided there was a good performance, the license would be renewed. However, implementation of market coupling would be tantamount to terminating the license early without cause. Rather than *reward* success, this would be *punishing* success and would have a chilling effect on electricity markets and beyond. This is not the way India moves forward. Indeed, it would be a highly regressive step – and would be interpreted as such not just in India but all over the world. Capital providers would become far more wary of committing capital to the sector. This would disrupt energy markets and put an unacceptable brake on India's growth prospects.

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It is worth repeating with emphasis that the sole goal of the CERC – which it has ably served – has been the dynamic development of the power market. This requires a stable regulatory framework that provides certainty to the participants. When the CERC initiates a discussion on market coupling, it achieves the opposite effect.

We should remember that India is a vast country in which electricity is delivered to end users through a large variety of energy sources. This power has to flow continuously and be balanced with demand. It is a delicate system. The last thing India's burgeoning and successful power market needs is Government mandates that tinker with existing arrangements that have been carefully worked out for many years.

Such changes will yield limited upside, and at worst could lead to enormous disruptions and might trigger unfortunate and unintended consequences. I am reminded, for example, of the case of California in the 1990s in the US. Regulatory changes were made to California's electricity market with the intention of increasing competition. The result was massive supply-and-demand imbalances, market manipulations and rolling blackouts. As a result, several companies were fined and some US energy executives even faced criminal charges.

The key for the CERC in avoiding such outcomes is to focus on conservative, incremental decision-making that solves specific problems. It should take decisions based on careful consultations with *existing* market players who have proven their ability to serve the market. The CERC should be extremely careful not to heed the siren call of hopeful new entrants with big theories and grand dreams, because those hopeful new entrants do not have the responsibility of delivering a system that works on a daily basis. They do not have practical experience of the careful details of a market that has been worked out over many years of careful incremental practice.

As was the case in California in the 1990s, there is an enormous amount to lose and not much to gain from tinkering with, and making big changes to, a system that works, and which is succeeding magnificently in delivering on India's energy priorities.

The upside of change is limited at best; the downside could be catastrophic – for individual officials at the CERC, for the CERC itself and of course, for India and the Indian economy. The sole interest of the CERC should be the successful development of India's energy markets and of the Indian economy.

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If there were some strange and unusual state of the world in which CERC were to go so far as to ignore the logic of submissions such as this and risk an enormous downside for not much upside, there would, no doubt be investors and electricity market participants calling for a public enquiry to understand exactly the motives of the CERC and its officials.

It would be an action that, for very good reasons, has not been taken or contemplated in any market anywhere in the world. It would throw into serious doubt the motivations of some of the key decision-makers.

In closing, I urge the CERC to build on India's successes without introducing entirely unnecessary changes. The potential disruptions could tarnish India's reputation. They might attract international attention and set back India's reputation for being a reliable destination for capital and investor attention by years if not decades.

In short, and to use a well-known American expression, 'If it ain't broke, don't fix it!' Tinkering and meddling could lead to disastrous consequences.

In conclusion, while I remain highly optimistic about India's power sector, recent policy directions are of deep concern to me. I request your esteemed institution's (CERC's) intervention to ensure a thorough evaluation before implementing market coupling or other significant market changes.

I am available for further consultation and would happily share my insights and thoughts.

Sincerely,

Guy Spier

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