KERC's COMMENTS ON THE PROPOSED AMENDMENTS TO KER ACT FOR INTRODUCTION OF MULTIYEAR TARIFF

EXECUTIVE SUMMARY

The Commission believes that the over riding objective of the KER Act, 1999, is the protection and promotion of consumer interest in the long term. Protection of the interests of licensees and investors in the Electricity Sector is, in the opinion of the Commission, not an end in itself; it is only a means to the protection of consumer interest. The Commission's comments have been formulated in the context of this view of the Act.

The amendments propose to empower the Government to enter into detailed and very complex contracts that incorporate the Distribution Margin(DM) and Risk Allocation Approach recommended by the FDP Consultants. No such approach should be attempted without detailed financial modelling to clearly understand the burdens that consumers and the Government will have to bear in a range of realistically defined scenarios. Such modelling has not been done.

While lack of information regarding these contracts may well be symmetrical as between the investors and the Government, past experience indicates that such contracts have invariably ended in the private party enforcing every right available to it while the public interest has suffered as a result of the Government not being able to enforce the corresponding obligations.

The amendments completely reverse the transparency and public participation that have been very important features of Electricity Regulation so far. Contracts are proposed to be entered in to between the Government and Private Investors even on the basis of negotiations though the terms of the contracts will not be available for public comment before the Government goes ahead with the transactions. As many as 4 Tariff revisions per year can take place without the need for any public consultation or regulatory approval.

During the first period of 10 years (that is the transition period and Ist Tariff period), the Commission is proposed to be vested

with an "oversight" role that is trivial and, even so, subject to the consent of the licensee.

The amendments proposed are also completely incompatible with the Electricity Act, 2003.

The Commission recommends that the approach explained in its paper on MYT framework, which is largely similar to the approaches adopted in Delhi, and Andhra Pradesh should be followed. However, should this view not find favour, the Commission recommends that it be kept in a state of suspended animation during this period of 10 years to avoid the completely unnecessary expenditure of around Rs. 2 crores per annum on its maintenance and upkeep.

I. Background to the KERC's Comments

The Commission has finalized its views on the proposed amendments in the light of the aims of the legislature in enacting the KER Act, 1999, as brought out in the Statement of Objects and Reasons for the Act as also in the long title of the Act.

In the Statement of Objects and Reasons, it has been stated that the legislation was proposed in order to provide for the establishment of the Karnataka Electricity Regulatory Commission with powers to regulate this sector with a view to promote efficiency, economy and safety in the use of electricity and to issue licenses and to do certain other matters. The Statement of Objects and Reasons further stated that the legislation was to enable the licensing of transmission and supply of electricity by the Commission, laying down the methodology and terms and conditions for determination of revenue of the licensee, designing tariffs, securing compliance of the Order of the Commission, etc.

The long title of the Act provides that the objective of the Act is, inter-alia, the rationalization of the generation, transmission, distribution and supply of electricity in the State, the taking of measures conducive to the development and management of the electricity industry in the State in an efficient, economic and competitive manner, to provide reliable, quality power, to protect the interests of the consumers and to vest powers in the Commission to regulate the activities of the power sector in the State.

It is seen, therefore, that a central thread that runs through the entire fabric of the Act is that of ensuring efficient, economical supply and safe use of electricity so as to provide reliable and quality power to the consumers and to thereby protect the interest of the consumers. A central institution to achieve these objectives is the Regulatory

Commission and a major instrument available to the Regulatory Commission for the achievement of these objectives is that of licensing.

The Act has explicitly talked about the need to balance the interest of the various players in the sector with a view to achieving the over all objectives of efficiency, economy and competitiveness. In fact Section 11(1) of the Act states that the objective of regulation of purchase, etc., should be the safeguarding of the interest of the consumer while at the same time recognizing the fact that supply and distribution cannot be maintained unless the charges for the electricity supplied are adequately levied and duly collected. In the Commission's opinion, this represents a recognition of the need to look at the interest of the consumer in a long term perspective. In other words, the Commission should not attempt to achieve short term gains for the consumer in such a fashion that the viability of the supplier is jeopardized. The Commission has to explicitly recognize the need for the long term viability of the supplier as being of fundamental importance in protecting the consumer's interest in the long term. Protection of the interests of the licensee and investors therein is not an end in itself. It has value, in the Scheme of the Act, only as a means of, and insofar as it helps in, protecting and promoting the consumer interest in the long term. At the same time, it is clear that the protection of the consumer's interest in a manner that is sustainable over the long term is clearly the overriding objective of the Act.

The Commission has, therefore, looked at the amendments proposed from the point of view of whether the amendments would go towards achieving the objects and purposes of the main statute, as explained above.

II. **Definitions of Important Concepts**

There are some important terms used in the proposed Amendments, the definitions of which have to be understood in detail. These are as follows:

1. Multi Year Tariff (MYT) Framework : This means the performance based, MYT setting, price and / or revenue control principles, methodology, formulae and other arrangements, including provisions for Tariff Adjustments based on a pre-specified Tariff Formula, and the regulatory processes referred to in Section 27A (Sec. 27(7)(g)).

The MYT framework therefore consists of two parts –

- The principles, methodology, formulae and other arrangements for Tariff setting and Tariff Adjustments.
- Regulatory processes referred to in Section 27A.

The MYT framework could be

- A Transition Arrangement or
- The Standard MYT framework

2. Transition Arrangement

This means

- The first MYT framework and
- Other arrangements

established for a particular Licensee by the State Government under Section 27B of the Act (Sec. 29(7)(p)).

3. Tariff Formula

This means –

- A formula notified by the State Government as being applicable to the Transition Period of a licensee; or

- A formula comprised within a MYT framework under Standard MYT framework as may be notified by the State Government for the first Tariff Period in respect of a licensee for which a Transition Arrangement has been notified; or

- Formula as notified by the Commission in respect of other licensees and other Tariff Periods.

It is not clear whether first Tariff Period in the definition above refers to the Transition Period or the first MYT period after the completion of the Transition Period. If it is the latter, this means that in respect of the privatized utilities, the Tariff Formula is decided by the State Government only and not by the Commission, both in respect of the Transition Period and for the first Tariff Period subsequent to the end of the Transition Period.

The latter interpretation seems to be correct based on the proposed Section 27A(2)(a) which says that the licensee has to file its proposals for the Tariff Formula for all Tariff Periods except in relation to the first Tariff Period following the expiry of the Transition Period.

In other words, if the Tariff Period is taken as five years, the Tariff Formula for the first ten years in respect of all privatized utilities will be decided by the State Government and not by the Commission.

4. Tariff Adjustments

This means the permitted changes in the Tariffs in accordance with the applicable Tariff Formula. This will include –

(1) Permitted cost pass through (automatic cost pass through to consumers in respect of input cost and changes to those input costs in terms of changes in the price, quantity or both that are beyond the control of a licensee);

(2) A periodic mechanism for true-up of a Tariff based on pre-defined parameters to account for errors in estimations and forecasts, for differences in the elements of costs and revenues actually incurred or realized from the projected costs and revenues anticipated under the Tariff and the applicable Tariff Formula; and

(3) Adjustments of costs, prices and charges based on pre-defined indices.

As provided in Section 27A, a licensee –

i) may make Tariff Adjustments necessary to reflect any specified increase in licensee's input costs;

ii) shall make Tariff Adjustments necessary to reflect any specified decrease in licensee's input costs.

during a Tariff Period relating to Standard MYT framework based on the applicable Tariff Formula.

The proviso lays down that not more than four Tariff Adjustments may be made in a calendar year (Sec. 27A(3)).

Clause (c) of Section 27A(3) very clearly provides that the Commission is not required either –

i) to conduct a public consultation or

ii) to approve a Tariff Adjustment filing.

The amendment therefore very clearly seeks to make the Tariff Adjustments completely automatic in that no approval from the Commission is required and neither will there be any scope for public consultation.

It is also obvious that the Multiyear Tariff Framework will eventually result in multiple revisions of Tariffs in a year. The Commission is strongly of the opinion that this provision is entirely against the interest of the consumers who will be faced with tremendous uncertainty about the tariffs payable even within the short period of one year.

The explicit provision in the amendment to bar public consultation is completely contrary to the spirit of transparency and public participation that runs through the Act and is, in the Commission's opinion, completely inimical to consumer interests.

While the above provision is explicitly made in respect of the post Transition Period, there is no specific statement in respect of the Transition Period; however it would be reasonable to presume that a similar stipulation would be introduced even into the Transition Arrangement notified by the State Government under Section 27B.

5. <u>Transition Arrangement</u>

The contents of the Transition Arrangement are listed in Section 27B. Some of these contents are expressed to be mandatory while some other items are stated merely to be permitted.

The mandatory contents of a Transition Arrangement are as follows:

(1) A special, flexible, risk sharing, contractual arrangement between the State Government, the bulk supplier or suppliers of energy, any distribution and retail supply licensee and third party investors in that licensee. This arrangement would enable the licensee to retain the amounts specified under the Distribution Margin (DM) method.

(2) A mechanism for allocating scarce wholesale supply of electricity amongst the retail licensees.

(3) A mechanism that is designed to create incentives for efficient capital expenditure and more efficient operations by the licensee.

(4) A mechanism for compensating the licensee for lack of wholesale supplies.

(5) A mechanism for the State Government to pay all the shortfalls in payments due from the retail licensee to the bulk supplier.

(6) Suitable mechanisms for paying subsidies to different categories of consumers.

(7) The procedures for determination of Tariffs so that the Tariffs shall move towards covering the average cost of supply while meeting the standards for technical and commercial quality of service established by the State Government for the Transition Period.

(8) The specific values for the different elements of the Tariffs and any Tariff Formula comprised in the Transition Arrangement.

(9) Targets for the gradual elimination of cross subsidies.

The Transition Arrangement may include a profit or revenue sharing mechanism to enable consumers to share unanticipated benefits from profits or revenues that are significantly (not defined) higher than the level of profits or projected revenues agreed with the licensee (Sec. 27B(3)(f)).

It will be seen from the above that the Transition Arrangement is an exceedingly complex set of contracts. These contracts have to build in the risk sharing and allocation mechanism between the Government, the investors, the utility and the consumers. We are not aware of the details of the risk sharing that is going to be proposed. However our comments relating to the original concept paper on Distribution Margin, which are reproduced below, are, in our opinion substantially applicable even now.

In the Commission's comments on the Distribution Privatization Strategy paper, the Commission had commented as follows on the risk allocation tentatively proposed by the FDP Consultants.

> "The Consultants have done a detailed job of dis-aggregating the risks involved in the Electricity Distribution Business in analyzing their nature, and in arriving at recommendations on the entity that is best placed to either mitigate or eliminate that risk and, therefore, to bear the same.

The following table gives the summary of the analysis :

Nature of Risk			Party to bear
Revenue risk	Tariff Risk	Tariffs fail to reach full cost recovery levels	GoK
		Tariff Methodology unclear or unreasonable in design and application.	GoK
		Ineffective `pass through' arrangements.	GoK
		GoK credit Risk: Delayed payment or non-payment or subsidy.	GoK
	Demand Risk	Demand differing from forecast demand	GoK
		Current demand levels	GoK
		Generation Capacity shortfalls	GoK
	Collection Risk	Metered consumers	Investor
		Those who cannot be managed (thieves, agriculture, etc.)	GoK
Commercial losses risks	Theft Risk	Starting theft levels as stated	Investor
		"Actual" theft being different from stated	GoK
	Inaccurate Metering		Investor
	Inaccurately estimated unmetered consumption		GoK

Nature of Risk			Party to bear
Capital expenditure risk	Capital expenditure cannot be evaluated		GoK until quality data is provided
	Capital expenditure financing risk		GoK until Distcoms can source non-resource financing
Opex Management Risk			Investor
Capital expenditure management risk	Time & cost overruns in implementing "approved" capital expenditure		Investor
Opening Balance Sheet Risk			GoK
Technical Losses Risk			GoK to bear responsibility if actual is found to be different from what is held out

It is clear that only the following risks are initially planned to be transferred to the Investors :

(1) **Collection risk in respect of metered consumers** : The Consultants have been explicit in stating that those customers whom the Distribution Business can best "manage" (for example metered commercial customers) should be separated from those whom the Distribution business cannot manage (for example thieves, agriculture, etc.) and that the collection risk only in respect of the former should be taken by the investor. The Commission is intrigued by the list of examples of "non-manageable" customers.

(2) **Theft risks** : The Consultants have stated that the risk of starting theft levels being different from levels stated should be allocated to the GoK. The implication of this is that the risk attached to whatever is stated to be the initial theft level is to be with the investors.

(3) **Inaccurate metering** : The Consultants felt that this risk is very small and is entirely within the capacity of Distribution Business capable to manage.

(4) **Operating Expenditure Management Risk**.

(5) **Capital Expenditure Management Risk** :

(6) **Technical Losses Risk** : Here again the implication of stating that the GoK will have to bear the responsibility of actual technical loss being different from what is stated is that the responsibility for the opening level of technical losses is with the investors.

While the logic of the risk allocation matrix is acceptable, the Commission has serious reservation about the practicability of implementing the suggestions. The reservations arise on account of the following issues.

(1) **Lack of data** : The initial base line conditions that need to be defined require a substantial input of fairly accurate data which the KPTCL system has so far been unable to provide. Going even by the KPTCL's own estimates of the time required for getting the necessary systems in place, it appears unlikely that reasonable accuracy in respect of base line data will be achievable before the end of FY2003.

(2) **Moral hazard** : The structuring of the proposed risk allocation seems to carry with it the potential for considerable moral hazard. The Consultants have sought to summarily dismiss this issue by stating that well defined requirements for the transition would have to be set up right at the outset and that the contracts are to be so written that the investors do not have any scope for prolonging the transition period. In the absence of clear baseline data and also in the context of the extremely fragile nature of projections in the FRP, it is not very clear as to how the moral hazard inherent in the situation can be overcome. The Commission feels that this matter deserves explicit and detailed analysis and consideration.

(3) **Contractual disputes** : An extremely fine slicing of the risks and responsibility therefore could very easily lead to complex disputes and litigation relating to the fulfillment of obligations or otherwise on the part of either party. It is well recognized that many performance standards, for example, require heavy capital investment to be achieved. Where the funding for this investment is not available due to lack of government guarantees, responsibility for the failure to achieve the standards will get diluted. This is in addition to the extremely difficult task of determining what standards require how much capital investment. This difficulty, which would be very great even in an ongoing dialogue between a regulator and a licensee, would get converted into a near impossibility when the same is

attempted to be finalized as one of the bidding parameters for the privatilization.

(4) **Limited scope for efficiency gains** : The risk allocation matrix clearly shows that efficiency gains can be expected only in Opex Management and in collection from metered consumers. Capex Management may have a small potential for efficiency improvements; however the uncertainties about Capex funding could lead to non-realization of this potential. Even Opex Management may not produce substantial gains in a situation where a Private Management will have several constraints on their freedom to deal with Human Resources issues. The conclusion, therefore, is that even with well-crafted incentives for efficiency gains, the potential for gains seems very limited. Such a inherently restricted potential could also lead to questions about whether Privatization is really worthwhile or not".

It is obvious that the method recommended by the FDP Consultants is exceedingly dangerous for the State and is fraught with the severest of the adverse consequences. No quantification of the risks to the Consumer and the government that are likely from the DM approach appears to have been attempted. The Commission strongly urges Government that merely discussing the DM approach at a conceptual level is totally inadequate. Detailed financial modelling involving consideration of all likely scenarios is absolutely essential to understand the implications of the approach. In fact, such financial modeling should be taken up before the approach is incorporated in the statute.

III. <u>Role of the Government and the Commission</u>

During the Transition Period, every aspect of the sector is to be governed fully and solely by the Transition Arrangement. The State Government is to be solely responsible for designing and implementing the Transition Arrangement. This Transition Arrangement will override all other provisions of the Act.

As has been noted above in the section relating to the definition of the Transition Arrangement, such an arrangement would be so comprehensive in its scope as to virtually leave nothing outside it. This will also include the standards of technical and commercial quality of service that will be established by the State Government for the Transition Period.

Since the State Government has clearly announced its decision to privatize all the four ESCOMs together, it is the provisions relating to Transition Arrangements which alone will be relevant for the Transition Period as well as the first Tariff Period thereafter, that is, for about ten years from the date on which these schemes are implemented.

The elaborate provisions that are proposed to be made in Section 27 relating to MYT framework and in Section 27A relating to procedures for operating the MYT regime are of no relevance whatsoever during this initial period of ten years.

As far as the Commission is concerned, Section 27B(7) clearly provides that the terms and conditions of a Transition Arrangement shall be deemed to be incorporated into the licence of the licensee to which it applies automatically from the date of transfer of control to the private investor. Section 27B(8) further provides that during the Transition Arrangement, the Commission shall be bound by the terms and conditions of such Arrangements.

Section 27B(9) provides that the Commission shall be responsible for oversight of implementation of a Transition Arrangement <u>on behalf of the State Government</u>. The exact scope of this oversight is vague. What is even more important is that the subsection clearly provides that the authority to take all decisions with respect to the Transition Arrangement and all other connected arrangements shall vest exclusively with the State Government "subject to the Transition Arrangements and any arrangements entered into by the State Government with the licensee in accordance with the Transition

Arrangement provided that the State Government may, from time to time during the Transition Period, delegate by a notification in the Gazette delegate its authority to the Commission to make decision on a matter relating to the Transition Arrangement".

Section 27B(2) explicitly provides that a Transition Arrangement for a particular licensee notified by the State Government shall be complied with and implemented by the State Government, the relevant licensee, the Commission and other affected parties as a matter of contract between the State Government and the licensee, strictly in accordance with its terms and shall not be amenable to any amendment / modification once any entity or person, other than the State Government, acquires controlling interest of the licensee concerned.

The said Subsection further makes it clear that any distribution and retail supply licensee and any third party investor in such licensee shall be entitled to obtain specific performance of the arrangements referred to in Subsection (1) (that is Transition Arrangement) by the State Government and the Commission and / or full compensation inb the event of their non-compliance with the arrangement referred to in this Subsection.

It is obvious and clear beyond any doubt that the State Government will not have any authority whatsoever that is not specifically provided for in the contract, that is the Transition Arrangement. Therefore the power to delegate such functions and authority as it may possess under the terms of the Transition Arrangement would also have to be specifically provided for in the Transition Arrangement. The said Transition Arrangement, being in the nature of a contract between the State Government and the licensee, would have to have the consent of the licensee. Therefore, any delegation of power that the State Government may have under the Transition Arrangement to the

Commission would also have to have the consent of the licensee. In other words, the exercise of any function or the taking of any decision by the regulator during the Transition Period would have to have the consent of the regulated entity namely the licensee.

In the Commission's considered opinion, such a provision represents a total perversion of the Scheme of the Act, the nature and scope of regulation and all canons of sound public policy. The Commission is of the opinion that this Scheme that has now been proposed is severely damaging to the consumer's interest.

In summary, these amendments seem to operationalize the concept of a Regulatory Holiday for a period of ten years, as was recommended by the FDP Consultants in one of their earlier papers.

Such amendments also seem to negative the objects and reasons for which the Act has been enacted.

A major problem of the electricity sector that has been identified is the politicization of all economic decision making associated with the sector. It is largely for this reason that it was felt necessary to create independent Regulatory Commissions to take decisions in an open, objective and rational manner, even without the transfer of ownership of the sector to private investors. The ills of politicization of economic decision making in this sector and the deleterious impact of such politicization on the public interests are too well known to need recounting here. It need hardly be emphasized that the damage to public interest arising out of politicization of decision making would be no less even in a situation of private ownership of the utilities as compared to public ownership. Available experience has told us that the negotiation of complex contracts that are to run for a very long term with no provision for any amendment or modification of any sort (as has been suggested in the draft amendment) is an activity that requires expertise of a kind not available with the Government. Government would also find it difficult to enforce its rights under the contract in an environment of political pulls and pressures. On the contrary, private investors would ensure that every ounce of benefit that is contractually due to them is extracted. As far as the advice of the FDP Consultants themselves is concerned, Government will have to bear in mind that, given the mandate to the FDP Consultants to ensure successful privatization of the utilities, recommendations from such Consultants are likely to suffer from the inherent bias in favour of the private investors.

Government should therefore arrange for all the recommendations of the FDP Consultants to be scrutinized and vetted by a panel of independent experts who could advice the Government on the suitability or otherwise of the Scheme suggested by the FDP Consultants and the legislative amendments to implement such a Scheme.

IV. Processes contemplated under the Amendment Act

1. Bidding or Negotiations: The Amendments very clearly provide that the Transition Arrangement may be based on the proposals of the successful bidder accepted by the State Government in the bid documents or resulting from negotiations (Subsection 12 of Section 27B).

   If bids are to be invited and evaluated on the basis of a specified parameter, all other conditions have to be standardized by the Government and made uniformly applicable to all the bidders. Without thus specifying the common platform on which the bids are to be made, a proper comparison of various bids cannot take place.

The amendments do not clearly specify the procedure for identifying the elements of the common platform and specifying them in advance of the invitation to bid.

2. Tariff Revision Process: Under the Transition Arrangement, a licensee can make up to four Tariff Adjustments in a calendar year. All such adjustments can be made by the licensee applying the formulae included in the Transition Arrangement without the necessity for any prior publication or allowing for public participation.

Transparency in the process of Tariff determination and the provision of an opportunity for all categories of consumers to participate in the process and express their opinion, both of which have been amongst the major positive features of regulation so far, would be completely discontinued.

3. Prior Publication of details of the Transition Arrangements: In a situation where the consumers no longer have a right to participate in decisions relating to periodic Tariff revisions, at least an opportunity should be provided at least before the scheme for automatic revision of Tariff is finalized and implemented. The amendments do not specify that the Government has to finalize the scheme and throw it open for public objections and suggestions in draft form before freezing the details of the same.

The Commission strongly recommends that Government should not finalize the Scheme before throwing it open in draft form for inviting comments and suggestions from the public.

4. Establishment of Technical and Commercial Service Standards :

During the Transition Period this will be established as part of the Transition Arrangements as explained above. For the period subsequent to the Transition Period, Section 57(2) is proposed to be amended to vest the power with the Government to determine by rules, the procedure and principles for establishing technical and commercial quality of service standards to be achieved by the distribution and retail supply licensees.

5. Rules relating to Commission's Procedures : The amendments under Section 57(2) seek to empower the Government to prescribe rules which will govern all procedures to be followed by the Commission. Such procedures include –

1. The procedure and principles for establishing technical and commercial quality of service standards.

2. Procedures to be adopted by the distribution and retail supply licensee for economical and efficient power procurement.

3. Procedures for dealing with an application of a licensee for Tariff Formula Change.

The proviso to this proposed rule lays down that the State Government shall make the rules with the objective of promoting private sector investment into distribution and retail supply with a view to achieving the overall objective of securing economic and reliable supply of electrical energy to consumers.

It is quite possible that such an elaborate system of rules that will govern practically all the procedures to be adopted by the Commission could lead to substantial dilution of independence of the

Commission and considerable rigidity with consequences that directly affect consumer interest.

V. <u>Compatibility of the Proposed Amendments with Electricity Act 2003</u>

According to Electricity Act 2003, which has already been passed by the Parliament and is awaiting notification, the State Commission shall discharge the following functions amongst others :

(a) Determine the tariff for generation, supply, transmission and wheeling of electricity, wholesale, bulk or retail, as the case may be.

(b) Regulate electricity purchase and procurement process of distribution licensees including the price at which electricity shall be procured from the generating companies or licensees or from other sources through agreements for purchase of power for distribution and supply.

(c) Facilitate intra-state transmission and wheeling of electricity.

(d) Issue licences to persons seeking to act as transmission licensees, distribution licensees and electricity traders with respect to their operations.

(e) Specify State Grid Code.

(f) Specify or enforce standards with respect to quality, continuity and reliability of service by licensees.

The major functions which are vested with the Commission under the Electricity Act 2003 are proposed to be shifted to the State Government during the Transition Period and the first MYT Period (a total of ten years) under the proposed amendments to the KER Act. The Commission is proposed to be vested only with oversight of the implementation of the Transition Arrangements on behalf of the State Government. Therefore, the proposed amendments are incompatible with the Electricity Act 2003.

VI. <u>Commission's Alternative View</u>

The Commission has already circulated a detailed paper dealing with the various issues relating to MYT framework. In conclusion, the Commission has stated the following about a MYT System for Private Distribution utilities in Karnataka :

"For the limited purpose of the MYT system to be used in a private sector context it would appear that government's role would be to lay down the broad structure of the privatisation process, similar to the one used in Delhi. For the various components of the Revenue Requirement, it would be best if there is an annual review, based on an MYT framework in which the most contentious and crucial parameter – the T&D loss – is determined through a bidding process as was done in Delhi. The reason for preferring the bidding system is that these losses contain a large element of theft, which can be reduced by better management. Unilateral determination of these is more likely to give room for renegotiation The potential investors would be best placed to determine how much effort can be put in and what results can be expected.

While the broad policy should be laid down by the government details like the opening loss levels and the minimum acceptable loss levels should be specified by the Regulator. This would be desirable because the regulatory process has acquired a certain legitimacy owing to the transparent process adopted. In addition, with the experience of the last three years the Commission is in a good position to judge the reasonableness of loss levels, either present or those to be achieved in the future.

Quite clearly for such an MYT system to succeed there needs to be sufficient competition. Without competition it is possible that very low levels of improvement are specified. Thus in Hyderabad the T&D losses are said to have come down by about 20% in two years, whereas in Delhi a 17% reduction over five years has been agreed to with the new private sector distributors. It is possible that with more competition, a higher level of loss reduction could have been built in to the privatization in Delhi.

> While it would be desirable to have a completely automatic MYT system, (that is, one which permits the utilities to revise end consumer tariffs without the need for any further approval from the regulator) it may not be possible to introduce such a scheme for the private sector to start with. Rather a system based on the Delhi model would be better with the AT&C loss determined by the market but with provision of annual reviews to assess the other cost components . Gradually these other cost components can also be reduced to a more mechanical system, but with some room for regulatory intervention to deal with unforeseen factors. Simultaneously Government would also have to specify a long term policy on agricultural subsidy to reduce the uncertainty on the revenue side. Such a system would have the advantage of having a flexible system with a transparent mechanism to resolve unforeseen contingencies. International experience is replete with such cases. Given the high dependence of Karnataka on hydro power there are even more chances of this happening here. Further the financial weakness of the electricity sector makes it more vulnerable to the impact of such unpredictable events as a drought. These contingencies can never be predicted and thus require an institutional mechanism. The Commission believes that as more information is made available to the public it would be easier to find solutions in a flexible framework. In contrast, a very tight scheme would have the advantage of clarity for stakeholders but would also have the disadvantage of rigidity and breakdown if no room is provided for mid course corrections. The dangers of a flexible mechanism leading to arbitrariness can only be overcome by having a credible and transparent mechanism of decision making, with extensive public consultation".

The Commission also notes that a somewhat similar approach has been followed in the case of Andhra Pradesh where APERC has recently issued its Order on Long Term Tariff Principles applicable to the public sector distribution companies. The broad approach of the APERC is also similar to the KERC's approach as explained in the above paragraphs (a copy of the APERC Order is enclosed for easy reference).

VII. Conclusion

The Commission is aware that it is entirely within the power of the legislature to amend the Act on the lines proposed by Government, acting on the advice of its FDP Consultants. However if the amendments as proposed are in fact implemented, the Commission is clearly of the view that it would be a complete waste of public money to continue with the Commission, at an average cost of approximately Rs.2 crores per annum, only for the very small and, for all practical purposes, unnecessary and irrelevant functions that the Commission is required to perform for a period of ten years. On the contrary, the Commission clearly recommends that, should the amendments as proposed be enacted and implemented, the Commission could be kept in a state of suspended animation, with the 'oversight' functions proposed to be vested in the Commission during this period being performed by a suitable officer of the Government designated for this purpose.

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