Appellate Tribunal for Electricity
(Appellate Jurisdiction)

Appeal No. 173/09

Dated, the 15th February, 2011

Present: Hon'ble Mr. Justice M. Karpaga Vinayagam, Chairperson
Hon'ble Mr. Rakesh Nath, Technical Member

In the matter of

Tata Power Company Limited … Appellant(s)
Bombay House, Homi Mody Street,
Fort, Mumbai-400 001

Versus

Mahrashtra Electricity Regulatory Commission
World Trade Centre, Centre No. 1,
13th Floor, Cuffe Parade,
Mumbay-400 006 Respondent(s)

Counsel for the Appellant	**Mr. Amit Kapur** **Ms. PoonamVerma**
Counsel for Respondent	**Mr. Buddy A. Ranganadhan for MERC**

JUDGMENT

PER HON'BLE MR. JUSTICE M. KARPAGA VINAYAGAM, CHAIRPERSON

1. Tata Power Company Limited is the Appellant herein.

2. Aggrieved by the order dated 28.05.2009, passed by the Maharashtra Electricity Regulatory Commission in the petition filed by the Appellant for approval of truing up for FY 2007-08, Annual Performance Review for FY 2008-09 and determination of tariff for FY 2009-10, the Appellant has presented this Appeal. The facts are as follows.

3. The Appellant is a company incorporated under the provisions of the Indian Companies Act, having its registered office in Mumbai. The Appellant is a generation company. The Appellants submitted a petition on 28.11.2008 in case 111 of 2008 for truing up for FY 2007-08, for approval of Annual Performance Review (APR) for FY 2008-09 and for determination of tariff for FY 2009-10 before the State Commission. After observing the required formalities, the State

Commission passed the impugned order on 28.05.2009. Having aggrieved over the disallowance of some of the claims made by the Appellant, the present Appeal has been filed.

4. In this Appeal, the following issues have been raised:

(1) Denial of carrying/interest cost;

(2) Disallowance of increased heat rate for thermal units at Trombay;

(3) Wrongful consideration of the difference between the normative interest on working capital and actual interest on working capital as gains and sharing of 1/3rd amount with the distribution licensee;

` (4) Denial of Tata Brand Equity expenditure;

(5) Wrongful reduction in gains due to inclusion of Fringe Benefit Tax in Employee's Expenditure;

(6) Wrongful treatment of Income Tax; and

(7) Entitlement of interest or carrying cost on deferred recoveries.

5. On these issues, the Learned Counsel for the Appellant has made the following submissions:

(i) **Disallowance of Carrying cost:** The State Commission, while approving the ARR of the Appellant disallowed the Carrying Cost of Rs. 137 crores on the ground that in the earlier Appeal filed by the Appellant in Appeal No. 60/07, it had not prayed for the Carrying Cost and, therefore, the Tribunal in that Appeal did not give any specific finding regarding the Carrying Cost. This is incorrect. The Appellant had specifically prayed the Tribunal for allowing the Carrying Cost by pleading that it is entitled to Carrying Cost and accordingly the Tribunal had allowed the Appeal on all counts. Once the expenditure is allowed, the Appellant is not only entitled to that cost but is entitled to Carrying Cost as its legitimate claim.

(ii) **Disallowance of increased Heat Rate of Thermal Units 5 & 7 at Trombay.**

The disallowance of increased Heat Rate by the State Commission is contrary to the Tariff Regulations. While approving the higher Heat Rate of 2500 Kcal/KWH for Unit-5 as compared to earlier approved value of 2489 Kcal/Kwh, the State Commission has not provided the basis for varying of the approved value. By disallowing the Heat Rate of 2567 Kcal/Kwh, as claimed by the Appellant for the FY 2007-08, the State Commission has penalised the Appellant by approving the Heat Rate norm far lower than that submitted by the Appellant. This has resulted in a loss of Rs. 16 crores in fuel cost to the Appellant. The contention of the State Commission that the Appellant is operating inefficiently is without any basis and deserves to be rejected. The Appellant has always endeavoured to use the cheapest fuel available and has always tried to optimise the fuel cost by changing its fuel indices and thereby increased its coal based generation. Similarly, in respect of Heat Rate of Unit-7, the Appellant prayed before the State Commission that the Heat Rate should be considered at 2001 Kcal/Kwh instead of at 1971 Kcal/Kwh. The State Commission rejected the claim of the Appellant on the ground that it had fixed a normative Heat Rate in a Multi Year Tariff and if the claim of the Appellant is accepted, the object of the Multi Year Tariff mechanism would be lost. However, considering open cycle operation of the Gas Turbine for some duration, the State Commission allowed a heat rate of 1992 Kcal/KwH on the basis of weighted average normative heat rate for open cycle and closed cycle operation. This finding is unsustainable since Regulation 26.2 mandates that in special circumstances, the State Commission may deviate from the norms. The Heat Rate of Unit-7 suffers on account of lower gas availability which was an uncontrollable factor and beyond the control of the Appellant.

(iii) **Wrongful consideration of the difference between the normative interest on Working Capital and actual interest on Working Capital as gains and sharing of 1/3rd amount with the distribution licensee**. On this point, in the earlier Appeal filed by the Appellant in Appeal No. 137/08 as against the State Commission's order dated 02.04.2008, the Tribunal allowed the Appeal in favour of the Appellant. Therefore, the State Commission may be directed to give effect to the judgment in Appeal No. 137/08 which was rendered on 15.07.2009.

(iv) **Denial of Tata Brand Equity Expenditure**. On this point also the Tribunal allowed the Appeal filed by the Appellant in Appeal No. 137/08 by the order dated 15.07.2009, in favour of the Appellant. Therefore, in respect of this claim, the State

Commission may be directed to give effect to this judgment.

(v) **Wrongful reduction in gains due to the inclusion in Employee's Expenditure.** In the impugned order, the State Commission adopted the view that it was appropriate to include the Fringe Benefit Tax under the Employee's Expenses rather than under the Income Tax expenses. Even though the Appellant had included the Fringe Benefit Tax of Rs. 3 crores under the Income Tax which was an additional expenses, it does not have any objection to the State Commission methodology of including the Fringe Benefit Tax under the head Employee's Expenses, but while doing so, the approved normative Operation & Maintenance expenditure also should be enhanced by identical amount so as to give effect of this methodology. The State Commission has failed to consider that Fringe Benefit Tax is statutory expenses and is uncontrollable in nature and, therefore, the same shall be allowed as a pass through.

(vi) **Wrongful Treatment of Income Tax**: The State Commission has wrongly proceeded in reimbursement of tax and computed the Income Tax liability by considering the Return on Equity as actual Profit Before Tax for its generation business without considering the fact that the Regulation 34.2.1 provides that the actual income shall form the basis for computation of income tax. It is the difference between (i) income and (ii) expenditure. The State Commission has deviated from its past practice without any reason and adopted an erroneous method for computation of income tax and has, therefore, denied the rightful entitlement of income tax.

(vii) **Entitlement of interest on carrying cost on deferred recoveries**: This Tribunal has already settled the principle that any deferred recovery of dues/entitlements involves time value of money and hence such recoveries have to be made allowing the carrying cost irrespective whether the dues are to be paid to the consumers or to be recovered from the consumers. This Tribunal in Appeal No. 117/08 dated 28.08.2009 directed the State Commission to allow the Short Term Prime Lending Rate of State Bank of India for deferred payments and incorporate the same while carrying out the truing up exercise. Therefore, this ratio has to be followed. In the present case, as a part of truing up, the State Commission has computed the ARR for each of the year under review. Apart from the prudent check of the various expenses, the State Commission has to consider any additional entitlement/surplus for adjustment for determining the ARR. These additional entitlements/surplus are required to be taken into consideration by taking into account its own orders and the orders of the Tribunal.

6. In reply to the above submissions, the Learned Counsel for the State Commission submitted that this Tribunal may give suitable direction regarding wrongful consideration of the difference between the normative interest of working capital and actual interest of working capital as gains and sharing of $1/3^{rd}$ amount with the distribution licensee (S.No. iii) and denial of Tata Brand Equity Expenditure (S.No. iv) for consideration. The Learned Counsel for the State Commission strongly refuted submissions made by the Learned Counsel for the Appellant in respect of all the issues in justification of the impugned order by pointing out the reasons given by the State Commission in the impugned order.

7. In the light of the rival contentions, let us frame the questions that arise for adjudication by this Tribunal. They are as under:

(i) Whether the State Commission is justified in denying the Appellant the carrying cost/interest cost towards various legitimate expenses for the period of 3 to 4 years as laid down by this Tribunal in the judgment dated 12.05.2008 in Appeal No. 60/07?

(ii) Whether the State Commission is justified in not allowing higher Heat Rate of Unit-5 and Unit-7 on account of higher coal firing and on account of lower gas availability respectively which is uncontrollable and not considering the reasons for the same attributed by the Appellant?

(iii) Whether the State Commission is justified in denying the Appellant the cost of internal cash utilised for funding part of its Working Capital requirement by considering the interest on difference between the normative working capital and actual working capital as gain out of which $1/3^{rd}$ has to be shared with the distribution licensee?

(iv) Whether the State Commission is justified in denying the legitimate and reasonable administration and general expenses to the Appellant towards Tata Brand Equity expenses?

(v) Whether the State Commission is justified in including the Fringe Benefit Tax in the Operation & Maintenance expenses which resulted into reducing the efficiency gains on account of Operation & Maintenance expenses?

(vi) Whether the State Commission is justified in computing the entitlement of income tax to be recovered from the consumers considering the return on equity as the regulatory profit before tax and disallowing tax on incentives on the ground that the expenses incurred for achieving better performance has already been allowed?

(vii) Whether the State Commission is justified in overlooking the time value of money by way of appropriate interest or carrying cost on any deficits/deferred recoveries which are legitimate entitlements of the generation utility.

8. Let us now analyse each of the issues one by one.

9. The first issue is denial of carrying cost. According to the Appellant disallowance of recovery of carrying cost of Rs. 137 crores on the ground that the carrying cost was not prayed in Appeal No. 60/07 and in the judgment dated 12.05.2008 in the said Appeal, the Tribunal has not given any specific finding about the carrying cost is quite incorrect. It is pointed out that the State Commission has misinterpreted the said judgment and did not appreciate the submissions made by the Appellant before the Tribunal. Similarly, it is wrong on the part of the State Commission to state that the Appellant would be entitled to the

carrying cost only on cash component and not on book adjustment.

10. In the petition filed by the Appellant for ARR for FY 2008-09 and for tariff determination for the FY 2009-10, the Appellant mentioned that the cost allowed by the Tribunal by the order dated 12.05.2008 can only be recovered in FY 2009-10 and since cost pertain to FY 2004-05 and 2005-06, the interest for 3 to 4 years would accrue and the Appellant would be entitled to the said interest. It is also noticed from the Appeal filed before the Tribunal in Appeal No. 60/07, it is specifically mentioned that denial of legitimate expenses and assured reasonable return is unjust and the aforesaid unjust denial of legitimate expenses and assured reasonable return and its delayed payment will have a cascading effect and, therefore, the Appellant in such situation is entitled to carrying cost. The Appellant also prayed for allowing the entire legitimate expenditure which includes the carrying cost as well. This Tribunal in the judgment dated 23.05.2007 reported in 2007

ELR (APTEL) 193 has held that once expense is allowed then the Appellant is not only entitled to the expense but is also entitled to the carrying cost as its legitimate claim. The relevant observation of the judgment is as follows:

> "*The appellant is not only entitled to depreciation at this rate but also entitled to a carrying cost as its legitimate claim was denied at the appropriate time*"

11. Although the Appellant may have accrued income, the cost had already been incurred by the Appellant and here has been cash outflow in respect of the same. On accrual income is allowed because corresponding expenses to earn that income had already been incurred. Hence it may not be appropriate to indicate that these accruals are mere book adjustment and do not involve the cash flow. In other words, it would not be appropriate to segregate the disallowance of expense into cash and non-cash expenditure. In this context, the following observation made by this Tribunal in the judgment dated 30.07.2010 in the case of New Delhi Power Limited V/s DERC

[passed in 153/09 2009(reported in 2010 ELR (APTEL) (891) is relevant:

> *"45. The carrying cost is allowed based on the financial principle that whenever the recovery of cost is deferred, the financing of the gap in cash flow arranged by the distribution company from lenders and/or promoters and/or accruals, has to be paid for by way of carrying cost. This principle has been well recognized in the regulatory practices as laid down by this Tribunal as well as the Hon'ble Supreme Court. In 2007 APTEL 193, this Tribunal has held that along with the expenses, carrying cost is also to be given as legitimate expense". Hon'ble Supreme Court in 2007 (3) SCC 33 has also held "the reduction in the rate of depreciation is violative of the legitimate expectation of the distribution company to get lawful and reasonable recovery of expenditure."*
>
> *"58. (iv): The carrying cost is a legitimate expense and therefore recovery of such carrying cost is legitimate expenditure of the distribution company."*

Judgment dated 28.08.2009 in Appeal No. 117/08.

Relevant extracts are quoted hereinbelow:

"46. Regulations 64.6.2 and 76.8.2 of MERC (Terms and conditions of Tariff) Regulations 2005 read as under:

…..

63.6.2 Interest shall be allowed at a rate equal to the Short Term Prime Lending Rate of the State Bank of India as at the date on which the application for determination of tariff is made.

76.8

…..76.8.2 Interest shall be allowed at a rate equal to the Short Term Prime Lending Rate of the State Bank of India as at the date on which the application for determination of tariff is made."

47. As the MERC Regulations deploy the Short Term Prime Lending Rate of State Bank of India for working out interest on Working Capital there is no reason why the same yardstick is not used when it comes to applying interest rate on deferred payments. The licensee shall have *to arrange the amount of deferred payment in the same way as the Working Capital. We, therefore, direct the Commission to allow Short Term Prime Lending Rate of SBI for deferred payments and incorporate the same while carrying out the truing up exercise for the year 2008-09"*

12. In the judgment dated 06.10.2009 in Appeal No. 16/08 (reported in 2009 ELR (APTGEL) 0880), the relevant extracts are quoted hereinbelow:

"116 Before parting with the judgment we have to remind the Commission of the observation in our judgment in Appeal No. 265 of 2006, 266 of 2006 and 267 of 2006 in the case of North Delhi Power Limited Vs. Delhi Electricity Regulatory Commission in which we said the following:

"60. Before parting with the judgment we are constrained to remark that the Commission has not properly understood the concept of truing up. While considering the Tariff Petition of the utility the Commission has to reasonably anticipate the revenue requested by a

particular utility and such assessment should be based on practical considerations. …. The truing up exercise is meant (sic) to fill the gap between the actual expenses at the end of the year and the anticipated expenses at the beginning of the year. When the utility gives its own statement of anticipated expenditure , the Commission has to accept the same except where the Commission has reason to differ with the statement of the utility and records reasons thereof of where the Commission is able to suggest some method of reducing the anticipated expenditure. This process of "restructuring the claim of the utility by not allowing the reasonably anticipated expenditure and offering to do the needful in the truing up exercise is not prudent. …

13. Accordingly, the issue of carrying cost is decided in favour of the Appellant.

14. The next issue is increased Heat Rate. According to the Appellant, the State Commission did not consider the reasons provided by the Appellant and disallowed the increased Heat Rate and this disallowance is contrary to Regulation 26.2 of the MERC Tariff Regulations, 2005. On the contrary, it is submitted by the Learned Counsel for the State Commission regarding higher generation on coal in Unit-5 that it is always accepted that any generator would generate by using the expected fuel but the Appellant has been operating inefficiently in the previous years and the consumer has always paid higher generation cost and the State Commission has adjusted these norms and considered relaxation of norms for heat rate. In respect of heat rate of Unit-7 also it is contended by the Learned Counsel for the Appellant that the heat rate of Unit-7 should be considered at 2001 Kcal/Kwh as regulation 17.6 and 18 provide that the uncontrollable factors shall be passed through as an adjustable tariff.

15. Unit heat rate is one of the efficiency parameter defining the quantum of heat utilised in a generating plant for generating one unit of electricity. The other parameters include Plant Load Factor etc. In the present case Unit-5 is a 500 megawatt unit commissioned in 1984 with a designed heat rate of 2370 Kcal/unit. According to the Appellant due to the environmental issues the unit being located within the metropolitan area, this unit had to shift to Indian coal from more expensive oil as primary fuel. It is also pointed out that Unit-5 was over 24 years old. In 2003 the Appellant obtained a permission from State Pollution Control Board to use coal to replace expensive oil generation. To comply with the prevailing efficiency norms, the Appellant started using low sulphur, Low Ash Indonesian coal which has a moisture content of 24% as against 9-10% moisture in the designed coal. The actual Heat Rate of Unit-5 for FY 2007-08 was 2567 Kcal/per unit.

16. The Appellant filed a petition on 28.11.2008 seeking actual heat rate of 2567 Kcal/per unit for the year 2007-08 as against the heat rate of 2489 Kcal. According to the Appellant the higher heat rate was as a result of (1) coal firing (2) higher moisture content in the coal; and (3) age of the unit. The State Commission did not consider the various reasons given by the Appellant including the report of International Consultant Solemn Associates which shows that the heat rate of Unit-5 is well within reference band for urban units while disallowing the increased heat rate. As a matter of fact, the State Commission has accepted the fact that there is a well established case for approving deviation in the heat rate from the approved norms of 2489 Kcal per unit without any analysis. The achievable heat rate considering the age and the operational systems of Unit-5 is higher than norms approved by the State Commission.

17. According to the Appellant, the State Commission by not allowing the increased heat rate on actuals has acted in

violation of provisions of the Act. Section 61(b) provides that the Appropriate Commission is to be guided by the fact that the generation business is to be conducted on commercial principles which mans that commercial viability of the project must be considered in allowing or disallowing any expense.. Section 61 (c) & (d) provide that the Appropriate Commission, while determining the tariff shall consider factors that would encourage competition, efficiency, economical use of the resources, good performance and optimum investment which would safeguard the consumers interest and recovery of cost of electricity in a reasonable manner. Section 61 (e) provides that the Appropriate Commission shall be guided by the principles rewarding efficiency in performance. By pointing out these provisions, the Learned Counsel for the Appellant submitted that the State Commission has failed to appreciate its efficiency in performance.

18. We have examined the matter. The State Commission's tariff Regulations provide for Multi-Year tariff under Part-C of the Regulations. Regulation 16.1 stipulates that the State Commission may specify a trajectory for variables such as station heat rate. Regulation 16.2 stipulates that where the State Commission has specified the trajectory for certain variables, the norms specified for generation under Part-E of the Regulations shall not apply with regard to such variables.

19. The State Commission in pursuance of the Regulations has determined Multi Year Tariff by its order dated 02.04.2007 for the control period FY 2007-08 to FY 2009-10 which also included trajectory for the heat rate for the generating units of the Appellant. The Commission after considering the submissions made by the Appellant regarding

age, use of high moisture content of coal used in Unit 5, and actual heat rate of the generating units for the period from 1996-97 to 2005-06 approved the following heat rate for the various Thermal generating units of the Appellant.

Table: Heat Rate (Kcal/kWh) for Control Period

Plant	**2006-07**	**2007-08**		**2008-09**		**2009-10**	
	Order	**Petitions**	**Approved**	**Petition**	**Approved**	**Petition**	**Approved**
Unit-4	2560	2573	2565	2586	2570	2599	2575
Unit-5	2450	2530	2489	2543	2494	2530	2499
Unit-6	2400	2400	2400	2406	2400	2400	2400
Unit-7	2000	2000	1971	2000	1971	2000	1971

20. The heat rates approved in the MYT order for the units 5 & 7 were higher than the design values and that specified under Part E of the Regulations for similar generating units.

21. In the True up for the year 2007-08 carried out in the impugned order the State Commission has

further relaxed the heat rate norms in view of the submissions of the Appellant and considering the actual open cycle operation of the Gas Turbine Unit-7. The relevant extracts from the impugned order dated 28.5.2009 are reproduced below:

"*The Commission has noted the reasons mentioned by TPC-G for variation in heat rate of Unit 5. However, the Commission is of the view that since the Commission had approved the Unit-wise heat rate in the MYT Order after considering the details of degradation factors provided by TPC-G, the same shall hold good. Further, if actual heat rate of Unit-5 is allowed then the purpose and objective of Multi Year Tariff mechanism of stipulating the norms at the beginning of the Control Period would be lost.*

The Commission, in its MYT order, has approved a heat rate of 2499 kcal /kWh for FY 2009-10 for

Unit-5, hence, the Commission has considered the heat rate of 2500 kcal/kWh for Unit-5 for FY 2007-08, and has considered the sharing of efficiency losses due to the higher heat rate for Unit-5, with reference to the heat rate of 2500 kcal/kWh considered in this Order".

"As regards the heat rate for Unit-7, the Commission is of the view that since the Commission had approved the Unit-wise heat rate in the MYT Order after considering the details of degradation factors provided by TPC-G, the same shall hold good. Further, if actual heat rate of Unit-7 is allowed then the purpose and objective of Multi Year Tariff mechanism of stipulating the norms at the beginning of the Control Period would be lost. Accordingly, the Commission does not agree with the contentions of TPC-G to allow the heat rate for Unit-7 on

actuals and is of the view as against the actual heat rate for period of operation of Unit -7 in open cycle mode, the normative heat rate as specified in the Tariff Regulations should be allowed. Accordingly, the Commission has considered the normative heat rate for open cycle mode as stipulated in Tariff Regulations for the period of operation of Unit-7 in open cycle mode and has accordingly considered the weighted average heat rate of 1992 kcal/ kWh for Unit-7 for FY 2007-08.

In case the actual heat rate of Unit-5 and Unit-7 is approved, it would amount to passing on the entire loss to the consumers and burden them with higher cost on account of fuel that should not have been used, which would be contrary to the treatment for other Units, where the benefit of reduction in fuel consumption is being shared between TPC-G and the distribution licensees *through efficiency gains. Under the MYT mechanism, it is appropriate to share both gains and losses on account of stipulated controllable factors instead of just sharing the gains for better performance and passing the entire losses due to under performance to consumers. Therefore, for computing the efficiency gains, the Commission has considered the normative heat rate as approved by the Commission for FY 2007 -08 for unit-4 and Unit-6. For computing the efficiency loss, the Commission has considered the heat rate for Unit-5 and Uniti-7 as approved by the Commission for FY 2007-08 in this order.*

The summary of Unit-wise heat rate approved in the APR Order, actual heat rate for FY 2007-08, and heat rate approved after truing up is given in the following table:

Particulars	***FY-2007-08***		
Heat Rate (kCal/kWh)	***APR Order***	***Actuals***	***Allowed after truing up***
Unit-4, Trombay	*2565*	*2497*	2565
Unit-5, Trombay	*2489*	*2567*	*2500*
Unit-6, Trombay	*2400*	*2306*	*2400*
Unit-7, Trombay	*1971*	*2001*	*1992"*

22. Thus the State Commission has given a reasoned order while approving the heat rate. We agree with the State Commission that under the MYT mechanism it is appropriate to share both gains and losses on account of controllable factor instead of just sharing the gains for better performance and passing on the loss due to under performance to consumers. The Appellant had made the submissions regarding age, high moisture content of coal, etc., being made in this Appeal before the State Commission while deciding the MYT order. The State Commission after considering all these factors and actual operation of the units for last 10 years decided the trajectory of heat rate norms for the control period in variance with the

design heat rate and the norms specified in the Regulations for similar units. The variation in heat rate due to supply of fuel can not be considered entirely beyond the control of the Appellant. However, the State Commission in consideration of the submission of the Appellant has allowed some relaxation in heat rate of units 5 with respect to the heat rate decided in the MYT order. For Unit 7, the State Commission has considered the actual operation in open cycle due to shortage of gas while allowing higher heat rate. Accordingly, we do not find any fault with the findings of the State Commission on the issue of heat rate.

23. The next issue is wrongful consideration of the difference between normative interest on working capital and the actual interest of working capital. In respect of this issue, according to the Learned Counsel for the Appellant,

the judgment rendered by this Tribunal in Appeal NO. 137/08, this point has been referred in favour of the Appellant. The relevant observation in the said judgment is as follows.

Analysis and decision

"20. in Appeal No. 111/08, in the matter of Reliance Infrastructure V/s MERC and Ors., this Tribunal has dealt the same issue of full admissibility of the normative interest on Working Capital where the Working Capital has been deployed from the internal accruals. Our decision is set out in the following paras of our judgment dated May 28, 2008 in Appeal No. 111 of 2008

" 7. The Commission observed that in actual fact no amount has been paid towards interest. Therefore, the entire interest on Working Capital granted as pass through in tariff has been treated as efficiency gain. It is true that internal funds also deserve interest in as

much as the internal fund when employed on Working Capital loses the interest it could have earned by investment elsewhere. Further, the licensee can never have any fund which has no cost. The internal accruals are not like some reserve which does not carry any cost. Internal accruals could have been inter corporate deposits, as suggested on behalf of the appellant. In that case the same would also carry the cost of interest. When the Commission observed that the REL, had actually not incurred any expenditure towards interest on Working Capital it should have also considered if the internal accruals had to bear some costs themselves. The Commission could have looked into the source of such internal accruals or funds could be less or more than the normative interest. In arriving at whether there was a gain or loss, the Commission was required to take the total picture into consideration which the Commission has not done. It cannot be said *that simply because internal accruals were used and there was no outflow of funds byway of interest on Working Capital and hence the entire interest on working capital was gain which could be shared as per Regulation No. 19. Accordingly, the claim of the appellant that it has wrongly been made to share the interest on Working Capital as per Regulation 19 has merit.*

15 b): The interest on Working Capital for the year in question, shall not be treated as efficiency gain."

21. In view of our earlier decision on the same issue we allow the appeal in this regard also."

24. In view of the law laid down by his Tribunal in the aforesaid judgment which covers the issue in hand, the State Commission is directed to restore the actual amounts considered as part of the gains on account of saving in interest expenditure in working capital.

25. The next issue is Denial of Tata Brand Equity Expenditure. On this point, it is submitted by the Appellant that the State Commission has wrongly disallowed the Tata Brand equity expenses for the FY 2007-08. As admitted by the Learned Counsel for the State Commission, this point has already been decided by the Tribunal in Appeal No. 137/08 dated 15.07.2009 wherein the Tribunal has allowed the said issue in favour of the Appellant. In reply filed by the Learned Counsel for the State Commission, it is stated that the State Commission has consented to give effect to this judgment. Therefore, the State Commission is directed to expeditiously give effect to the judgment dated 15.07.2009 in Appeal No. 137/08 by allowing the said issue in favour of the Appellant.

26. The next issue is wrongful inclusion of Fringe Benefit tax under Operation & Maintenance expenses. According to the Appellant, the State Commission has wrongly

disallowed the Fringe Benefit tax as a pass through. It is pointed out that this error has resulted in lower efficiency gains on account of O&M expenditure thereby depriving the Appellant its rightful entitlement as per Regulations i.e. 2/3rd share of the efficiency gains. It is the contention of the State Commission that on the basis of its MYT order dated 02.04.2008 it is admitted that the approved O&M expenses did not consider the Fringe Benefit Tax as an expense item either under the Income Tax or under the employee’s expenses.

27. The State Commission cannot deprive the Appellant of a pass through effect for incidence of tax merely because it did not include the same within the approved Operation & Maintenance expenses in the MYT order. It is pointed out by the Learned Counsel for the Appellant that the fact that the applicability of Fringe Benefit Tax was not known to the Appellant at the time of filing of the ARR and hence it was

not possible for the Appellant to estimate the quantum of Fringe Benefit tax payable and include the same as a part of employee's expense. That apart, it is stated that on the date of the MYT order dated 02.04.2007, it would have been difficult to factor the impact of FBT and hence the same was not factored in the approved O&M expenses under the head Employees Expenses. If this had been considered by the State Commission, the State Commission would have increased the approved O&M expenses by the actual quantum of FBT paid by the Appellant.

28. It cannot be disputed that it is a statutory expense and hence it has to be construed as uncontrollable. The State Commission in its MYT order had approved the O&M expenses which did not envisage the FBT. As FBT was levied subsequently, it will not be proper to compare the approved O&M expenses with the actual O&M expenses. The correct approach would be to compare the actual O&M

expenses without FBT with the approved expenditure, compute the gains and loss and then add the FBT paid by the Appellant to allow for the pass through for uncontrollable factors.

29. The State Commission's Tariff Regulations provide that any increase in O&M expenses on account of uncontrollable expenses are entitled to be treated as pass through in the computation of the efficiency gains.

30. In view of the above, the State Commission is directed to consider FBT as a pass through being an element of tax or in the alternative to allow as pass through as uncontrollable factor in O&M expenses and thereafter compare actual O&M expenses excluding FBT with approved O&M expenses for computation of sharing of gains and loss for controllable factors. Accordingly ordered.

31. The next issue is wrongful treatment of Income Tax. According to the Appellant, the State Commission has to implement the mandate of the Regulation 34 of the State Commission's Tariff Regulations 2005. The mandate is that 'the State Commission is required to adjust the regulatory accounts' profit (income minus permissible expense) to the taxable profits. This has to be done in the following manner:

(i) Start from regulatory profit before tax computed as Revenue – permissible expenses.

(ii) Adjust this for normative interest/regulatory depreciation etc. to arrive at book profit before tax.

(iii) This is further adjusted for various tax disallowances/exemptions/deductions under the Income Tax Act, 1961.

(iv) The resultant figure is the taxable income on which tax is to be paid.

(v) Current tax rate is applied on the taxable income to arrive at the tax entitlement.

32. The State Commission has attempted to follow the Profit Before Tax method instead of computing Regulatory Profit Before Tax by the traditional method of revenue, -permissible expenses. By this method the State Commission has taken return on equity as Profit Before Tax.

33. The grievance of the Appellant is that in making the adjustment to arrive at the Income Tax that should be allowed as pass through, the State Commission has committed the following mistakes:

(a) Instead of computing Profit Before Tax as comprising of total revenue minus allowable expenditure, the State Commission has taken the Return on Equity (RoE) as the start point, thereby wrongly reducing the taxable income and hence the tax that has to be allowed. In doing so, it went against the principle of this Tribunal's judgment 2009 ELR (APTEL) 560. Relevant extracts of the said judgment are quoted hereinbelow :

"Income tax liabilities on incentives" :

"11) The appellant claimed an amount of Rs. 22.79 Crores as PLF incentive for the FY 2006-07. The Commission permitted an amount of Rs. 21.83 Crores as PLF incentive and considered the said amount as part of the revenue for FY 2007. However, coming to the income tax liability on the amount of incentive allowed the Commission had the following to say:

"As regards tax on income arising out of sharing of gains due to better performance and PLF incentive, the Commission is of the view that the expenses incurred for achieving better performance (such as A&G, R&M etc.) including higher PLF has already been allowed as pass

through by the Commission and allowing tax on income arising out of better performance will put additional burden to consumers. Hence, the Commission has not considered the tax on income arising out of sharing of gains due to better performance and PLF incentive income.

Based on above principles, the Commission has estimated the income tax of REL-G on stand alone basis by considering the income and expenses as per approved ARR after truing up for FY 2006-07, as Rs. 7.69 Crore."

12) *As can be seen from the portion of the impugned order, quoted above, the Commission has disallowed the tax arising out of the better performance on the ground that the same would be an additional burden on the consumers. The Commission itself has not*

quoted any Regulation under which income tax on the incentive allowed can be denied to a generating company. The Regulation 34.2.1, of the MERC Tariff Regulations, which deals with income tax does not make any exception for the income arising out of incentive. Therefore, as per the Regulation the appellant is entitled to recover the income tax payable on the change in income on account of PLF incentive. Therefore, we find merit in the appellant's prayer for income tax on incentive to be given to it as a pass through.

13) *The other two prayers related to employees expense and R&M of fuel gas de-sulphurization plant have not been pressed.*

15) *We allow the appeal in part with the following directions:*

(c) The income tax payable on the PLF incentive will be treated as pass through."

(b) Departing from its past practice which was based on the method as mentioned above, the State Commission started the computation with Return on Equity (RoE) and adjusted for items of consequentially further depressing the income tax allowable.

(c) Further, the State Commission has ignored the fact that while it has claimed to reimburse the tax payable by the Appellant as computed by its erroneous approach, the Appellant was liable to pay tax on the total amount of Return on Equity and tax, thereby paying a higher quantum as compared to that computed by the State Commission which was only on the amount of Return on Equity. Thus, it has ignored the requirement of grossing up for tax so that the Appellant can earn the rightful entitlement of Return on Equity.

34. Regulation 34.1 and 34.2 of the Regulations 2005 provide for 14% return on equity and Income Tax on the income of the generating business in the Annual Fixed Charges. As interpreted by this Tribunal reported in 2009 ELR (APTEL) 560 income must include income from incentives and efficiency gains. But despite this the State Commission has considered the Profit Before Tax as being the same as Return on Equity.

35. The State Commission considered the Return on Equity as being equal to the regulatory profit before tax. This error has reduced the taxable income by Rs. 240 crores and consequently the tax entitlement of the Appellant

36. The State Commission has also ignored the fact that the allowed Income Tax would also be considered a revenue gains and the Appellant would have to pay Income Tax on the same. The State Commission ought to have grossed up the tax computed by it and pass the same to the Appellant.

37. In view of the above, the State Commission's conclusion, in our view, may not be correct and therefore, the State Commission is directed to compute the income tax entitlement of the Appellant by replacing Return on Equity by Regulatory Profit Before Tax i.e. income less permissible expenses. This point is answered accordingly.

38. The next issue is entitlement of interest on carrying cost for the deferred recoveries. According to the Appellant, this Tribunal upheld the principle that any deferred recovery of dues/entitlement involve time value of money and hence such recoveries have to be made along with the carrying

cost, irrespective whether the dues have to be made along with the carrying cost irrespective of whether the dues are to be paid or to be recovered. This Tribunal in its judgment in Appeal No. 117/08 dated 28.08.2009 had directed the State Commission to allow Short Term Prime Lending Rate of State Bank of India for deferred payment and incorporate the same while carrying out the truing up exercise. This finding on the basis of which direction has been issued would apply to the present fact as well. That apart, in one more judgment the same observation has been made by this Tribunal. The relevant judgment and the observations are as follows.

39. In the judgment dated 28.08.2009 passed in Appeal No. 117 of 2008, the relevant observation is as follows:

> "*Regulations 63.6.2 and 76.8.2 of the MERC (Terms and Conditions of Tariff) Regulations 2995 read as under:*

63.6 Interest on Working Capital

63.6.2 Interest shall be allowed at a rate equaloa to the Short Term Prime Lending Rate of the State Bank of India as at date on which the application for determination of tariff is made.

76.8

76.8.2 Interest shall be allowed at a rate equal to the Short Term Prime Lending Rate of the State Bank of India as at the rate on which the application for determination of tariff is made."

47 As the MERC Regulations deploy the Short Term Prime Lending Rate of State Bank of India for working and interest on Working Capital there is no reason why the same is not used when it comes to applying interest rate on deferred payments. The licensee shall have to arrange the amount of deferred payment in the same way as the Working Capital. We therefore, direct the Commission to allow Short Term Prime Lending Rate *of SBI for deferred payments and incorporate the same while carrying out the truing up exercise for the year 2008-09.”*

40. The next judgment is dated 06.10.2009 passed in Appeal No. 36 of 2008 reported in 2009 ELR (APTEL) 880). Relevant extracts are quoted hereinbelow:

“116 Before parting with the judgment we have to remind the Commission of the observation in our judgment in Appeal No. 265 of 2006, 266 of 2006 and 267 of 2006 in the case of North Delhi Power Limited Vs. Delhi Electricity Regulatory Commission in which we said the following:

“60. Before parting with the judgment we are constrained to remark that the Commission has not properly understood the concept of truing up. While considering the Tariff Petition of the utility the Commission has to reasonably anticipate the revenue requested by a particular utility and such assessment should be based on

practical considerations. …. The truing up exercise is meant (sic) to fill the gap between the actual expenses at the end of the year and the anticipated expenses at the beginning of the year. When the utility gives its own statement of anticipated expenditure , the Commission has to accept the same except where the Commission has reason to differ with the statement of the utility and records reasons thereof of where the Commission is able to suggest some method of reducing the anticipated expenditure. This process of "restructuring the claim of the utility by not allowing the reasonably anticipated expenditure and offering to do the needful in the truing up exercise is not prudence

117. All projection and assessments have to be made as accurately as possible. Truing up is an exercise that is necessarily to be done as no projection can be so accurate as to equal the real situation. Simply because the truing up exercise will be mae on some day in future the Commission cannot take a casual approach in making its *projections. We do appreciate that the Commission intends to keep the burden on the consumer as low as possible. At the same time one has to remember that the burden of the consumer is not ultimately reduced by under estimating the cost today and truing it up in future as such method also burdens the consumer with carrying cost.”*

41. The next judgment is dated 30.07.2010 passed in Appeal No. 153 of 2009 reported as 2010 ELR (APTEL) 0891. The relevant observation is as follows:

“45. The carrying cost is allowed based on the financial principle that whenever the recovery of cost is deferred, the financing of the gap in cash flow arranged by the distribution company from lenders and/or promoters and/or accruals, has to be paid for by way of carrying cost. This principle has been well recognized in the regulatory practices as laid down by this Tribunal as well as the Hon’ble Supreme Court. In 2007 APTEL 193, this Tribunal has held that “along with the expenses, carrying

cost is also to be given as legitimate expense". Hon'ble Supreme Court in 2007 (3) SCC 33 has also held "the reduction in the rate of depreciation is violative of the legitimate expectation of the distribution company to get lawful and reasonable recovery of expenditure."

"58. (iv): The carrying cost is a legitimate expense and therefore recovery of such carrying cost is legitimate expenditure of the distribution company"

42. The above judgments of the Tribunal lay down the dictum regarding entitlement of carrying cost for deferred recoveries. However, in the present appeal the Appellant has raised carrying cost as a general issue without reference to any finding of the State Commission in the impugned order or specific claim of interest on deferred recovery. Therefore, while holding the principle of carrying cost on deferred recovery, we are not in a position to give any specific direction to the State Commission in this regard except to

take decision on the claim of the Appellant on carrying cost keeping in view the above judgments of the Tribunal. However, we would like to add that the Appellant is entitled to carrying cost on his claim of legitimate expenditure if the expenditure is:

(a) accepted but recovery is deferred, e.g. interest on regulatory assets;

(b) claim not approved within a reasonable time; and

(c) disallowed by the State Commission but subsequently allowed by the superior authority.

43. **Summary of Our Findings**

(1) Carrying cost is a legitimate expense. Therefore, recovery of such carrying cost is legitimate expenditure of the distribution companies. The carrying cost is allowed based on the financial principle that whenever the recovery of cost is deferred, the financing of the gap in cash flow

arranged by the Distribution Company from lenders/promoters/accruals is to be paid by way of carrying cost. In this case, the Appellant, in fact, had prayed for allowing the legitimate expenditure including carrying cost. Therefore, the Appellant is entitled to carrying cost.

(2) We are in agreement with findings of the State Commission relating to heat rate for Unit-5 and Unit-7.

(3) In regard to the issue of denial of Tata Brand Equity expenditure, the Tribunal has already decided in favour of the Appellant in Appeal No. 137/08 dated 15.07.2009. Therefore. The State Commission is directed to give effect to this judgment in favour of the Appellant by allowing the said issue.

(4) In respect of the issue with reference to wrongful inclusion of Fringe Benefit Tax to Operation & Maintenance expense, it cannot be disputed that it is a statutory expense and hence it can be construed as uncontrollable. The State Commission's Tariff Regulations provide that any increase in the Operation & Maintenance expenses on account of uncontrollable expenses are entitled to be treated as a pass through. Hence the State Commission is directed to treat FBT being an element of tax or in the alternative allow as a pass through as uncontrollable factor in O&M and thereafter compare actual O&M expenses excluding FBT with approved O&M expenses for computation of sharing of gains and loss for controllable factors and pass suitable orders.

(5) The next issue is treatment of Income Tax. The State Commission instead of computing Profit Before Tax as comprising total revenue minus allowable expenditure has taken it as Return on Equity. In doing so it went against the principle of this Tribunal's judgment 2009 ELR (APTEL) 560. The State Commission did not consider that the allowed income tax would also be considered as revenue gain and the Appellant would have to pay income tax on the same. The State Commission should have included the income due to incentive and efficiency gains with Return on Equity and ought to have grossed up the tax computed by it. Accordingly, this issue is decided in favour of the Appellant and the State Commission is directed to compute income tax entitlement of the Appellant by replacing Return on Equity by

regulating Profit Before Tax based on income less permissible expenses.

(6) The next issue is carrying cost on deferred recoveries. This Tribunal in earlier judgments has laid down the dictum regarding entitlement of carrying cost on deferred recovery. In the absence of specific claim for interest on deferred recovery by the Appellant, we have given general directions in para 42 above, which may be followed by the State Commission in deciding the claim of carrying cost on deferred recovery of the Appellant.

44. On the basis of above conclusions, we set aside the impugned order in respect of all items except heat rate and allow the Appeal partly. We remand the matter back to the State Commission for passing suitable orders in line with the

findings and observations of this Tribunal referred to in the above paragraphs.

45. With these observations, the Appeal is disposed of. No order as to cost.

(Rakesh Nath)	**(Justice M. Karpaga Vinayagam)**
Technical Member	**Chairperson**

Dated, the 15th February, 2011

REPORTABLE/NON-REPORTABLE