



केन्द्रीय विद्युत विनियामक आयोग
CENTRAL ELECTRICITY REGULATORY COMMISSION



Dr. Pramod Deo
Chairperson

D.O.No. Chmn/CERC/2009
Dated : 18th November, 2009

Subject : Advice of the Commission on issues relating to regulation of electricity forward contracts and electricity derivatives markets

Dear Shri Brahma,

The Constitution of India has a specific place for legislation on "electricity" at item 38 of List III. The Parliament enacted the Electricity Act, 2003 ("the Act") as the need for a new self contained comprehensive legislation arose. This is explained in the Statement of Objects and Reasons of the Act. The Supreme Court of India has considered that the Electricity is a code in itself, in *KSEB vs. M/s. Kalpetta Estates Ltd and Anr* 1976 AIR 1031 SC; *Hyderabad Vanaspati Ltd Vs. APSEB & Ors* 1998 AIR 1715 SC; *HSEB vs. Mam Chand* 2006 AIR SCW 4065 SC. The High Court of Delhi has held that "No doubt Electricity Act is a complete code in itself.." in its judgment in *Sh. B.L. Kantroo Vs. BSES Rajdhani Power Ltd.* 154(2008)DLT56, 2009ELR(DEL)762. The Electricity Act, 2003 is a special Act and is a complete code with respect to all matters concerning electricity, including the development of a market in power.

2. Constitutional, Parliamentary and legislative intent, and Common Law principles require that the regulatory bodies constituted by the Act ensure that "electricity" be given widest scope and be interpreted to extend to all ancillary or subsidiary matters which can fairly and reasonably be comprehended in it. In this regard, the Central Electricity Regulatory Commission ("the CERC") has endeavoured to develop electricity markets in India at interstate level by taking several regulatory initiatives in discharge of its powers and functions specified in the Act. Whether this has been by way of issuing licenses for trading in electricity, conceptualizing and formulating guidelines and framework for establishing "power exchanges", and to see to it that eligible users get to have the legal and statutory right to "open access", are to name a few of the initiatives taken by CERC. Based on the experience gained so far, the Commission has also formulated draft regulations on power markets under section 66 of the Act which is currently undergoing consultation with stakeholders and the public in general. In brief, these draft regulations (copy enclosed at Annex-I) deal with the creation of a comprehensive market structure and enabling the trading of, execution of, and contracting of, all types of possible products in the electricity markets. Although, this is at a nascent stage, at the same time these regulatory measures propose a calibrated approach for introducing electricity forward contracts, futures, and, electricity derivatives at a later date to be notified keeping in view the ground realities of demand - supply gap and power shortages and the pressing need of controlling the prices of electricity to ensure its reasonableness.

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3. In due discharge of its statutory responsibility, the Commission had floated a Staff Paper on "Developing a Common Platform for Electricity Trading" in July, 2006 inviting comments/suggestions from the stakeholders and the interested parties/persons on the viability, structure, management and operational arrangement of power exchange. Thereafter, the Commission passed an Order dated 18.1.2007 (in Petition No. 155 / 2006) which contained the 'Statement of Reasons' for 'Development of a common platform for electricity trading' towards the establishment and management of the Power Exchange. Thereafter, the Central Commission laid down the 'Guidelines for the grant of permission for setting up and operation of Power Exchange' vide its Order dated 6.2.2007 (in Petition No. 155/2006). The launching and execution of a specie of electricity forward contracts viz., "term ahead delivery based contracts" on power exchanges have also been enabled vide the Commission's order dated 31st August 2009. These products are delivery based.

4. While one considers the foregoing Constitutional, Parliamentary and legislative intent, and Common Law principles as also, the several regulatory measures by the Commission on one hand, issues of collision of jurisdiction raised by the Forward Market Commission ("the FMC") constituted under the Forward Contract (Regulation) Act, 1952 ("the FCRA"), require special consideration. Recently, with regard to the "term ahead contracts" enabled by the Commission as mentioned above, FMC had communicated their objection to the Commission vide letter dated 23rd September, 2009 also marked to the power exchanges, that "term ahead delivery based contracts" could not be launched by power exchanges without having to obtain a certificate of registration from the FMC under the provisions of Section 14A of the FCRA on the ground that these contracts envisage delivery after a period of more than 11 days, and therefore, these are a category of forward contracts. Immediately thereafter, the FMC moved for amending their Writ Petition No. 1604 of 2009 in Bombay High Court to challenge the validity of the CERC's order dated 31st August 2009 in addition to its already pending challenge to the jurisdiction of the CERC to at all have any powers, functions or oversight on electricity forward contracts. It is learnt that the FMC has issued show cause notices to the power exchanges to explain as to why they should not be penalised for launching "term ahead delivery based contracts" without obtaining certificate of registration from the FMC.

5. The Ministry of Power ("the MoP") vide its letter dated 30th September, 2009 has requested information in the above matter. Reference is also necessary to MoP's letter dated 31st August, 2009 in which views of CERC have been sought on the letter dated 7th August, 2009 (copy enclosed at Annex-II) written by PXIL, one of the power exchanges, to the MoP. In this letter, PXIL has raised two issues, viz., (1) need to revoke the notification of the Ministry of Consumer Affairs dated 9th January, 2006 under section 15 of the FCRA bringing electricity under the purview of FCRA; and (2) raising a concern that the proposed amendments to FCRA in the offing would undermine the powers, functions and regulatory role of CERC pertaining to the development of power markets including trading in/of diverse contracts such as electricity forwards, futures and electricity derivatives and consequent undermining of the role of MoP in guiding the development of electricity sector as a whole.

6. Before commenting on the issues involved in the matter, it needs to be highlighted that development of power markets in India has to be a calibrated exercise. We require the power markets for incentivizing new investments but at the same time power market needs to be very carefully regulated to control the volatility of the prices. Multiple regulatory oversight and collision (real or perceived) of jurisdiction of regulators under separate legal regimes and enactments, both will lead to confusion in this exercise and consequently would lead to either dampening the investors' confidence or lead to un-controlled speculation which will go against the interest of the consumers.

7. Certain important points relating to the matter are mentioned briefly in the succeeding paragraphs.

7.1 The Electricity Act has been enacted by the Parliament as a self contained comprehensive legislation and a complete code in itself for power sector. Regulatory Commissions as expert bodies have been created under the Act and empowered to govern all matters related to power sector. The superior position of the Electricity Act over other laws has been recognized by the Supreme Court in its judgement reported as Gujarat Urja Vikas Nigam Ltd., Vs. Essar Power Ltd. [(2008) 4 SCC 755]. The Hon'ble Supreme Court held that-

"57. in our opinion the principle laid down in Section 174 of the Electricity Act, 2003 is the principal or primary whereas the principle laid down in Section 175 is the accessory or subordinate to the principal. Hence Section 174 will prevail over Section 175 in matters where there is any conflict (but no further).

58. In our opinion Section 174 and Section 175 of the Electricity Act, 2003 can be read harmoniously by utilizing the samanjasya, badha and gunapradhana principles of Mimansa. This can be done by holding that when there is any express or implied conflict between the provisions of the Electricity Act, 2003 and any other Act then the provisions of the Electricity Act, 2003 will prevail, but when there is no conflict, express or implied, both the Acts are to be read together." {Emphasis added}

7.2 FCRA was enacted by the Parliament in the year 1952 in the context of the need for controlling speculation in essential commodities such as foodgrains, oil seeds, spices, sugar, raw cotton and controlling forward trading in such commodities. A copy of the Statement of Objects and Reasons (SOR) of FCRA is enclosed at Annex-III which specifically provides that the regulatory provisions of this Act will be extended by notification to different classes of goods and to different areas as and when necessary. It has been further stated that the provisions of this Act will apply to non-transferable special delivery contracts only in certain areas to be notified by the Central Government. Amendments to FCRA enacted in 1960 are also relevant in this matter. This amendment added Chapter III-A to FCRA which provided for registration with FMC to be obtained by all associations concerned with the regulation and control of business relating to forward contracts. The SOR of the amended Act have also been extracted in Annex-III which clarifies that the intention of the amending Act was only to improve the enforcement of the 1952 Act and there is not a whisper in the SOR of the amending Act that the intent of the parent Act that the regulatory provisions will be extended by notification to different classes of goods and to different areas was being altered through the amendment.

7.3 Briefly, by a notification under section 15 of the FCRA (as has been done for electricity), the provisions of FCRA are invoked for forward contracts in that commodity. However, section 18 of the FCRA specifically exempts non-transferable specific delivery (NTSD) contracts from the regulatory oversight or control of the Central Government under the FCRA. If at all non-transferable specific delivery contracts are to be regulated or controlled under the FCRA the Central Government has to, in terms of subsection (3) of Section 18 of the FCRA, issue a notification in the official Gazette declaring that non-transferable specific delivery contracts are to be regulated or controlled under the FCRA and further as to which class or classes of non-transferable specific delivery contracts in specific area in respect of specific goods or class of goods are to be specified in the said notification besides the manner in which and the extent to which such regulatory oversight or control is to apply. Importantly, thus, non-transferable specific delivery contracts cannot be regulated or controlled under the FCRA simply by virtue of a notification issued under section 15 of the FCRA. At this point, it is relevant to state that power purchase agreements including the ones which have been entered into for sale of power from ultra-mega power projects are non-transferable specific delivery contracts, as the rights and obligations are not transferable and they are specific in delivery by way of predetermined price, quantity, seller and buyer.

7.4 As the position goes, that non-transferable specific delivery contracts cannot be regulated or controlled under the FCRA simply by virtue of a notification issued under section 15 of the FCRA, the least that can be said is that FMC's objection to "term ahead delivery based contracts" without obtaining certificate of registration from the FMC, as conveyed vide letter dated 23rd September, 2009, is not sustainable. Noticeably, FMC has not produced any notification in terms of subsection (3) of Section 18 of the FCRA declaring that non-transferable specific delivery contracts in electricity are to be regulated or controlled under the FCRA. To expressly exempt NTSD contracts from regulation and control of the Central Government on one hand under Section 18(1) of the FCRA while at the same time retain the power to regulate and control NTSD by the FMC, does not appear to be the legislative intent. This issue needs special consideration.

7.5 However, the larger issue that remains is the statutory mandate of the CERC to develop power markets. The desirability of introducing derivatives in electricity needs to be determined keeping in view the larger public interest. Derivative contracts as the name suggests *derives* their value from the underlying asset. In case of electricity derivative contracts it derives its value from electricity spot markets (Day ahead market in Indian markets). Hence derivative markets and spot markets are very closely coupled as far as price discovery is considered. If introduced at an appropriate time when the spot markets in the concerned commodity have matured and developed sufficient liquidity, the economic purpose served by derivatives market is that it allows participants to hedge and undertake price risk management. These markets are finally for the benefit of the sector players by

acting as a risk transfer platform. Hedging leads to cash flow certainty and thus reduces the cost of debt for any company as the bankers are assured of debt servicing. These underscore the importance of the derivative contracts for the power sector participants. Looking at spot market and derivative market in isolation (as is intended by FMC) and the attempt to bifurcate the jurisdiction, powers, functions, and regulatory oversight between two different regulators under separate legal regimes and enactments will possibly lead to confusion for the public, collision for the regulatory bodies, and would therefore be detrimental to the development of power markets which are at nascent stage i.e. spot market is still facing serious liquidity problem. A major risk perceived is that presently there is a supply demand deficit in power. Creating a financially settled derivative market may lead to abrupt increase in prices of electricity. The timing of introduction of derivatives should be to lead to a systematic development of power markets which is one of the statutory mandates of CERC.

7.6 This dimension is also supported by the information posted by FMC on its website as FAQ (frequently asked questions). An extract of questions 7 to 10 is at Annex-IV. In the answer to Q.No.10, it has been said that for a commodity to be suitable for futures trading it must, inter alia, have large volume and marketable surplus, should be free from substantial control from government regulations (or other bodies) and should be storable. These three conditions are obviously not met by the electricity at the present juncture. Hence, electricity is not suitable for non delivery based future trading especially in present period of shortages. In reply to Q.No.7 in FAQ, it has been published on the website of FMC that though the Forward Contracts (Regulation) Act, 1952, contains enabling provisions to regulate or prohibit such contract in notified goods, the Government have freed N.T.S.D. contracts from regulation or prohibition by issue of notification No. 369(E) dated 1.4.2003.

7.7 Under FCRA, forward contract means a contract for the **delivery of goods** and which is not a ready delivery contract. The aspect of 'delivery of goods' is relevant here. The whole scheme of FCRA is to permit forward contracts which are to be delivered but the data extracted from the websites of NCDEX and MCX and placed at Annex-V show that most of the future contracts being traded by these exchanges are not being delivered. This shows that the future trading currently in commodities is ultimately largely leading to financial settlement and not delivery of actual commodities. In its aforesaid writ petition filed in the Bombay High Court in which CERC is the main respondent, FMC has in one of the affidavits that has been filed conceded this point and has stated therein that the nature of future contracts is such that it seldom results in delivery. An extract of the relevant para of the writ petition filed by FMC is enclosed at Annex-VI. This ground situation is perhaps not in consonance with the provisions of the FCRA which defines forward contracts as a "contract for delivery". Therefore creating a financially settled derivative market in electricity in the present situation of shortages may lead to abrupt increase in prices.

7.8 Prices in power markets have been a matter of concern from various quarters. Recognizing this important dimension for the power markets, CERC resorted to price cap recently for a period of 45 days.

8. In view of the above, the following points emerge:

- a) The power markets in electricity are in a nascent and evolving stage and they need consistent, unified and clear regulatory approach. Regulatory overlap/confusion would result in consequences inconducive to the electricity sector. Market in electricity needs to be governed by the provisions of the Electricity Act, 2003 which is complete and comprehensive as far as the subject of electricity is concerned. Any avoidable intervention under the provisions of any other law would cause confusion. This is also the legislation intent as expressed by overriding provisions of the section 174 of the Electricity Act.
- b) CERC has been taking various initiatives to shape up the power markets which as aforesaid are at a nascent stage and is also framing comprehensive power market regulations in consultation with all concerned. The National Electricity Policy provides in its para 5.7.1 that development of power market would need to be undertaken by the appropriate commission in consultation with all concerned. It is to be noted that the National Electricity Policy was approved by the Cabinet and notified under the statutory provisions whereas notification dated 9th January 2006 under FCRA regarding electricity was done apparently without any public consultation. Not even the sector regulator was consulted whereas the National Electricity Policy mandates consultation with all concerned. The CERC had raised this issue of this notification in its letter dated 26th April, 2006 (Annex-VII) and requested the Ministry of Power to consider the issue of appropriately taking up the need of de-notification of electricity from the said notification. As already mentioned above, FMC's objection to "term ahead delivery based contracts" is not sustainable. FMC is functioning under FCRA and provisions of FCRA are to be applied to the commodities and areas as notified by the Central Government. Ignoring the provisions of FCRA and going by the mere text of section 14A, the act of issuing notices by FMC to power exchanges regulated by the CERC, needs to be urgently given consideration. This is at the least creating avoidable confusion in this sector which in turn has the potential of dampening the investment climate and creating significant doubt in the minds of the stakeholders about products being offered by the power exchanges thereby creating a major hindrances for a unified and systematic development of power market that is being undertaken by CERC.

9. In view of the above, CERC under the provisions of section 79(2) of the Electricity Act, 2003, advises the Central Government (Ministry of Power) that in the interest of smooth development of power markets in India and for facilitating promotion of investment in electricity sector and also for protecting the interest of the consumers :

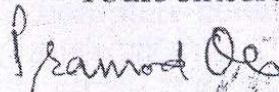
- a) Central Government should de-notify electricity under section 15 of FCRA so that power markets are regulated with a unified and calibrated approach solely by a sector regulator viz. CERC without the risk of having to collide with FMC, in conformity with the provisions of Electricity Act 2003. Electricity derivatives would be launched in the country with the regulatory oversight of the CERC (including the manner in which the same would be exercised).
- b) To take up the need to issue an appropriate amendment to Section 14A or Section 18(1) of FCRA to the effect that Electricity NTSD Contracts are expressly excluded from the requirement to obtain registration of the FMC as in any case, NTSD Contracts under the FCRA are exempted from regulation and control of the Central Government under FCRA. Further, the amendment could exclude electricity all together since it has a peculiar nature of not being storable which is different from the goods generally regulated under the FCRA.

With regards;

Encls : as above

Shri Harishankar Brahma
Secretary (Power)
Ministry of Power
Government of India
Shram Shakti Bhawan
Rafi Marg, New Delhi

Yours sincerely,


(Dr. Pramod Deo)