

THE HIGH COURT OF DELHI AT NEW DELHI

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Judgment delivered on: 29.07.2016

+ **W.P.(C) 2203/2012 & C.M. No.4756/2012**

TATA POWER DELHI DISTRIBUTION LIMITED Petitioner

versus

**DELHI ELECTRICITY REGULATORY
COMMISSION**

..... Respondent

Advocates who appeared in this case:

For the Petitioner : Mr C.S. Vaidyanathan, Senior Advocate with
Mr Anand Kumar Srivastava.

For the Respondent : Mr Sanjay Jain, ASG with Ms Suparna
Srivastava, Ms Anushka Arora, Mr Manu Dev
Sharma, Ms Bani Dikshit and Mr Shreshth Jain.

CORAM:-

HON'BLE MR JUSTICE BADAR DURREZ AHMED

HON'BLE MR JUSTICE VIBHU BAKHRU

JUDGMENT

VIBHU BAKHRU, J

1. The petitioner has filed this writ petition under Article 226 of the Constitution of India, *inter alia*, challenging the Delhi Electricity Regulatory Commission (Terms and Conditions of Wheeling Tariff & Retail Supply Tariff) Regulations, 2011 (hereinafter 'the impugned Regulations') issued by the Delhi Electricity Regulatory Commission (hereafter 'the Commission').

2. The impugned Regulations set out the principles for determination of tariff for wheeling and retail supply of electricity for the period of three years commencing from 01.04.2012. The petitioner, which is an electricity distribution company, challenges the impugned Regulations as being contrary to the provisions of the Electricity Act, 2003 (hereinafter 'the Act') read with the National Tariff Policy, 2006 (hereafter 'the NTP, 2006').

3. The principal dispute raised by the petitioner in this petition relates to treatment of certain components of costs (discussed in detail hereinafter) as controllable; according to the petitioner, the specified elements of costs are uncontrollable and are required to be considered as such for the purposes of determining the electricity tariff. This is disputed by the Commission and it asserts that the principles of tariff as embodied in the impugned Regulations adequately take into account the controllable as well as uncontrollable elements of costs for fixation of the tariff. According to the Commission, the impugned Regulations provide sufficient scope for electricity distribution companies to not only recover all costs but also to earn a reasonable return on the capital employed.

4. Briefly stated, the context in which the above controversy arises is as under:

4.1 The petitioner is a company incorporated under the provisions of the Companies Act, 1956 in the nature of a joint venture between Tata Power Company Ltd. (hereafter 'TPCL') and Government of National Capital Territory of Delhi (hereafter 'GNCTD') wherein TPCL holds 51% of the outstanding share capital of the petitioner, the balance 49% is held by GNCTD.

4.2 The petitioner took over the distribution of electricity for North and North-West Delhi w.e.f. 01.07.2002. This was pursuant to the electricity reforms and privatization process whereby the erstwhile Delhi Vidyut Board (hereafter 'DVB') was unbundled into separate electricity distribution, transmission and generating companies. The functions and assets of erstwhile DVB relating to distribution of electricity were transferred to separate distribution companies. This included assets relating to distribution of electricity in North and North-West Delhi, which were transferred to North-Northwest Delhi Distribution Company Limited. Fifty-one percent of the equity of the electricity distribution companies - including North-Northwest Delhi Distribution Company Ltd - were sold to

private sector enterprises that were selected on competitive bidding process; the competitive criteria included commitments of reduction in loss levels/efficiency gains. TPCL was selected as the constituent joint venture partner in North-Northwest Delhi Distribution Company Ltd. The Petitioner is a distribution licensee in terms of Section 14 of the Act.

4.3 In terms of the policy directions dated 22.11.2001 issued by GNCTD, Delhi Power Supply Company Ltd. (the unbundled transmission entity, also referred to as TRANSCO) was charged with the responsibility of procuring bulk power on behalf of the three distribution companies resulting from unbundling of the erstwhile DVB. During the period 01.04.2002 to 31.03.2007, the electricity distribution companies (including the petitioner) were required to pay the bulk supply tariff as determined by the Commission to TRANSCO. Subsequently, with effect from 01.04.2007, the electricity distribution companies were independently responsible for procuring power and supplying the same to the consumers. The power purchase agreements entered into by TRANSCO with electricity generating companies were re-assigned to the distribution companies including the petitioner.

4.4 On 26.07.2007, the Commission notified the Delhi Electricity Regulatory (Terms and Conditions of Wheeling Tariff & Retail Supply Tariff) Regulations, 2007. These Regulations, for the first time, provided for multi-year tariff framework for determination of tariff for wheeling and retail supply of electricity. These Regulations were initially applicable for the period 01.04.2007 to 31.03.2011 but were subsequently extended for a further period of one year, that is, upto 31.03.2012.

4.5 The Commission circulated a draft of the new Regulations - which subsequently culminated in framing of the impugned Regulations - for setting out the principles of methodology for determination of the tariff for the control period comprising of financial years 2012-2015. These draft Regulations were published in September, 2011 and comments on the same were invited from the public as well as other stakeholders. It is stated that the petitioner submitted detailed comments in respect of various provisions of the aforesaid draft Regulations; in particular, the petitioner objected to certain provisions as being contrary to the principles of tariff determination under the Act and NTP, 2006. The petitioner also asserted the provisions of the draft Regulations to be unfair and unreasonable. On 14.11.2011, the Commission held a public hearing in respect of the aforesaid draft

Regulations and, thereafter, notified the impugned Regulations in exercise of powers conferred under Section 181 (2) (zd) of the Act read with Section 61 (2) (g) of the Delhi Electricity Reforms Act, 2000.

Submissions

5. Mr C. S. Vaidyanathan, learned Senior counsel appearing for the petitioner contended that NTP, 2006 contemplated that the uncontrollable components of costs be recovered speedily to ensure that future consumers are not burdened with past costs. He submitted that, accordingly, the uncontrollable costs were required to be trued up; but, since the impugned Regulations consider some of the uncontrollable expenses as controllable, no provision for periodical truing up of such expenses has been made. In particular, he referred to Regulation 4.7 (d) and Regulation 4.21(b)(i) of the impugned Regulations which relate to Operation and Maintenance (O&M) expenses. He submitted that although the said expenses were not controllable, the same were erroneously classified as controllable expenses. According to the petitioner, such expenses included increase on account of actual levels of inflation; costs relating to employees transferred from erstwhile DVB; costs resulting from increase in consumer base; working capital; and interest rates. Mr Vaidyanathan submitted that all such

expenses and/or increase in expenses on account of the aforesaid factors, were uncontrollable and were required to be trued up on an annual basis. He contended that the O&M expenses were computed by applying a normative formula and since the said formula did not provide for truing up on account of variation in the costs which were beyond the control of the petitioner, the impugned Regulations were contrary to Section 61(b), 61(c) and 61(d) of the Act read with NTP, 2006.

5.1 Mr Vaidyanathan further submitted that the impugned Regulations were also arbitrary and unreasonable inasmuch as they restrict the return on equity to investment in fixed assets and completely ignore the equity deployed as working capital. He submitted that the revenue gap, which was funded by the petitioner, was also erroneously considered as financed entirely by debt. He submitted that the debt-equity ratio under the impugned Regulations was assumed as 70:30 and the impugned Regulations did not take into account repayment of debt during the control period which would inevitably reduce the debt component.

5.2 He submitted that the impugned Regulations assumed that the distribution companies would avail the maximum rebate (of 2%) in the purchase cost of power, which was available only on payment of bills

through letter of credit on presentation. He contended that the aforesaid provisions of the impugned Regulations were contrary to Section 61(b) of the Act which required distribution of electricity to be conducted on commercial business principles.

6. Mr Sanjay Jain, learned Additional Solicitor General countered the arguments advanced on behalf of the petitioner and submitted that the impugned Regulations were framed after hearing the representations made by the petitioner as well as other stakeholders. He argued that the impugned Regulations had considered various components of costs as well as return on investment. He submitted that whilst the power purchase cost which comprised of 82% to 85% of the annual revenue required were considered on actual basis, other components of costs such as O&M expenses were determined keeping in view the trends of both controllable and uncontrollable elements of costs. He admitted that although certain elements of costs were uncontrollable, the impugned Regulations had provided a normative formula for determining the same which also took into account a reasonable increase in such costs on a normative basis. Thus, even though the impugned Regulations did not provide for any further truing up of such expenses, the same was not unreasonable as the

impugned Regulations provided for a normative increase in both controllable and uncontrollable elements of costs. He referred to the various elements of costs which were contended to be uncontrollable and provided justification for their treatment under the impugned Regulations.

Reasoning and Conclusion

7. The brief controversy to be addressed is whether the impugned Regulations fall foul of the provisions of the Act. It is the petitioner's case that Regulations 4.2, 4.7, 4.21, 5.5, 5.10, 5.11, 5.24 and 7.3 of the impugned Regulations are contrary to the provisions of the Act and have no nexus with the object or intent of the Act. According to the petitioner, the said Regulations are also contrary to the provisions of the NTP, 2006.

8. Before proceeding to address the controversy, it is necessary to refer to certain provisions of the Act. Section 3 of the Act provides that the Central Government shall prepare a National Electricity Policy and Tariff Policy in consultation with the State Governments and the Central Electricity Authority for development of a power system based on optimum utilization of resources. NTP, 2006 has been published by the Central Government in accordance with Section 3 of the Act. Part VII of the Act

contains provisions – Section 61 to 66 – concerning tariff. Section 61 of the Act requires the appropriate Commission to specify the terms and conditions for the determination of tariff and mandates that in doing so, it be guided by the principles enunciated therein. Section 62 of the Act requires the appropriate Commission to, *inter alia*, determine the tariff in accordance with the Act for (a) supply of electricity by a generating company to a distribution licensee; (b) transmission of electricity; (c) wheeling of electricity; and (c) retail sale of electricity.

9. Section 61 of the Act is set out below for ready reference:

“Section 61. (Tariff Regulations):

The Appropriate Commission shall, subject to the provisions of this Act, specify the terms and conditions for the determination of tariff, and in doing so, shall be guided by the following, namely:-

- (a) the principles and methodologies specified by the Central Commission for determination of the tariff applicable to generating companies and transmission licensees;
- (b) the generation, transmission, distribution and supply of electricity are conducted on commercial principles;
- (c) the factors which would encourage competition, efficiency, economical use of the resources, good performance and optimum investments;

- (d) safeguarding of consumers' interest and at the same time, recovery of the cost of electricity in a reasonable manner;
- (e) the principles rewarding efficiency in performance;
- (f) multi year tariff principles;
- (g) that the tariff progressively reflects the cost of supply of electricity and also reduces cross-subsidies in the manner specified by the Appropriate Commission;
- (h) the promotion of co-generation and generation of electricity from renewable sources of energy;
- (i) the National Electricity Policy and tariff policy:

Provided that the terms and conditions for determination of tariff under the Electricity (Supply) Act, 1948, the Electricity Regulatory Commissions Act, 1998, and the enactments specified in the Schedule as they stood immediately before the appointed date, shall continue to apply for a period of one year or until the terms and conditions for tariff are specified under this section, whichever is earlier.”

10. Section 181 of the Act enables the State Commissions to make Regulations consistent with the Act and the Rules to carry out the provisions of the Act. By virtue of clause (zd) of Section 181 (2) of the Act the State Commissions are specifically empowered to make Regulations to provide for “*the terms and conditions for the determination of tariff under section 61*”. The impugned Regulations have been made in exercise of the powers conferred under Section 181 (2) (zd) of the Act.

11. In terms of Section 3 of the Act, the Central Government notified the National Electricity Policy on 12.02.2005 and, thereafter, issued NTP, 2006. The objectives of NTP, 2006 are quoted below:-

“The objectives of this tariff policy are to:

- (a) Ensure availability of electricity to consumers at reasonable and competitive rates;
- (b) Ensure financial viability of the sector and attract investments;
- (c) Promote transparency, consistency and predictability in regulatory approaches across jurisdiction and minimize perceptions of regulatory risks;
- (d) Promote competition, efficiency in operations and improvement in quality of supply.”

12. At this stage, it is also necessary to refer to relevant extracts of para 5.3 of NTP, 2006, which is set out below:

“5.3 Tariff policy lays down following framework for performance based cost of service regulation in respect of aspects common to generation, transmission as well as distribution. These shall not apply to competitively bid projects as referred to in para 6.1 and para 7.1 (6). Sector specific aspects are dealt with in subsequent sections.

a) Return on Investment

Balance needs to be maintained between the interests of consumers and the need for investments while laying down

rate of return. Return should attract investments at par with, if not in preference to, other sectors so that the electricity sector is able to create adequate capacity. The rate of return should be such that it allows generation of reasonable surplus for growth of the sector.

The Central Commission would notify, from time to time, the rate of return on equity for generation and transmission projects keeping in view the assessment of overall risk and the prevalent cost of capital which shall be followed by the SERCs also. The rate of return notified by CERC for transmission may be adopted by the State Electricity Regulatory Commissions (SERCs) for distribution with appropriate modification taking into view the higher risks involved. For uniform approach in this matter, it would be desirable to arrive at a consensus through the Forum of Regulators.

While allowing the total capital cost of the project, the Appropriate Commission would ensure that these are reasonable and to achieve this objective, requisite benchmarks on capital costs should be evolved by the Regulatory Commissions.

Explanation: For the purposes of return on equity, any cash resources available to the company from its share premium account or from its internal resources that are used to fund the equity commitments of the project under consideration should be treated as equity subject to limitations contained in (b) below.

The Central Commission may adopt the alternative approach of regulating through return on capital.

The Central Commission may adopt either Return on Equity approach or Return on Capital approach whichever is considered better in the interest of the consumers.

The State Commission may consider ‘distribution margin’ as basis for allowing returns in distribution business at an appropriate time. The Forum of Regulators should evolve a comprehensive approach on “distribution margin” within one year. The considerations while preparing such an approach would, inter-alia, include issues such as reduction in Aggregate Technical and Commercial losses, improving the standards of performance and reduction in cost of supply.

b) Equity Norms

For financing of future capital cost of projects, a Debt : Equity ratio of 70:30 should be adopted. Promoters would be free to have higher quantum of equity investments. The equity in excess of this norm should be treated as loans advanced at the weighted average rate of interest and for a weighted average tenor of the long term debt component of the project after ascertaining the reasonableness of the interest rates and taking into account the effect of debt restructuring done, if any. In case of equity below the normative level, the actual equity would be used for determination of Return on Equity in tariff computations.

c) Depreciation

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d) Cost of Debt

Structuring of debt, including its tenure, with a view to reducing the tariff should be encouraged. Savings in costs on account of subsequent restructuring of debt should be suitably

incentivised by the Regulatory Commissions keeping in view the interests of the consumers.

e) Cost of Management of Foreign Exchange Risk

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f) Operating Norms

Suitable performance norms of operations together with incentives and dis-incentives would need be evolved along with appropriate arrangement for sharing the gains of efficient operations with the consumers. Except for the cases referred to in para 5.3 (h)(2), the operating parameters in tariffs should be at “normative levels” only and not at “lower of normative and actuals”. This is essential to encourage better operating performance. The norms should be efficient, relatable to past performance, capable of achievement and progressively reflecting increased efficiencies and may also take into consideration the latest technological advancements, fuel, vintage of equipments, nature of operations, level of service to be provided to consumers etc. Continued and proven inefficiency must be controlled and penalized.

The Central Commission would, in consultation with the Central Electricity Authority, notify operating norms from time to time for generation and transmission. The SERC would adopt these norms. In cases where operations have been much below the norms for many previous years, the SERCs may fix relaxed norms suitably and draw a transition path over the time for achieving the norms notified by the Central Commission.

Operating norms for distribution networks would be notified by the concerned SERCs. For uniformity of approach in determining such norms for distribution, the Forum of

Regulators should evolve the approach including the guidelines for treatment of state specific distinctive features.

g) Renovation and Modernisation (sic)

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(h) Multi Year Tariff

1) Section 61 of the Act states that the Appropriate Commission, for determining the terms and conditions for the determination of tariff, shall be guided inter-alia, by multi-year tariff principles. The MYT framework is to be adopted for any tariffs to be determined from April 1, 2006. The framework should feature a five-year control period. The initial control period may however be of 3 year duration for transmission and distribution if deemed necessary by the Regulatory Commission on account of data uncertainties and other practical considerations. In cases of lack of reliable data, the Appropriate Commission may state assumptions in MYT for first control period and a fresh control period may be started as and when more reliable data becomes available.

2) In cases where operations have been much below the norms for many previous years the initial starting point in determining the revenue requirement and the improvement trajectories should be recognized at “relaxed” levels and not the “desired” levels. Suitable benchmarking studies may be conducted to establish the “desired” performance standards. Separate studies may be required for each utility to assess the capital expenditure necessary to meet the minimum service standards.

3) Once the revenue requirements are established at the beginning of the control period, the Regulatory Commission should focus on regulation of outputs and not the input cost

elements. At the end of the control period, a comprehensive review of performance may be undertaken.

4) Uncontrollable costs should be recovered speedily to ensure that future consumers are not burdened with past costs. Uncontrollable costs would include (but not limited to) fuel costs, costs on account of inflation, taxes and cess, variations in power purchase unit costs including on account of hydro-thermal mix in case of adverse natural events.

5) Clear guidelines and Regulations on information disclosure may be developed by the Regulatory Commissions. Section 62 (2) of the Act empowers the Appropriate Commission to require licensees to furnish separate details, as may be specified in respect of generation, transmission and distribution for determination of tariff.”

13. The impugned Regulations require the Commission to determine the Annual Revenue Requirement (ARR) for determining the tariff for the entire control period in advance. The ARR is required to be determined based on the data provided by the distribution licensees which also includes the projections on the basis of financial and operational standards. The Commission is also required to review the performance of the licensees in respect of components of ARR which are determined as uncontrollable and such elements are required to be trued up. This is in accordance with Article 5.3 (h) (4) of the NTP, 2006 which requires that uncontrollable

costs be recovered speedily to ensure that future consumers are not burdened with past costs.

14. We now proceed to examine the petitioner's grievance with the impugned Regulations in the context of specific expense heads.

Classification of O&M Expenses as Controllable

15. Regulation 4.7 of the impugned Regulations requires the Commission to set annual targets during the control period in respect of certain parameters which are deemed to be controllable. In terms of Regulation 4.7(d), O&M expenses - which include employee expenses, repairs and maintenance expenses, administration and general expenses - are deemed to be controllable. Regulation 4.21 of the impugned Regulations provides for truing up of various controllable and uncontrollable parameters as per the principles stated therein. In terms of Regulation 4.21(b)(i), any surplus or deficit on account of O&M expenses would be to the account of the licensee and would not be trued up in ARR. However, O&M expenses are to be determined using a formula - as specified in Regulation 5.5(a) - which includes a normative annual increase

based on an inflation factor. Regulation 4.7, 4.21, 5.3, 5.4 and 5.5(a) are set out below:-

“Targets for Controllable Parameters

4.7 The Commission shall set targets for each year of the Control Period for the times or parameters that are deemed to be "controllable" and which include:

- (a) AT & C Loss, which shall be measured as the difference between the units input into the distribution system for sale to all its consumer and the units realised wherein the units realised shall be equal to the product of units billed and collection efficiency:

Provided that units billed shall include the units realised on account of theft measured on actual basis i.e. number of units against which payment of theft billing has been realised;

- (b) Distribution losses, which shall be measured as the difference between the net units input into the distribution system for sale to all its consumer and sum of the total energy billed in its Licence area in the same year;
- (c) Collection efficiency, which shall be measured as ratio of total revenue realised to the total revenue billed in the same year:

Provided that revenue realisation from electricity duty and late payment surcharge shall not be included for computation of collection efficiency;

- (d) Operation and Maintenance Expenditure which includes employee expenses, repairs and maintenance expenses, administration and general expenses and other miscellaneous expenses viz. audit fees, rents, legal fees etc;

- (e) Return on Capital Employed;
- (f) Depreciation; and
- (g) Quality of Supply.”

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True Up

4.21 The true up across various controllable and uncontrollable parameters shall be conducted as per principle stated below:

- (a) Variation in revenue / expenditure on account of uncontrollable sales / power purchase respectively shall be trued up every year;
- (b) For controllable parameters,
 - (i) Any surplus or deficit on account of Operation and Maintenance (O&M) expenses shall be to the account of the Licensee and shall not be trued up in ARR; and
 - (ii) Depreciation and Return on Capital Employed shall be trued up every year based on the actual capital expenditure and actual capitalisation vis-a-vis capital investment plan (capital expenditure and capitalisation) approved by the Commission:

Provided that any surplus or deficit in Working Capital shall be to the account of the Licensee and shall not be trued up in ARR:

Provided further that the Commission shall not true up the interest rate, if variation in State Bank of India Base Rate as on April 1, 2012, is within +/- 1% during the Control Period. Any

increase / decrease in State Bank of India Base Rate beyond +/- 1% only shall be trued up.”

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Operation and Maintenance Expenses

5.3 Operation and Maintenance (O&M) expenses shall include:

- (a) Salaries, wages, pension contribution and other employees costs;
- (b) Administrative and General expenses which shall also include expense related to raising of loans;
- (c) Repairs and Maintenance; and
- (d) Other miscellaneous expenses, statutory levies and taxes (except corporate income tax).

5.4 The Licensee shall submit the O&M expenses for the Control Period as prescribed in Multi Tear Tariff filing procedure. The O&M expenses for the Base Year shall be approved by the Commission taking into account the latest available audited accounts, business plan filed by the Licensees, estimates of the actuals for the Base Year, prudence check and any other factor considered appropriate by the Commission.

5.5 O&M expenses permissible towards ARR for each year of the Control Period shall be determined using the formula detailed below:

$$(a) \quad O\&M_n = (R\&M_n + EMP_n + A\&GO * (I - X_n))$$

Where,

- (i) $R\&M_n = K * GFA_{n-1}$;
- (ii) $EMP_n + A\&G_n = (EMP_{n-1} + A\&G_{n-1}) * (INDX)$
- (iii) $INDX = 0.55 * CPI + 0.45 * WPI$;
- (iv) X_n is an efficiency factor for n^{th} year. Value of X_n shall be determined by the Commission in the MYT Tariff order based on Licensee's filing, benchmarking, approved cost by the Commission in past and any other factor the Commission feels appropriate;
- (v) EMP_n — Employee Costs of the Licensee for the n^{th} year;
- (vi) $A\&G_n$ — Administrative and General Costs of the Licensee' for the n^{th} year; and
- (vii) $R\&M_n$ — Repair and Maintenance Costs of the Licensee, for the n^{th} year.

Where,

'K' is a constant (could be expressed in %). Value of K for each year of the Control Period shall be determined by the Commission in the MYT Tariff order based on Licensee's filing, benchmarking, approved cost by the Commission in past and any other factor considered appropriate by the Commission;

INDX - Inflation Factor to be used for indexing. Value of INDX shall be a combination of the Consumer Price Index (CPI) and the Wholesale Price Index (WPI) for immediately preceding five years before the base year.”

16. According to the petitioner, since the O&M expenses are required to be computed by applying a normative formula and there is no provision for truing up such expenses on account of any uncontrollable elements affecting such expenses, the impugned Regulations are violative of Section 61(b), 61(c) and 61(d) of the Act. It is also asserted that not providing for truing up of uncontrollable costs would also be contrary to paragraph 5.3(h)(4) of NTP, 2006. According to the petitioner, the O&M expenses constitutes several uncontrollable elements including (i) change in taxes, statutory levies(ii) minimum wages (iii) inflation (iv) service terms and conditions of employees transferred from erstwhile DVB; (v) increase in consumer base; (vi) costs relating to career growth and replacement of employees and inflation in repairs and maintenance expenses.

17. Section 61 of the Act requires that the appropriate Commission be guided by various principles and factors as specified therein. Thus, indisputably, the impugned Regulations must conform to the principles as referred to in Section 61 of the Act. By virtue of Section 61(i), the framing of the impugned Regulations are also to be guided by the National Electricity Policy and the Tariff Policy. NTP, 2006 clearly lays down that uncontrollable costs should be recovered speedily to ensure that future

consumers are not burdened with past costs. Further, fuel costs, costs on account of inflation, taxes and cess, variations in power purchase unit costs are specifically stated to be uncontrollable costs.

18. In view of the above, it cannot be disputed that Regulations made under Section 181 (2) (zd) of the Act must necessarily provide for speedy recovery of uncontrollable costs. However, this does not necessarily mean that the impugned Regulations must provide for a specific determination of all uncontrolled elements of costs and provide for directly loading of those costs on the tariff for each year. NTP, 2006 only states the principles which would guide determination of tariffs. Indisputably there would be several ways to give effect to those principles. Providing an increase in costs on a normative basis taking into account the inflation factor would - if such normative basis has been arrived at after exercising due skill and after taking into account the relevant factors - also provide for a method of recovering uncontrollable costs.

19. The term 'true-up' is commonly understood to mean align/ balance/ make level. The term as used in the impugned Regulations must be read in the context of NTP, 2006, which inter alia requires that uncontrollable costs be recovered speedily. In the present context, the expression 'true-up' would

be to balance and align costs. Providing for an increase in costs on normative basis is also one of the ways to balance and correct the recoveries.

20. Paragraph 5.3(h)(4) of NTP, 2006 specifically requires the uncontrollable cost to be recovered and not accumulated so as to burden future consumers. A plain reading of the impugned Regulations also indicate that they do not permit carry forward of O&M expenses or recovery of the same in the future years; all O&M expenses which may remain unrecovered are to the account of the licensee. Although O&M cost are deemed to be controllable, nonetheless, the impugned Regulations do provide for a normative increase in such costs based on a specified formula. Clearly, the intention of the Commission is to ensure that such costs are passed through but instead of bisecting the expenses' head into various cost elements and providing for truing up of the actual variation in each year, the Commission in its wisdom has framed a formula for absorbing the increased costs in the tariff on a normative basis. This is clearly to insulate the consumers from wide variation and provide for an overall uniform increase based on an inflation factor. Indisputably, the O&M expenses include both elements which are controllable as well as uncontrollable, thus

admittedly, it would also not be apposite to treat all O&M expenses as uncontrollable. The Commission has adopted a broad approach and whilst all O&M expenses are treated as controllable under the impugned Regulations, it also provides for an increase in such expenses based on inflation factor. This is merely an alternate method for the pass through of increase in expenses and absorbing the effect of inflation in the tariff.

21. We are unable to accept the contention that such approach militates against the principles specified in Section 61 of the Act or falls foul of paragraph 5.3(h)(4) of NTP, 2006. It is necessary to bear in mind that Section 61 of the Act specifies certain principles/factors for guidance of the Commission in framing the Regulations. These are in nature of broad principles to be considered while framing Regulations; and not rigid formulae as is sought to be canvassed on behalf of the petitioner. Section 61(b) of the Act, *inter alia*, requires the supply of electricity to be conducted on commercial principles; merely because some elements of variation in actual costs are not directly incorporated in the tariff does not necessarily mean that commercial principles have been disregarded.

22. The petitioner has been unable to establish that the tariff fixed according to the impugned Regulations would render the activity of

distribution unviable and that no person could possibly recover his costs in carrying out the said business. Thus, we are also unable to accept that the impugned Regulations violate Article 19(1)(g) of the Constitution of India.

23. The impugned Regulations have been framed in exercise of powers conferred under Section 181 of the Act and are in the nature of subordinate legislation. It is well settled that scope of judicial review of subordinate legislation is very limited. And, any interference by this Court would not be warranted unless it is established that the impugned Regulations are inconsistent with the Act; are *ultra vires* the Constitution of India; or the due procedure for making such legislation has not been followed. In the present case, we are not persuaded that either of the said grounds have been made out.

Return on Equity

24. One of the grievances urged by the petitioner is that the impugned Regulations do not provide for any return on equity capital used as working capital. It is asserted that in terms of the impugned Regulations, the Return on Capital Employed (RoCE) is computed on the basis of the asset base for each year and the Weighted Average Cost of Capital (WACC). WACC is a

combination of interest on the debt component of the total funds employed and 16% post-tax return on the equity component. Although asset base includes working capital but for purposes of computing WACC, the working capital is considered to be financed entirely by debt. This is postulated by the first proviso to Regulation 5.11. Regulation 5.11 reads as under:-

“5.11 The WACC for each year of the Control Period shall be computed at the start of the Control Period in the following manner:

$$\text{WACC} = \left[\frac{D / E}{1 + D / E} \right] * r_d + \left[\frac{1}{1 + D / E} \right] * r_e$$

Where,

D/E is the Debt to Equity Ratio and for the purpose of determination of tariff, debt-equity ratio for the asset capitalized shall be 70:30. Where equity employed is in excess of 30%, the amount of equity for the purpose of tariff shall be limited to 30% and the balance amount shall be considered as notional loan. The interest rate on the amount of equity in excess of 30% treated as notional loan shall be the weighted average rate of the loans of the Licensee for the respective years and shall be further limited to the prescribed rate of return on equity in the Regulations. Where actual equity employed is less than 30%, the actual equity and debt shall be considered:

Provided that the Working capital shall be considered 100% debt financed for the calculation of WACC;

Provided further that the Debt to Equity Ratio for the assets covered under Transfer Scheme, dated July 1, 2002 shall be considered as per the debt and equity in the transfer scheme;

Provided further that Debt to Equity Ratio for the assets capitalised till 1.04.2012 (other than assets covered under Transfer Scheme) shall be considered as per the debt and equity approved by the Commission at the time of capitalization.

r_d is the Cost of Debt and shall be determined at the beginning of the Control Period after considering Licensee's proposals, present cost of debt already contracted by the Licensee, credit rating, benchmarking and other relevant factors (risk free returns, risk premium, prime lending rate etc.);

r_e is the Return on Equity and shall be considered at 16% post tax:

Provided further that any additional investment made by the Licensee other than in the fixed asset of the distribution business, shall not qualify for the return on equity.”

25. In addition, the petitioner is also aggrieved by the third proviso to Regulation 5.11 in terms of which revenue gap is also considered as entirely financed by the debt component. The petitioner submits that revenue gap of approximately Rupees three thousand crores has been created in the earlier years and the petitioner has been constrained to infuse equity to finance such revenue gap. According to the petitioner, it is also entitled to return on equity infused to finance such revenue gap and since the impugned Regulations do not provide for return on such equity, the

same are violative of the tariff policy which requires a reasonable return on equity employed.

26. The above submissions have been countered by the Commission and it is asserted that the working capital margin has been funded by 15% receivables and further 10% by inventories and the petitioner has not brought any shareholders' funds for financing working capital. This is stoutly disputed by the petitioner and it is asserted that as per the banking norms, 25% of the working capital is required to be funded by shareholders. It is further asserted that the receivables and inventories which form part of the current assets cannot be considered as financing working capital.

27. In our view, the question whether the working capital is to be considered as financed wholly or partly by debt is not an issue which is amenable to judicial review. Even if it is assumed that the petitioner is right in its contention that a part of the working capital is financed by shareholders' funds and the impugned Regulations consider the same to be financed entirely by debt, it is difficult to accept that the same violates Section 61 of the Act. The net effect of treating the entire working capital as financed through debt is that the return on the amount so utilized is restricted to the rate of interest on debt. This *per se* cannot be considered as

unreasonable or arbitrary so as to render the impugned Regulations violative of Article 19(1)(g) of the Constitution of India or Section 61 of the Act. Section 61 merely requires that distribution of electricity be done on commercial principles. And, restricting the return on working capital does not militate against any commercial principle.

28. Paragraph 8.2.2 of NTP, 2006 also permits the Commission to provide for a facility of a regulatory asset in order to limit the impact of tariff in a particular year. Thus, provision of a revenue gap also cannot be considered as violative of NTP, 2006. The petitioner would be justified to make a grievance if as a result of the revenue gap, the return on equity becomes unreasonably low. However, in the present case, there is no material which would indicate that as a result of the regulatory asset - funding of the revenue gap - the return on equity has become unreasonably low. On the contrary, it is the petitioner's case that the revenue gap is assumed to be financed entirely by debt and, thus, return equivalent to the interest rate on such regulatory asset would be available to the petitioner.

29. In our view, no interference would be warranted by this Court on this count. Similarly, considering the revenue gap to be financed entirely by debt and thereby restricting the rate of return to the rate of return on debt

also cannot be *per se* arbitrary or unreasonable or violative of Section 61 of the Act.

Truing up of working capital

30. The petitioner has also made a grievance against the working capital being classified as a controllable parameter. It is submitted that both revenue on account of sales and power purchase cost have been classified as uncontrollable factors but nonetheless working capital, which is dependent on revenue on account of sales and power purchase cost, has been classified as controllable. According to the petitioner, there is an inherent inconsistency in the aforesaid treatment.

31. We are unable to accept the aforesaid contention as even though revenue on account of sales or power purchase cost may be uncontrollable factors, the petitioner would, nonetheless, exercise sufficient control over its working capital. The manner in which working capital is to be funded is entirely at the discretion of the petitioner. Even though the Commission has adopted a normative approach for determining the tariff, the requirement of working capital is also determined by the working capital cycle. Reduction in the period of availing credit and also efficiency in recovery would reduce

the working capital. It has been submitted on behalf of the Commission that working capital for retail supply of electricity consists of receivables for two months of revenue from sales of electricity less: (i) power purchase costs for one month; (ii) transmission charges for one month; and (iii) wheeling charges of two months. It was further submitted that the working capital has been determined by the Commission to be two months receivables less one month power purchase cost and the average receivable cycle has been assumed as two months even though majority of the consumers are billed on monthly basis. It has been further pointed out that the power purchase bills are raised by the generating companies only at the end of the month and this also results in the petitioner being granted one month's credit period for the electricity purchase cost.

32. In view of the explanation provided by the Commission, we find no merit in the contentions advanced by the petitioner. In any event, as stated earlier, the scope of judicial review is highly limited and we are unable to accept that the impugned Regulations insofar as they consider the working capital as a controllable parameter are contrary to the guiding principles specified in Section 61 of the Act.

Truing up of interest rates

33. The petitioner contends that although Regulation 5.6 of the impugned Regulations provides for return on capital employed including for the financing cost in the ARR, however, variation of 1% (both negative and positive) from the SBI base rate is to be absorbed by the licensee. This, according to the petitioner, is contrary to the mandate under Section 61(b) of the Act. In our view, the aforesaid contention is also without merit. Section 61(b) of the Act requires that the Commission be guided by the principle that generation transmission distribution and supply of electricity are conducted on commercial principles. Requiring the distribution companies to absorb increased rate to the extent of 1% from the SBI base rate as on 1st April, 2012 and similarly also permitting the licensee to take benefit of reduction in the interest rate to the same extent, cannot be accepted as offending any commercial principle. There is no material to indicate that commercial principles require even minor fluctuation of interest to be immediately passed on to the consumers. On the contrary, minor cost variations are usually absorbed by business entities without necessarily passing them on to the consumers. Similarly, decrease in financing costs within the specified limit also stand to the benefit of

business entities and it is not necessary for the same to be passed on to the consumers.

34. Next, the petitioner complained that in terms of Regulation 5.24, it is assumed that the petitioner would avail the 2% rebate on power purchase costs allowed to a distribution licensee on immediate payment of purchase bills. It was submitted on behalf of the petitioner that even though the working capital has been determined on the basis that bills for purchase of electricity would be paid within a period of one month, nonetheless, the impugned Regulations assumed availing of rebate of 2% which is only possible if the bills are paid by a letter of credit. It is submitted that to the aforesaid extent, the impugned Regulations are contrary to Section 61(c) and 61(e) of the Act which required the Commission to be guided by the principle of rewarding efficiency in performance while determining the tariff. Mr Sanjay Jain countered the aforesaid submissions by pointing out that the bills for purchase of electricity are raised only at the end of the month and, therefore, the petitioner is expected to pay the same immediately thereafter and there is no inconsistency in the Regulations.

35. It is not necessary for us to examine the merits of this dispute because the principles as referred to in Section 61(c) and 61(e) of the Act are broad principles for guidance of the Commission. It is not necessary for the Commission to ensure that each and every component of ARR be so determined so as to incorporate an incentive for rewarding efficiency. As long as the Regulations as a whole promote efficiency in performance, no grievance in this regard can be made by any distribution licensee.

Debt-Equity Ratio

36. Lastly, the petitioner submitted that impugned Regulations insofar as they restrict the Debt-Equity Ratio as 70:30 violates Section 61(b) of the Act. It was contended on behalf of the petitioner that the Commission has not taken into account progressive repayment of debt during the control period. It is submitted that repayment of debt would result in increase in the ratio of equity component and the petitioner would be entitled to return on the enhanced equity component.

37. Paragraph 5.3(b) of NTP, 2006 provides that for financing of future capital cost of projects, a Debt-Equity Ratio of 70:30 should be adopted. But, it is also expressly provided that the Promoters would be free to have

higher quantum of equity investments and the equity in excess of the norm should be treated as loans advanced. It is, thus, seen that Regulation 5.11 of the impugned NTP, 2006 which provides for the formula for computing the weighted average cost of capital assumes the Debt-Equity Ratio for the assets capitalized to be 70:30. The formula under Regulation 5.11 only provides for a norm for determining the cost of capital. We find no infirmity with the approach of the Commission in fixing a normative formula and there is no mandatory provision which proscribes the Commission from taking such approach.

38. It is a well accepted principle of financial management that enterprises align their financial structure for optimizing the return on equity by properly leveraging the equity base. The extent of leverage is determined by a host of factors including the risk appetite of the management, availability of owned resources, cost of debt, etc. Thus, business entities consciously make effort to maintain a certain Debt-Equity Ratio which is considered by them to be optimal. Thus the assumption that the component of equity would progressively continue to increase may not hold good. Further, as is rightly pointed out by the Commission, the repayment of debt over a passage of time is also coupled with an erosion in

the value of the capital assets and if it is assumed that the capital asset is financed 30% by equity and 70% by debt, any depreciation in the value of the assets would also correspondingly result in erosion of the value of equity to that extent.

39. The Commission is an expert body which is constituted to perform the functions as specified under the Act including determination of the tariff and specifying the terms and conditions for such determination. Such functions which by nature require expert knowledge would ordinarily be outside the scope of judicial review and no interference would be warranted unless it is established that the actions of the Commission are contrary to the provisions of the Act and/or *ultra vires* the Constitution. In **Transmission Corporation of Andhra Pradesh Ltd. & Anr. v. Sai Renewable Power Pvt. Ltd. & Ors.**: (2011) 11 SCC 34, the Supreme Court held as under:-

“..... This Court has consistently taken the view that it would not be proper for the Court to examine the fixation of tariff rates or its revision as these matters are policy matters outside the preview (sic) of judicial intervention. The only explanation for judicial intervention in tariff fixation/revision is where the person aggrieved can show that the tariff fixation was illegal, arbitrary or ultra virus (sic) the Act. It would be termed as illegal if statutorily

prescribed procedure is not followed or it is so perverse and arbitrary that it hurts the judicial conscious of the Court making it necessary for the Court to intervene. Even in these cases the scope of jurisdiction is a very limited one.”

40. In view of the above, we are unable to accept that the impugned Regulations are violative of any provision of the Act or are *ultra vires* the Constitution of India.

41. Before concluding, we may also note the stand of the Commission that it has sufficient powers under the impugned Regulations to relax any of the provisions of the impugned Regulations (Regulation 12.4); amend the impugned Regulations (Regulation 12.8); and power to remove difficulty in giving effect to any of the provisions of the impugned Regulations (Regulation 12.3). It has been contended on behalf of the Commission that in the event if any serious difficulty is encountered by the petitioner on account of tariff fixation, it would be open for the petitioner to approach the Commission to invoke the above powers. Thus, in the event the petitioner finds that despite achieving the requisite efficiency norms, the tariff determined on the basis of the impugned Regulations is not sufficiently remunerative or renders the carrying on of its business unviable, it would

always be open for the petitioner to approach the Commission to exercise its powers in accordance with law.

42. The petition is dismissed with the aforesaid observations. The pending application also stands disposed of.

VIBHU BAKHRU, J

BADAR DURREZ AHMED, J

JULY 29, 2016
MK/RK

