23rd March 2009

To,
The Secretary,
MERC
Mumbai

Sub: Prayas Submission on RInfra–Distribution – Wire and Retail Annual Performance Review under MYT Framework towards: Truing up of ARR of FY 08, APR of FY 09 and Determination of ARR and Tariff for FY 10

Ref: Public Notice dated 25.02.2009 in the above matter, MERC case MERC Case No 121 of 2008

Dear Sir,

In response to above public notice please find enclosed comments/suggestions by Prayas (Energy Group), Pune on RInfra-D APR and Tariff petition under MYT Framework towards: Truing up of ARR of FY 2008, APR of FY 2009 and Determination of ARR and Tariff for FY 2010.

We request the commission to kindly permit us to make a presentation during the public hearing in Mumbai on 26th March 2009 and to make additional submissions if any.

Yours sincerely

Ashwini Chitnis and Shantanu Dixit
For, Prayas (Energy Group) Pune

BEFORE MAHARASHTRA ELECTRICITY REGULATORY COMMISSION, MUMBAI

Objections/Comments/Suggestions
on

Annual Performance Review under MYT Framework towards: Truing up of ARR of FY 08, APR of FY 09 and Determination of ARR and Tariff for FY 10 Of RInfra–Distribution (RInfra-D) – Wire and Retail

By
Prayas Energy Group, Pune
23rd March, 2009

Table of contents

1. Introduction and Context 4

2. Sharp increase in Cost of Supply in licensee's area:............................ 6

3. Major cost components of the ARR 7

3.1 Power purchase cost 8

3.2 Distribution cost 10
 3.2.2.1 Employee cost 15
 3.2.2.2 Administration & General and Repair & Maintenance Costs 16
 3.2.2.3 Excess O & M costs: 18

4. The Appellate Tribunal of Electricity (ATE) Order............................ 19

5 Need to experiment and evolve new tariff policies 22

6 End of License term and subsequent issues 23

7. Prayers and suggestions/comments: 25

1. Introduction and Context

1.1. Indian power sector reform process started in the late 80s and early 90s when most of the public utilities, which dominated the sector, were plagued by financial crises. These utilities had little or no threat of financial penalty or incentive to improve operational efficiency and hence the role of the regulator was assumed necessary as an independent authority that will promote competition, efficiency and economy in the power sector and regulate tariffs of power generation, transmission and distribution and to protect the interests of the consumers and other stakeholders. The Maharashtra Electricity Regulatory Commission was established in 1999 with the same mandate and responsibility. Similarly most of the state electricity commissions came into force around 2000 and many state electricity boards were unbundled. The reform process lead to a lot of causal-analysis on the failure of public utilities to achieve operational efficiency and what role regulator can play in ensuring that.

1.2. With a short term view of mitigating financial crisis of public utilities coupled with an excitement and eagerness to attract private capital, the policy debate on the role of regulatory body often ignored the issues and challenges involved in regulating private utilities. In spite of the fact that private utilities have been operational in states like Maharashtra, Gujarat and West Bengal for close to a century, the policy debate and discussion concerning regulation of private utility has not received adequate attention. Like many other states, the regulatory commission in Maharashtra has been functional for more than 10 years now and hence has gathered enough experience and understanding of the issues, challenges and opportunities present in regulating private utility so as to promote rationalization of cost of supply and encourage and promote efficiency improvements. This submission is aimed at highlighting some the critical issues and challenges involved in regulating private sector utilities.

1.3. The commission issued its first tariff order on 1st July 2004 in accordance with the Schedule VI of the Electricity (Supply) Act, 1948 for BSES Limited (BSES), which was renamed as Reliance Energy Limited (REL) in 2003 and now as Reliance Infrastructure limited. In 2005 the MERC published its terms and conditions of tariff regulations 2005. The tariff order dated 3rd October 2006 was designed in accordance with these regulations. The above terms and conditions also mandated the commission to implement multi-year tariff framework with effect from April 1, 2006. As per this mandate the commission issued its first MYT tariff order for REL in April 2007 for the control period FY 2007-08 to FY 2009-10. The MYT

framework incorporated principles of sharing of gains/ losses for controllable and uncontrollable parameter as a means to ensure efficiency improvement.

1.4. ARR and tariff determination process for FY 2009 is critical part of the first control Period of Multi Year Tariff framework (MYT) from FY 2007-08 to FY 2009-10. Considering the public outcry in Mumbai over the precipitous rise in cost of supply, this is also a year that will test the capability of MYT regime to control costs to a rational and affordable level.

1.5. Objective of this petition: Our comments and suggestions mainly deal with the important techno-economic and regulatory aspects. We would specially like to highlight the following important issues:

1.5.1. Sharp increase in cost of supply on account of the following reasons:

1.5.1.1. Lack of planning and timely efforts to source economical/reasonable cost power

1.5.1.2. Very high capital expenditure in the recent years.

1.5.1.3. Large increase in Operations and Maintenance cost in spite of very high capital expenditure.

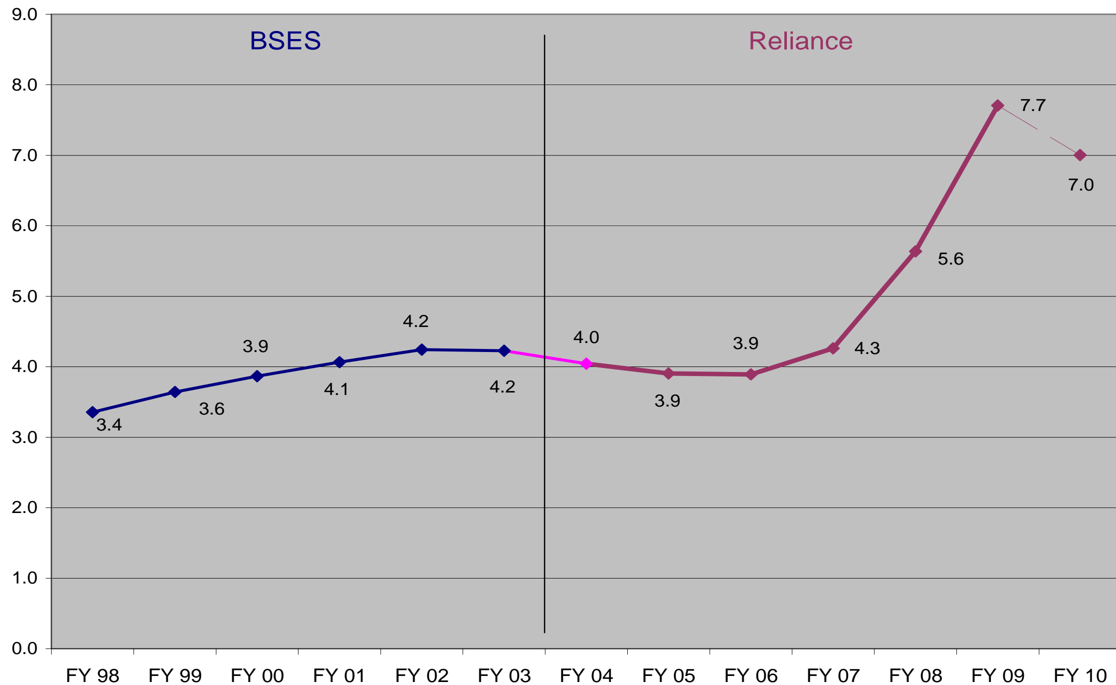
1.5.2. Impact of past appellate tribunal for electricity's judgments

1.5.3. Need to experiment and evolve new tariff policies to ensure efficiency improvements.

1.5.4. **End of License term in 2011**: Need to define the procedure for appointing new licensee and terms and conditions of license.

2. Sharp increase in Cost of Supply in licensee's area:

Figure 1: Trend in Avg Cost of supply since FY 98



Figures indicate average g cost of supply per unit sales

Figure 1 above, shows the trend of changes in average cost of supply since 1997-98 (FY 98). One can see steady growth in cost of supply till 2003-04. This was the year when Maharashtra Electricity Regulatory Commission came out with the first tariff order for Reliance Energy and tariff was reduced by around 8.5%. But from the year 2006-07, there is a sharp upward trend and the cost of supply has increased from 4.30 Rs/unit to 7.7 Rs/unit

The steep rise in cost of supply in recent years in mainly on account of very high energy costs. But along with the energy cost the distribution cost, most of which should be controllable under MYT framework has also significantly gone up which is a worrisome phenomenon and needs to be analyzed in detail.

3. Major cost components of the ARR

The two major cost components of ARR are the energy cost and the distribution cost. Table below shows the approved figures for these costs for FY 07 as per tariff order dated 4th June 2008 and the values projected in the ARR for FY 08 to FY 10

Particulars	All amounts in Rs. Cr			
	FY 07	FY 08	FY 09	FY 10
Distribution cost	868	981	1068	1186
Energy cost	2361	3419	5194	4736
Total cost of supply	3229	4400	***6261***	5922

Thus it can be seen that total cost of supply has almost doubled over that of FY 2007.

Let us now analyze each of the two major cost components.

3.1 Power purchase cost

After sourcing power from RInfra-G, TPC-G and RPO, balance energy requirement is sourced by RInfra-D through Bilateral Contracts.

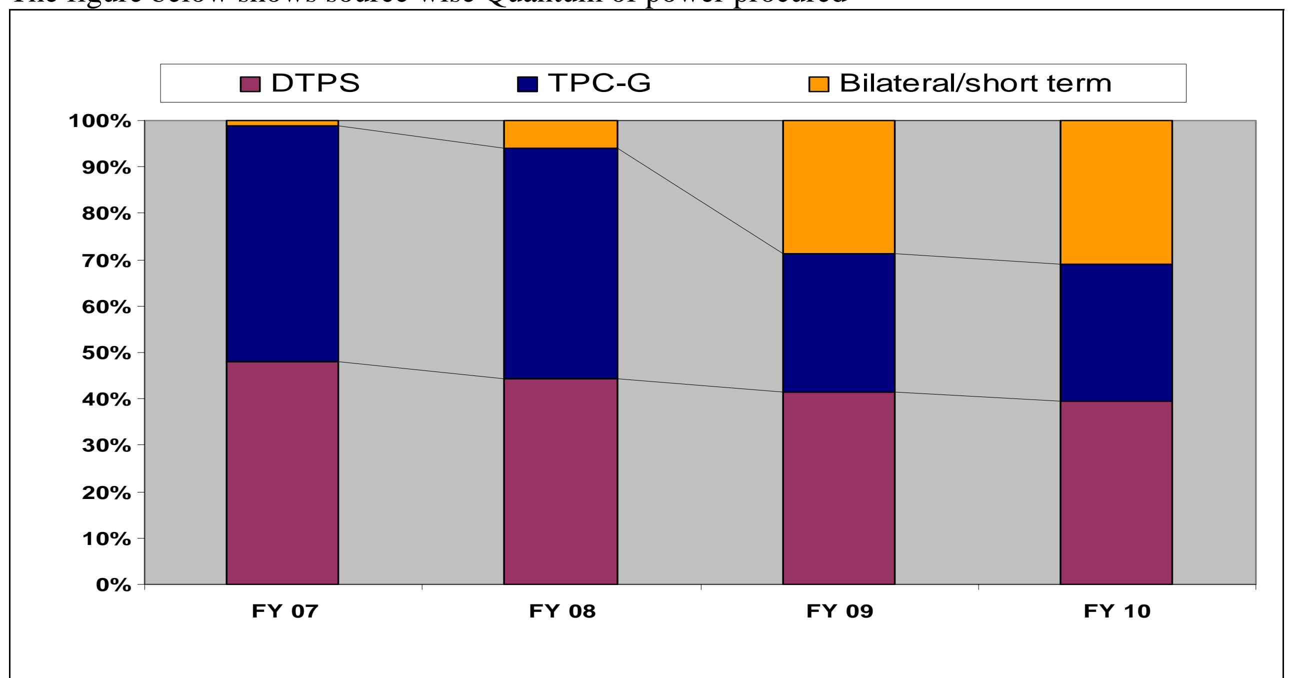
In the ARR and tariff petition submitted last year, REL-D stated that the bilateral power purchase for FY 2007-08 and FY 2008-09 forms only 5-7% of the energy input requirement and the power procured so far has been at various rates ranging from Rs 3.97/kWh to Rs 5.51/kWh.

The table below shows source wise avg cost of power procured. The % figures in brackets indicate share in total quantum of power

Source	FY 07	FY 08	FY 09	FY 10
DTPS	**2.01 (48%)**	**2.13 (44%)**	**2.45 (41%)**	**2.65 (39%)**
TPC-G	**3.02 (51%)**	**4.02 (50%)**	**4.83 (30%)**	**3.82 (30%)**
Bilateral	**4.39 (1%)**	**5.49 (5%)**	**8.77 (20%)**	**7.00 (29%)**
RPO	**0.00 (0%)**	**3.49 (0%)**	**3.50 (0%)**	**3.65 (2%)**
Imbalance Pool	**7.13 (0%)**	**5.69 (1%)**	**9.45 (8%)**	**0.00 (0%)**

As against its own projections, the bilateral/short term power share is 20% and 29% of the total power purchase quantum for FY 09 and FY 10 respectively and the costs per unit are almost double of what REL-D had estimated.

The figure below shows source wise Quantum of power procured



As is obvious from above table and chart, RInfra-D is procuring around 30% of its total power purchase quantum at rate more than Rs. 8.5 /unit! This exceptionally high cost of power procured is placing a very high tariff burden on the consumers and most of it is on account of lack of planning and timely actions by the utility to procure/contract economical cost power. In spite of being aware about the likely shortage, since the past 6 years, RInfra-D has not entered into any long or even medium term power purchase agreement with any new supplier/source. There is nothing new about the power shortage scenario in Maharashtra as well as whole of the country and 6 years is a sufficiently long period to plan and procure power in sufficient quantity to mitigate the crisis.

This is the case, in spite of repeated directives by the commission, to undertake demand forecast studies and plan for long term power procurement. The utility has hardly done anything is this regard. It is quiet ironical that the same utility / group has shown remarkable zeal and perseverance in winning contracts for establishing new generation capacity of thousands of MWs for the benefit of other utilities. If the Reliance Infra had sourced its additional power requirement in a timely and cost effective manner, it could have saved at least Rs.3 per unit (against the projected short term power purchase cost of Rs. 7 / unit) for its consumers, which would amount to about Rs. 1000 Cr. saving for FY 2009-10 alone!

The MERC order dated 4th Jan 2008 in connection with the same utility clearly states: *‘licensees should not seek post facto approval for power procurement that has been undertaken on account of inadequate planning and demand assessment.’*

Clearly, the sharp rise in power purchase expense for FY 08-10 is mainly on account of improper planning for last 5-6 years and absolute failure to source adequate quantity of economical / cost effective power, in spite of being aware of the shortages. Hence in such a case, the burden of this high cost power purchase cannot be passed on to consumers and the licensee should be financially and legally penalized for this irresponsible behavior. Financial and legal penalty seems to be the only mechanism that can ensure that the utility takes planning activity seriously and fulfils its primary obligation of sourcing adequate amount of reasonable cost power.

3.2 Distribution cost

This is the total expenditure of the utility excluding power purchase and transmission cost and including return on equity. Many of the cost heads that come under distribution cost such as operations and maintenance, investment related costs are controllable parameters under the multi year tariff framework.

Figure 2 below shows the percent wise break-up of distribution costs.

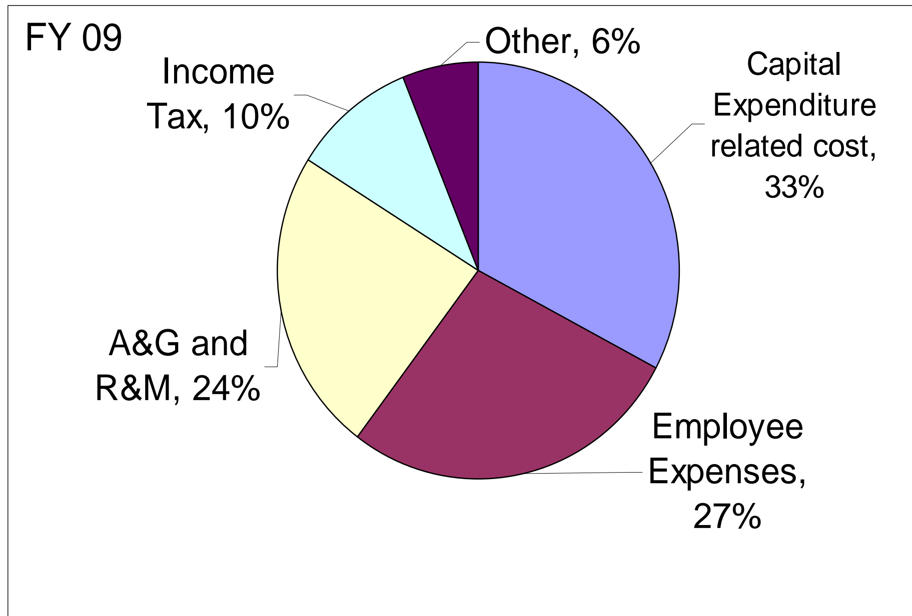


Figure 2: Break up of REL ARR for 2008-09

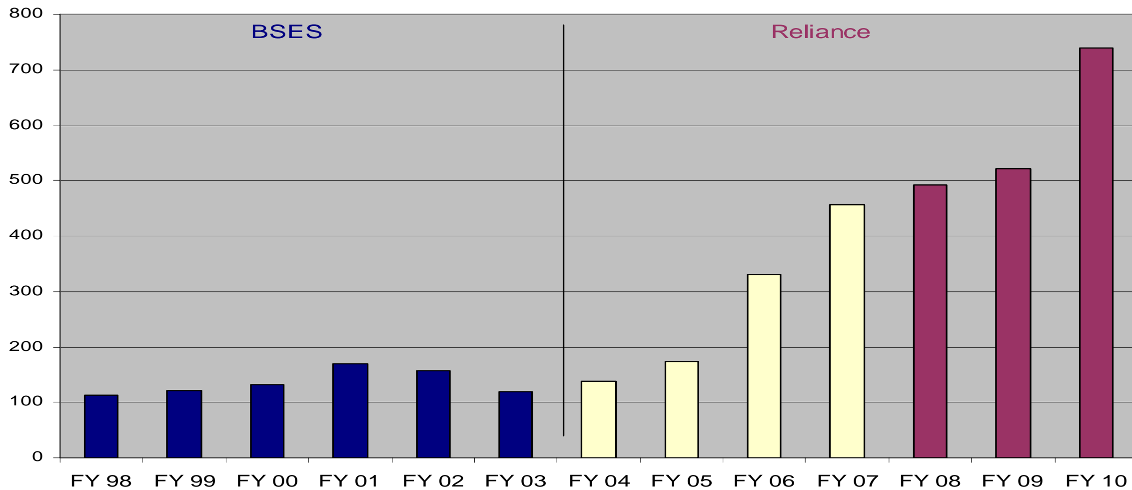
From the above chart it is clear that capital expenditure and Operations & Maintenance related costs are the major components of distribution cost and need to be analyzed in detail. Incidentally these are also the major controllable parameters under MYT regime and the entire strength of the MYT framework rests on controlling these costs to ensure efficiency gain. Subsequent sections of this submission present detailed analysis of various cost components of ARR submitted by Reliance. The analysis compares levels of different cost components before and after 2002-03, the year when BSES was taken over by Reliance.

3.2.1 Capital expenditure (Capex)

Capex related costs in the tariff petition include depreciation, interest on long-term debts and Return on Equity (RoE). Income Tax (IT), though shown separately, depends on the return on equity, which in turn depends on the extent of capital expenditure undertaken by the licensee. It is clear from the distribution cost pie chart that, capital expenditure and Operations and Maintenance costs constitute **84%** of the distribution cost and hence need to be carefully scrutinized.

As per commission's tariff order dated Jul 04 for the same utility, the commission has stated: *'Any capital expenditure increases the Capital Base and hence the Reasonable Return, thus affecting the tariff to the consumers.'* In the same order, with reference to capital expense for system modernization, the commission observes: *'The Commission is of the opinion that such systems should be selected carefully keeping in mind the high level of obsolescence of these systems.'*

Figure 3 below shows the trend in capital expenditure from 1998



As it can be seen above, the compounded annual growth rate of capital expenditure from 98 to 03 is 1% whereas it is 30% for the next six years.

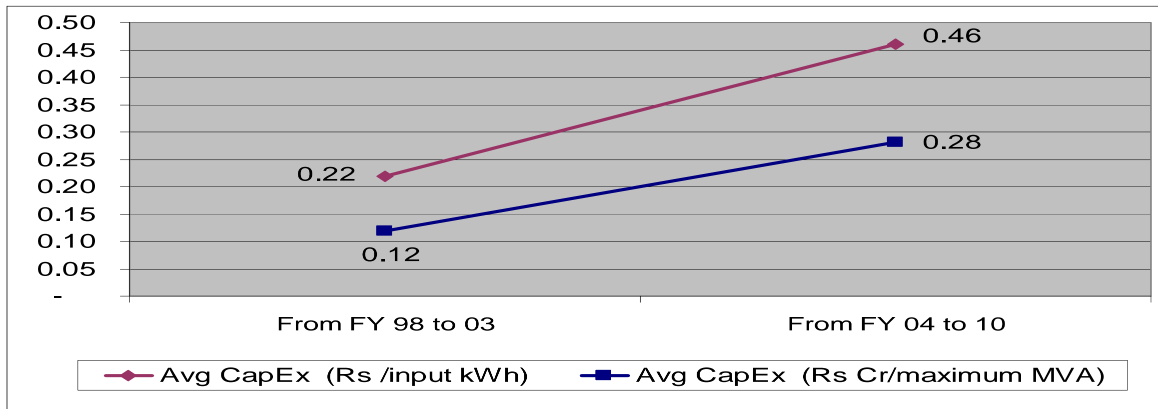


Figure 4: Growth in Capex vs. I/p Energy and Max Demand

3.2.1.2. The capital expenditure in recent years is huge, not just in terms of absolute amounts but even in terms of per unit basis. The average capital expense per unit of input energy which was **0.22 Rs/unit** during 98-03 has gone up to **0.46 Rs/unit** during 04-10. Similarly the average capital expense per MVA of maximum demand has gone up from **0.12 Rs/MVA** to **0.28 Rs/MVA** during the same period.

3.2.1.3 The table below shows that average capex that was Rs. 135 Cr during 98-03 has gone up to Rs.407 Cr during 04-10

Particulars	From FY 98 to 03	From FY 04 to 10
Average Capital expenditure in Rs. Cr / yr.	**135**	**407**
Compounded Annual growth in Input energy in %	**1%**	**5%**
Compounded Annual growth in Maximum MVA demand in %	**3%**	**3%**
Increase in Capex in Rs.Cr per unit MVA increase	**4.62**	**8.22**

3.2.1.4 It is clear from the table that CapEx shows disproportionately sharper growth than the growth of input energy and maximum demand. Therefore, RInfra's projections of CapEx need to be critically evaluated.

3.2.1.5 As stipulated in the in-principle clearance of Capex schemes by MERC, before allowing tariff impact on account of Capex schemes, it is essential to validate that said schemes have been completed within the scope and other parameters mentioned in the in-principle approval by MERC and that the said benefits are realized. MERC's in-principle clearance letter clearly states: *'in-principle clearance should not be construed as final approval for ARR purpose and the scheme will be open for scrutiny during tariff determination process/ARR review…'*

3.2.1.6 As capital expenditure of such high magnitude has enormous tariff implications for years to come, it is very important to analyze the prudence as well as performance improvement and efficiency gains in monetary terms of such expenditure. It is thus extremely important to undertake the scrutiny of capex in terms of prudence and cost-benefit analysis before passing on these costs to consumers.

3.2.1.7 Though REL has described the investment schemes individually, it does not present even preliminary quantification of benefits of the schemes. Therefore, we request the Commission to perform a detailed scrutiny and cost-benefit analysis of individual CapEx schemes and should approve the schemes only if they stand the tests of prudence and usefulness.

3.2.1.8 Till date MERC has never undertaken such a scrutiny, nor is there a clearly defined procedure for undertaking the same.

3.2.1.9 The Delhi Electricity regulatory Commission (DERC) undertook such a scrutiny and the results are quiet revealing. In its Order dated 23rd Feb 2008 in the matter of ARR of BSES Yamuna Power Limited and BSES Rajdhani Power Limited for the Control Period of F.Y. 2007-08 to F.Y. 2010-2011; both of which are group companies of Reliance, the DERC observed the following:

- *'During the years 04-05 and 05-06, both BRPL & BYPL made* ***extensive purchases of capital goods from REL at rates considered exorbitant by the Commission****, resulting in transfer of substantial funds from these companies to REL by way of profit on sale of the capital goods.'*

- *'Restrictions are considered necessary on these companies for being instrumental in unjust enrichment of the group company REL...'*

- '*Capital expenditure and asset capitalization in respect of these amounts totaling Rs.535 crore is accordingly disallowed.... '*

The above analysis and evidence clearly underlines the need for through scrutiny of investment plans beyond in-principle clearance and detail cost-benefit analysis of all major capex related projects. For this purpose, the commission should constitute a transparent and accountable procedure for cost-benefit and prudence analysis of all such projects. The tariff impact of such huge capital expenditure is largely subdued in initial years due to assumption of the long term of loan repayment and depreciation considered by the licensee based on normative approach adopted by the commission. But nonetheless as shown in following table within 3 years the capital expenditure related component of tariff has increased to **150 %**!

Table shows the tariff burden of capital expenditure related costs, all amounts in Rs. Cr

Particulars	Audited & approved as per 08 order	Proposed as per the current ARR		
	FY 07	FY 08	FY 09	FY 10
Capital expenditure related tariff cost (includes RoE, depreciation and interest on long term loan capital)	270	309	350	402

Considering the sharp rise in capital expenditure by the licensee and lack of detailed scrutiny by the MERC, all the incremental capex related cost over what was approved by the commission for FY 07 should be disallowed until the commission undertakes a thorough scrutiny of these expenses and is satisfied with the cost/efficiency benefits thus achieved.

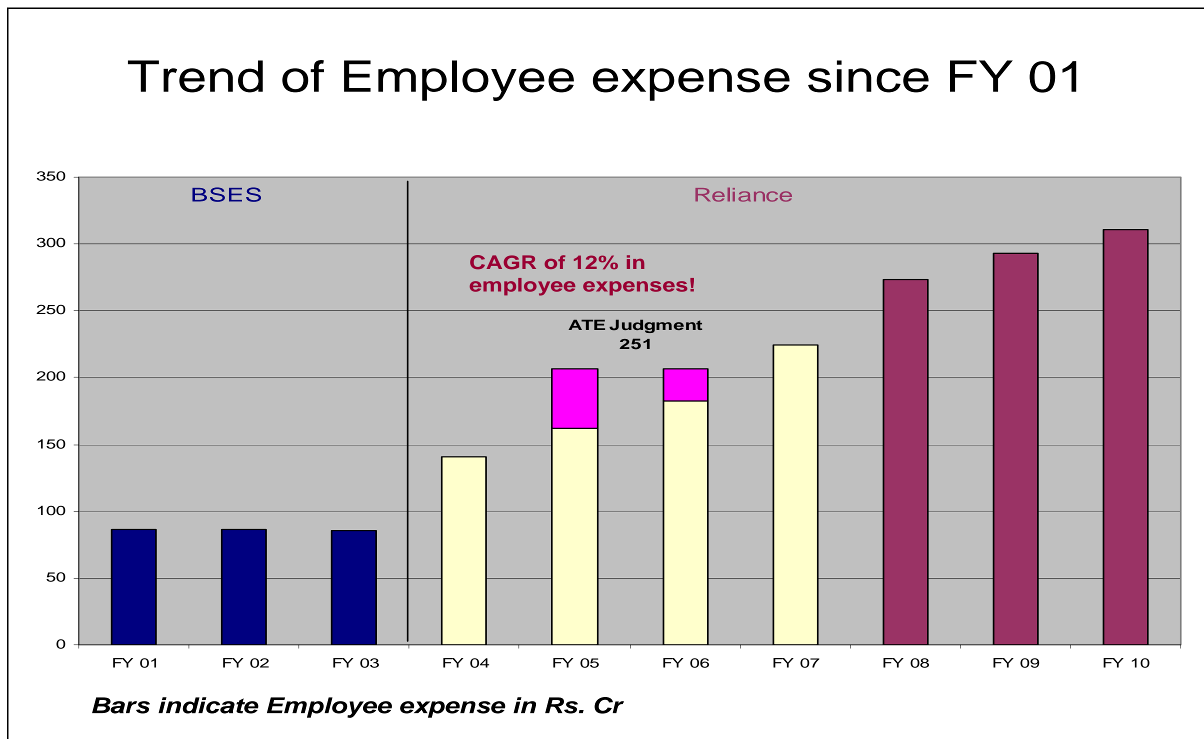
Thus the incremental tariff burden of **Rs. 251 Cr** due to high capital expenditure during control period should not be passed on to consumers until through scrutiny by the MERC.

3.2.2 Operations and Maintenance Costs

Employee costs, administration and general (A&G) costs and repair and maintenance (R&M) costs together constitute the operations and maintenance (O&M) costs. Out of these costs, employee costs are a significant factor which is also linked to variation in inflation rate. In order to ensure efficiency improvement, O&M costs are defined as controllable factors under the MYT framework as per Tariff Regulations of MERC. Also it needs to be emphasized that if a utility is spending heavily on system modernization and state of art facilities such as GPS enabled automatic consumer meter reading and so on, its man power and A&G costs should actually reduce. Only in such a case can the capital cost of high tech distribution system be justified.

3.2.2.1 Employee cost

RInfra-D claims to have incurred an amount of Rs. 273 Crore towards Employee expenses for FY 08 which is Rs. 26.5 Cr more than what MERC, in its Order dated June 04, 2008, has allowed. Ever since 2004, there has been a steady rise in employee expenses. The figure below shows trend in employee expenses since 2001



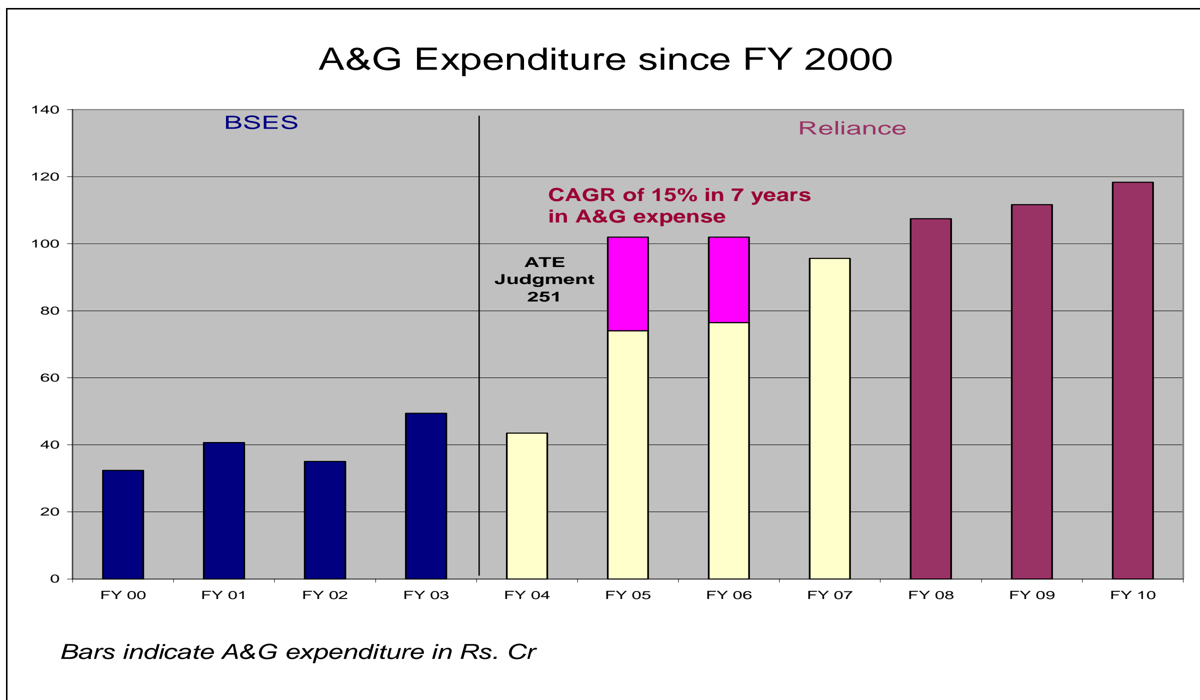
The blue bars indicate employee costs during BSES regime. The yellow bars indicate commission approved employee costs for RInfra. The ATE judgments in case of 251 of 2006 and appeal 90 of 2007 led to increase in total employee expenses of FY 05 and FY 06 by Rs.45 Cr. and Rs. 25 Cr respectively and thus have significantly changed the

baseline of employee expenses[1]. The red bars are the employee costs estimated by RInfra for the current control period.

3.2.2.2 Administration & General and Repair & Maintenance Costs

For estimating A&G expenses of FY 09, RInfra has assumed an increase of approx. 4% over actuals of FY 08 and for FY 10 RInfra has considered an increase of 6% over FY 09 estimated. Similarly in case of R&M, for FY 10 RInfra has considered an increase of 6% over FY 09 estimated.

Like employee expenses, A&G and R&M expenses have also witnessed a sharp rise since 2004 and more so after ATE judgments of 251/2006 and 90/2007. The figures below shows trend in A&G expenses since 2000 and R&M expenses since 2001 respectively.



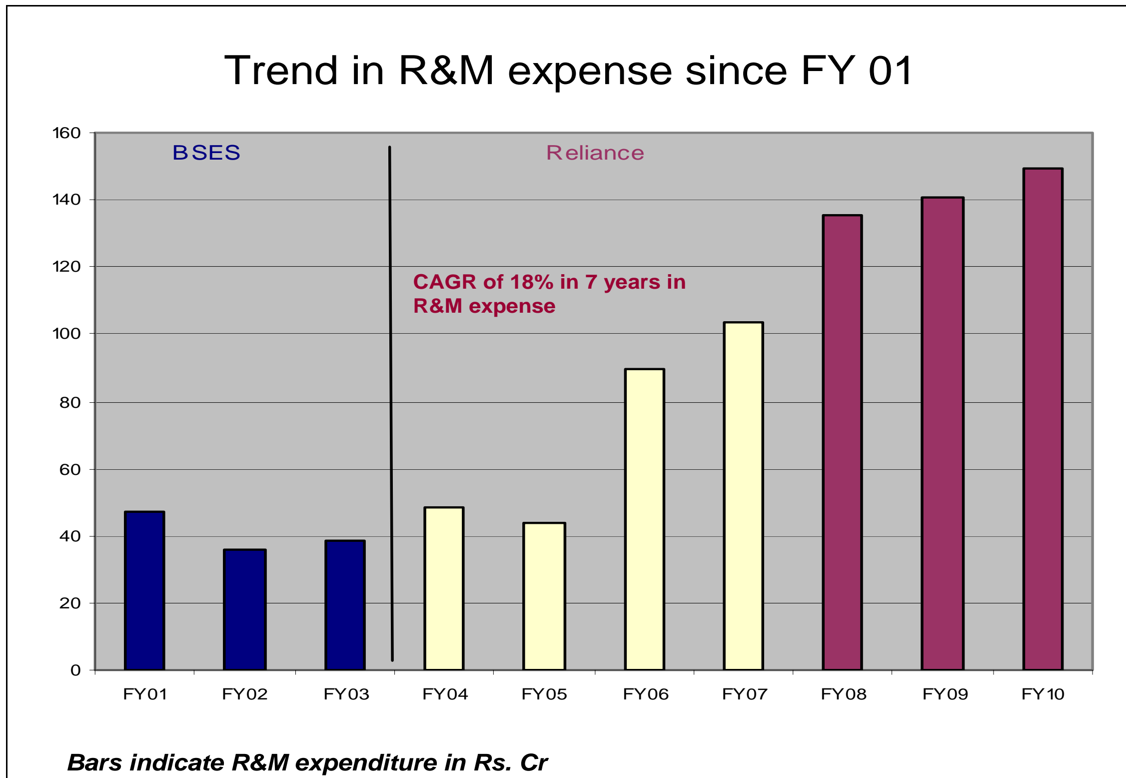
The compounded annual growth rate of A&G expenses is **15%** from 2004 to 2010 which is almost twice the inflation rate.

The blue bars indicate A&G costs during BSES regime. The yellow bars indicate commission approved A&G costs for RInfra. The ATE judgment in case of 251 of 2006

---

[1] Reliance Infra appealed before the Appellate Tribunal for Electricity against the tariff order issued by MERC for FY 20005-06. In the appeal, RInfra contended that MERC ought to have approved its entire employee (and other O&M) costs, as claimed by it in audited financial statements and that MERC should not disallow any of these audited costs (which MERC had done based on 'prudence' and other justification). ATE in this matter (appeal no. 251 / 2006) upheld RInfra's contentions, which resulted in significant increase in employee and O&M costs passed on to consumers. Unfortunately, in spite of specific requests by Prayas, MERC did not appeal against the said order..

led to increase in total A&G expenses of FY 05 and FY 06 by Rs.28 Cr. and Rs. 25 Cr respectively and thus have significantly changed the baseline of A & G expenses. The red bars are the A&G costs estimated by RInfra for the current control period.



Here again, the blue bars indicate R&M costs during BSES regime. The yellow bars indicate commission approved R&M costs for RInfra. The red bars are the R&M costs estimated for RInfra by the current control period.

There has been a sharp rise in R&M expenses from FY 06. The compounded annual growth rate of R&M expenses is **18%** from 2004 to 2010 which is more than twice the inflation rate.

3.2.2.3 Excess O & M costs:

As mentioned before, O & M expenses, which consist of employee expenses, administration & general expenses and repairs & maintenance expenses are controllable expenses and the regulatory process should strive to ensure efficiency gain through reduction in these expenses. This is especially critical in cases where these expenses are showing significant, sudden increase in claimed costs, as is the present case of Reliance Infrastructure. Reliance Infra's present petition is part of multi-year tariff regime applied through MERC Tariff Regulations 2005. As per the MYT regime, O& M costs are considered as controllable costs.

Considering these factors, we urge the commission not to pass on any excess O & M costs to consumers. Any O& M costs over and above, estimated increase at the rate of inflation, of say 6.5% p.a. during the control period should not be considered as prudent expenditure and should not be passed on to consumers through ARR.

Thus the 'prudent' O&M expense during 3 years of control period, considering growth at a rate of 6.5% per year works out to be **Rs.1443 Cr** as against **Rs.1640 Cr** as claimed by RInfra. **Thus the additional O&M expense of Rs.198 Cr should not be passed as expenditure in ARR.**

4. The Appellate Tribunal of Electricity (ATE) Order

Reliance Infra has appealed against most of the tariff orders issued by MERC and has mostly received favorable judgments in these appeals. Cumulative impact of these ATE judgments has been around Rs. 1000 Cr. increase in tariff charged to consumers over last 3-4 year period. Details of these judgments are narrated below as they raise important questions about the mandate and authority of regulatory commissions to strive for efficiency gains in distribution sector.

The table below outlines the major ATE judgments which contributed to a tariff burden of around Rs.1000 Cr

Sr No	Details of the Challenged Order	Appeal No	Bench	Judgment in Favor of	Financial Impact in Rs. Cr
1	MERC Order dated 20th February, 2004	Appeal No. 32 of 2005	Mr. H. L. Bajaj, Technical Member Mr. Justice E Padmanabhan, Judicial Member	REL	Rs. 350 Cr
2	MERC Order dated October 3,2006	Appeal No.251 of 2006	Mr. H.L. Bajaj – Technical Member Mrs. Justice Manju Goel, Judicial Member	REL	Rs. 400 Cr
3	MERC Order dated April 23, 2007 in case No. 2 of 2007 and tariff order dated April 24, 2007	Appeal No.90 of 2007	Mr. H.L. Bajaj – Technical Member Mrs. Justice Manju Goel, Judicial Member	REL	Rs. 225 Cr

4.1 MERC Order dated 20th February, 2004: This order relates to rebates granted by BSES / REL to its large consumers on selective basis. During 1998 to 2003 BSES had granted rebates in tariff on a selective basis to certain large consumers to avoid competition from Tata Power which was also authorized to supply to large consumers. Subsequently, during the tariff petition before MERC, REL sought to include the amount of rebates passed on to selected consumers to all consumers as part of ARR. MERC rejected this plea by REL on the ground that the rebates were granted by REL on it's own and in a discretionary manner as a marketing strategy. Passing on these rebates to all consumers through ARR / tariff would imply that small consumers would pay for rebates granted to large consumers, on a selective / discretionary basis without any regulatory approval. REL appealed against this order of MERC in ATE appeal no. 32 of 2005 (bench: Mr. Bajaj H.L. and Mr. Jst. Padmanabhan). In this case ATE upheld REL's plea. This one judgment of ATE

alone burdened consumers by about Rs. 350 Cr. Tata power has appealed against this order of the ATE in Supreme Court and SC judgment is awaited.

4.2 Tariff Order dated October 3, 2006: The Commission in the said order decided on the revenue requirement of Reliance Energy Limited (REL) for FY2006-07 and truing up of cost and revenues for FY2004–05 and FY 2005–06 based on MERC (Terms and Conditions of Tariff) Regulation, 2005 and prudent norms. REL challenged this order of the MERC in the Appellate Tribunal for Electricity (ATE) on the issues of various costs which were not considered prudent by the commission. In the appeal, RInfra contended that MERC ought to have approved its entire employee and other O&M costs, as claimed by it in audited financial statements and that MERC should not disallow any of these audited costs (which MERC had done based on 'prudence' and other justification). ATE in this matter (appeal no. 251 / 2006) upheld RInfra's contentions, which resulted in significant increase in employee and O&M costs passed on to consumers. As a result of this ATE judgment alone consumers have been burdened with additional tariff of **Rs. 400 Cr.**

4.3 Tariff order of the commission dated April 24, 2007: The tariff order passed in case No. 75 of 2006 and order dated April 23, 2007 in case No. 2 of 2007 were again challenged by REL in the ATE on the issues of disallowance of capital expense, employee costs, income tax, stand by charges, etc . In this case as well, the ATE has upheld most of the contentions of REL in its judgment dated December 11, 2007 for appeal no 90 of 2007.

4.4 Overall, ATE judgments in appeal no 32 of 2005, 251 of 2006 and 90 of 2007 have imposed a tariff burden of around **Rs.1000 Cr** on the consumers by way of increase in tariff. What is even more worrisome is that apart from the excessive tariff increase, such litigations negate the state commissions' authority and render MYT process futile. Being one of the authorized consumer representatives at MERC, Prayas Energy Group (PEG) has been a party to above ATE proceedings and made detailed submissions highlighting the serious impacts of the said judgments.

4.5 PEG Intervention in ATE appeal no 251 of 2006: As mentioned above, PEG was one of the respondents and made a detailed analytical submission opposing REL's demands. The written submission made by PEG in the matter of appeal no 251 of 2006, we stated that: *'Through the present appeal, the appellant is seeking to pass on to consumers the cost of nearly Rs.400 Cr., that the MERC has disallowed and thereby render the regulatory tariff determination process meaningless and to pass on to consumers the costs that are **not 'prudent' and 'justifiable'**.'* While highlighting various regulatory and legal provisions, PEG demanded that ***merely incurring of expenditure by a licensee can not be a ground to pass on costs to consumers*** and hence SERC / ATE must pass on costs to consumers only based on tests of **'prudence'** and **'justifiability'**.

4.6 PEG submission dated 10 April 2007 before MERC: The ATE upheld the appeals of REL in its order dated April 4, 2007 in the matter of appeal no 251 of 2006 putting a tariff burden of around Rs.400 Cr on the consumers. In our submission to the commission subsequent to the ATE judgment, we drew the attention of the commission towards the large financial impact of this ATE judgment and urged MERC to undertake prudence check of employee expenses and Capital expenditure. We also prayed to the commission to undertake a public hearing before passing on these costs and to appeal against the said judgment in the Supreme Court of India. Unfortunately, MERC chose not to undertake public hearing or to approach Supreme Court.

4.7 Need for the commission to defend its Orders: In this context the Commission should make all efforts to defend its orders right up to the highest legal forum that is the Supreme Court of India to protect sanctity of the regulatory process and consumers' interests.

5 Need to experiment and evolve new tariff policies

5.1 **Failure of MYT regime in controlling costs**: The main purpose behind initiating MYT framework was to ensure good planning and efficiency improvements so as to have better control on various costs. But in reality MYT regime has failed to control any costs. Almost all claimed/projected costs have been passed on in the ARR. Most notably in the areas such as capital expenditure and operations and maintenance costs which can be certainly controlled to achieve efficiency improvements, the utility has claimed very high expenses than the approved estimates and recovered all the additional spending by way of true-up, thus completely defeating the purpose behind implementing MYT regime.

5.2 **Low operational efficiency in spite of very high capex:** The utility's capital expenditure is exceptionally high but what is even more worrisome is the sharp growth in O&M expenses (18% in the last 6 years) during the same period indicating very little or no operational efficiency gains from the capex. Hence the commission should very closely analyze not just prudence but the cost benefit of all the proposed capital expenditure schemes/projects.

5.3 **Need to experiment with innovative tariff approach:** As MYT regime has failed to control tariff expenses and ensure efficiency gains, the commission should consider newer approaches such as 'distribution margin' based tariff mechanism, (which allows distribution margin/cost to increase at a rate lower than inflation rate) to ensure efficiency improvements.

6 End of License term and subsequent issues

6.1 Failure of licensee to meet its statutory duties: As per the electricity act, (S. 42.1) it is the primary responsibility of the distribution licensee to build an efficient and economical distribution system and ensure reasonable cost of supply. The licensee has clearly failed on both accounts as capital expenditure costs and the cost of supply have sky-rocketed in the recent years.

6.2 End of the licensee's term: As per the MERC regulations 2008, Specific conditions of Distribution License applicable to Reliance Energy Limited, the term of license ends on 15th Aug, 2011. The commission should undertake public process for deciding terms of new license and licensee. Agreed distribution cost reduction trajectory and firm commitment to procure adequate amount of economical/reasonable cost power should be the criteria for appointing new licensee.

6.3 Creation of future regulatory asset by suppressing tariff increase: As per RInfra's tariff proposal the total revenue gap in FY 10, after considering the carrying cost is **Rs. 1,376 Crore**, which would require an average **23% tariff rise** to all the Consumers. But the licensee has proposed to recover only an amount of **Rs. 297 Crore** during FY 10, which requires an average tariff rise of 5%. The balance un-recovered amount of **Rs. 1,079 Crore** is being proposed to be deferred to FY 11 & FY 12.

6.3.1 But the **term of the licensee ends on 15th Aug 2011**. As such any burden of past liability can not be passed on to new licensee that will come in force after this date. Hence the commission should not allow the licensee to create any financial burden for the future licensee.

6.3.2 The National Electricity Tariff Policy clearly states that the facility of a regulatory asset should be used only as exception, and subject to certain guidelines such as: *'The circumstances should be clearly defined through regulations, and should* ***only include natural causes or force majeure conditions****. Under business as usual conditions, the opening balances of uncovered gap must be covered through transition financing arrangement or capital restructuring'* ***emphasis added***

6.3.3 Clearly the excessive increase in revenue gap on account of exceeding approved distribution and energy costs is result of failure of planning and inefficiency, resulting into higher than approved/prudent expenditure and not a natural cause or force majeure event. Also considering the peculiarity of the present situation in context of end of license term, the commission should make all efforts in not

allowing creating of any financial burden for the future licensee to recover through high tariff which the new licensee has no control on and is not responsible for creating it in the first place.

6.3.4 Hence in accordance with the National Electricity Tariff Policy, recovery of the regulatory asset should be planned within the control period itself.

6.4 Grant of new license after 2011: As per the MERC regulations 2008, Specific conditions of Distribution License applicable to Reliance Energy Limited, the term of license ends on 15th Aug, 2011. The commission should undertake public process for deciding terms of new license and licensee. Agreed distribution cost reduction trajectory and firm commitment to procure adequate amount of economical/reasonable cost power should be the criteria for appointing new licensee.

7. Prayers and suggestions/comments:

7.1 Financial and/or legal penalty for failure to procure adequate power at economical rate in a timely manner: The power supply shortages were evident not just for Mumbai but for the whole of Maharashtra from 2003 and demand in licensee's area was also increasing at an expected pace. In spite of number of directives by the MERC and strong financial as well as claimed project / contracting capabilities licensee has failed to contract long/mid term power, and has not entered in to any long/mid term power purchase agreement till date. The exceptionally high cost of power purchase in FY 08 and projected for FY 09 and FY 10 is solely on account of improper planning and failure to sign long/mid term power purchase agreement. Hence we pray to the commission that the Licensee should be financially and legally penalized for failure to ensure cost effective power procurement on timely basis.

7.2 Capital expenditure: All the incremental capex related cost over what was approved by the commission for FY 2006-07 should not be allowed to be passed on as tariff component until the commission undertakes a thorough scrutiny of these expenses and is satisfied with the cost/efficiency benefits thus achieved. **Thus the incremental tariff burden of Rs. 251 Cr due to high capital expenditure during control period should not be passed on to consumers until through scrutiny by the MERC.**

7.3 Operations and Maintenance Costs: Merely incurring an expense and having it as an audited actual expense in balance sheet does not imply the appropriateness and/or prudence of the expense. Even the ATE judgment dated 11th Dec. 2007 in the appeal no. 90 of 2007, states that 'while *truing up the Commission* ***may allow*** *the actual incremental expenditure due to wage revision* ***subject to prudence check***." **emphasis added**. One of the prudence check parameters that can be applied to these expenses is inflation rate. Thus applying inflation rate of 6.5% per year as a 'prudent' benchmark for growth, the total O&M expenses for the control period works out to be **Rs.1443 Cr** as against **Rs.1640 Cr** as claimed by RInfra. **Thus the additional O&M expense of Rs.198 Cr should not be passed as expenditure in ARR.**

7.4 Need for the commission to defend its orders: As highlighted in the previous sections, the past judgments of Appellate Tribunal for Electricity have resulted in tariff increase of around Rs.1000 Cr! We urge the commission to not shy away from defending its orders right up to the highest legal forum i.e. Supreme Court of India to maintain sanctity of its orders and to protect consumers from excessively high tariffs.

7.5 Need to experiment and evolve new tariff policies: As the MYT regime has proved ineffective in controlling tariff expenses and ensuring efficiency gains, the commission should consider newer approaches such as 'distribution margin' based tariff mechanism, (which allows distribution margin to increase at a rate lower than inflation rate) to ensure efficiency improvements.

7.6 End of License term in 2011: The term of current license ends on 15th Aug, 2011. MERC should undertake public process for deciding terms of new license and licensee. Parameters for appointing new licensee should be agreed distribution cost reduction trajectory and a firm commitment to procure adequate quantity of power at reasonable rates.

7.7 Not to create any future regulatory asset by suppressing tariff increase: The licensee's proposal to defer recovery of the actual revenue gap of FY 10 by an amount of **Rs. 1,079 Crore** to FY 11 & FY 12. But the term of the current licensee ends on 15th Aug 2011. Any burden of past liability should not be passed on to new licensee. The commission should not allow such creation of such regulatory liability for the future licensee. Hence in accordance with the National Electricity Tariff Policy, recovery of the regulatory asset should be planned within the control period itself.

- - x - -