

Is the power sector in India ready for derivatives?

The introduction of forward contracts will benefit distribution companies and industrial consumers, although futures and other financial derivatives need to be approached with caution

Ann Josey and Shantanu Dixit

The Supreme Court in October finally permitted power exchanges regulated by the Central Electricity Regulatory Commission (CERC) to offer monthly, seasonal or even annual contracts. As per the [press release](#) on the judgment, the apex court resolved a decade-long jurisdictional battle between the CERC and the Securities and Exchange Board of India (Sebi) on regulating forward contracts in power exchanges.

Forward contracts are those where delivery is made after 11 days. Currently, exchanges only offer contracts that are settled within 11 days.

With the judgment, the CERC will have exclusive jurisdiction to regulate all physical delivery contracts. However, financial derivatives, yet to be introduced in the power sector, will be regulated by Sebi.

Increased Choice

For power distribution companies (discoms), flexibility and choice are crucial, given the growing demand uncertainty driven by the rising share of variable renewable energy. The uncertainty is amplified with industrial consumers investing in electricity supply from sources other than the discom.

Thus, seasonal surpluses, and shortages are becoming a challenge. To reduce costs, and increase operational efficiency, long-term supply arrangements need to be complemented with other contracts. Monthly and seasonal contracts would help address this challenge, and aid planning for eventualities such as the recurring crises due to dwindling coal supply.

Discoms, and industrial consumers rely on traders, and bilateral contracts to meet their seasonal power requirements. With forwards, industrial consumers will have more choice. Currently, seasonal procurement is through non-transparent, fragmented processes. Discoms will benefit, too, as most short-term contracts take place through the government-administered DEEP portal with limited participation, and options.

Power is unscheduled mostly due to low demand, and discom consent for sale, though required, is seldom provided. Recently, the ministry of power [issued guidelines](#) allowing the sale of unscheduled power on the exchanges without additional permission from contracting discoms. With these guidelines, the use of multiple exchange contracts will reduce idle capacity, improve price discovery, and reduce costs.

Forwards provide a new avenue for competition among the three power exchanges, presently facing low liquidity in the term-ahead segment, limited to less than [1 percent of the electricity supplied in India](#).

Price Signals

The exchanges account for [4-5 percent of the country's electricity supply](#) but are witnessing high volume growth, and addition of new contracts. With these changes, the introduction of financial derivatives, which are transferable contracts that do not translate to physical power delivery, must be approached with caution.

The power ministry, the finance ministry CERC, Sebi, the Central Electricity Authority, the Power System Operation Corporation Ltd, and the exchanges have deliberated on the launch of financial derivatives since [2018](#). However, many aspects are yet unclear.

With separate regulators for forwards and futures, the need for concurrent, connected market monitoring, though paramount, has not yet been detailed. Further, it is unclear if Sebi's jurisdiction will extend to non-power exchange contracts. Would Sebi

regulate derivatives such as contracts for differences to operationalise virtual power plant arrangements? If so, state electricity regulators would also be involved, adding another layer of jurisdictional complexity.

When seen with other considerations, financial derivatives in the power sector can provide helpful signals to investors. However, given their speculative nature, these prices make poor benchmarks in decision-making processes.

The outcomes in the derivatives market should not be used to set ceiling tariffs for competitive bidding or to determine limits for short-term power. It would be tragic if high prices in this speculative market are used as a signal to justify increased investments in capacity addition by bankers, developers or regulators.

Discoms are regulated utilities whose costs, if deemed prudent, are allowed for recovery through consumer tariffs. If discoms or the generators they have contracts with, participate in the financial derivatives market, the cost impact and risks should be not passed on to tariff-paying consumers.

Strong co-operation and information-sharing between the financial and electricity regulators as well as public availability of critical data would be imperative to protect the interests of buyers, sellers, and final consumers.

While we usher in a new era of competitive choice, and transparent trading, it is hoped that keeping sector sustainability, and consumer interests in mind, financial derivatives are not introduced hastily.

A version of this article was published on 8th November 2021 in MoneyControl.

-X-