<u>Note on Entity Structuring of Puducherry Electricity Department</u>

Background

The Electricity Act, 2003 (referred to as The Act from here on) came into force (except for section 121) on June 10, 2003. The Act professes that the SEBs should not be continued in their present form. It makes it mandatory for all SEBs to unbundle into separate generation, transmission and distribution entities, to make them more efficient than vertically integrated utilities.

Government of Puducherry (GoP), to comply with the Act, has initiated reform and restructuring of power sector and conversion of functions of transmission and distribution into corporate bodies. This reform initiative is pursuant to the objective of creating conditions for sustainable development of power industry in the state by promoting competition, efficiency and transparency; thus improving the quality of the electricity services in the state.

Guiding principal for sector structuring

The enactment of the Electricity Act, 2003 (EA, 2003) was a milestone in the development of the power sector, and aims at, inter-alia, supply of electricity to all citizens at reasonable tariff, provision of transparent subsidies, establishment of Electricity Regulatory Commissions and Appellate Tribunal, and promotion of policies conducive to the growth of the electricity sector. The EA, 2003 has, in particular, made 'restructuring' of SEBs/Electricity Departments, on functional basis, mandatory.

There are certain guidelines (clauses) in the Act which form the set of principals need to be kept in mind while deciding on the new sector structure. These guidelines may include:

- Part XIII – "Reorganization of Board" – Electricity Act, 2003 draws a timeframe for State Govt to unbundle and corporatize the unbundled entities with in one year of appointment of the Act
- Indian Electricity Rules, 1956 defines the boundaries for distribution and transmission network. Distribution system should be 33 kV and below however transmission network can be anything above 650 V
- Clause 39 – "State Transmission Utility shall not engage in the business of trading in electricity"
- Clause 12 – "No person shall transmit, distribute or undertake trading in electricity unless he is authorized to do so by a License issued by respective state regulatory commission"

In addition to the abovementioned policy level guiding principal, there are certain important steps which need to be taken to go ahead with the new sector structuring plan:

- Classification and valuation of assets and liabilities which will be transferred to new entities
- Terminal benefit liability need to be quantified and funded through actuarial valuation
- Provide a healthy balance sheet to the successor entities to manage future activities

Since, by now, sufficient experience is available to gauge the performance of the restructured Utilities, we felt it opportune to have the issue revisited and studied in depth, based on the hindsight and foresight warranted by the emerging challenges. Therefore, we withdrew experience from restructuring of SEBs of other States to make it seamless transition from existing monolith structure to efficiency improvement oriented functionally focused companies.

Restructuring of Electricity Department will have finalization of Transfer Scheme as a first step which includes three major measures:

1) Creation of companies
2) Valuation of assets and liabilities
3) Transfer of employees

Pre-requisites of a successful transition program

- Strong backing and support of leadership
- Appropriate communication strategy for buy-in of all stakeholders
    - The need to communicate advantage and essentiality of the power sector reforms and its rationale
    - Likely benefits such as quality of supply, consumer care and grievance redressal
    - Positive impact on public finance due to reduction of subsidy burden on government; availability of additional resources for social development programs
    - Impact on industrial and economic development of state
    - Measures proposed to safeguard the service interests of employees, including past and future terminal benefits

Existing Power Sector Structure of Puducherry

In current setup Government of Puducherry is responsible for:

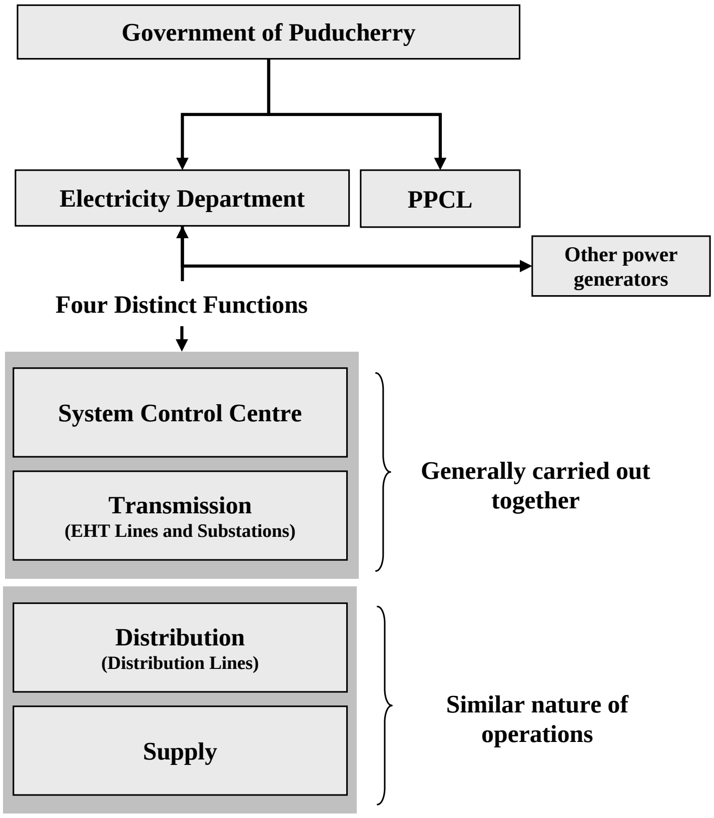
- Budgetary allocation of funds to Electricity Department under Planned and Non-planned expenditure
- Decision on tariff rates
- Responsibility of other regulatory matters like quality of supply etc.

An SE rank official heads the PPCL, the generating company of Government of Puducherry with installed capacity of 33 MW. Its primary functions include:

- Procurement of fuel for power generation
- Establish, operate and maintain generating station
- Sale of power to Electricity Department

Currently, SE-I heads the Electricity Department. The Electricity Department is responsible for:

- Optimum scheduling and dispatch of electricity
- Real time monitoring for grid operation and control
- Operation and maintenance of EHV substation and EHV lines
- Purchase power from various generation sources like PPCL, NTPC, NLC etc.
- Operation and maintenance of distribution network
- Metering, billing and collection
- Customer related services (new connection, disconnection, fault restoration etc.)



A. Creation of Companies

Given the guiding principle for sector restructuring mentioned above, we identified two most suitable sector structures for ED of Union Territory of Puducherry. These structures have their own advantages and disadvantages.

Option -1 "One transmission and one Distribution Company"

In the first option, we recommend to create one transmission and one Distribution Company from existing Electricity Department. The structure would not only comply with the Act but also easiest to implement among all. The generation company (PPCL) is kept untouched under this option. Following are the key advantages and disadvantages of the structure:

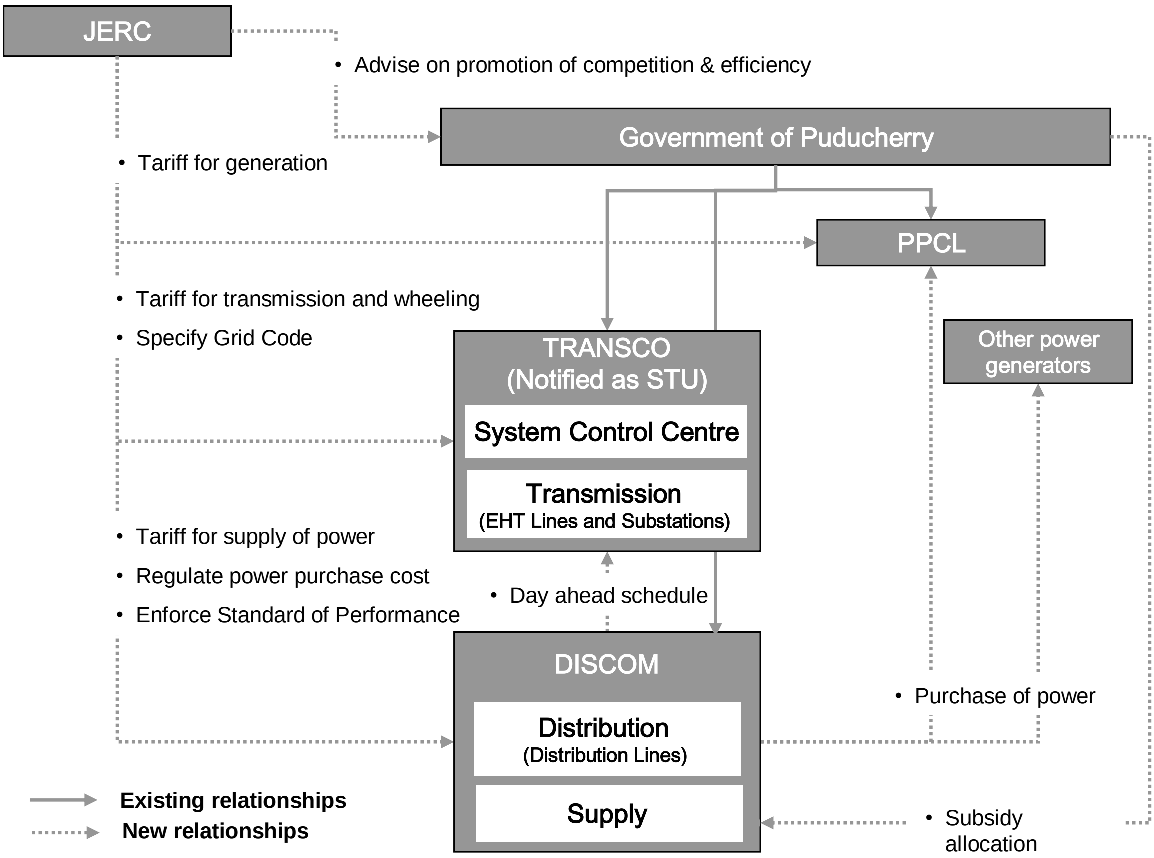
Advantage:

- The structure complies the EA 2003
- Being two distinct activities, Transco focus on maintaining high availability of transmission network whereas Discom can focus on consumer related issues
- Focused approach shall also bring operational efficiency in the system

Disadvantage:

- Companies may not have balance sheet strength individually
- Discom may have better supply portfolio to derive competitive benefits

The schematic below shows the functioning of recommended structure. It provides an idea about responsibilities of various new and existing entities towards each other. It's a high level structure and will be detailed out after finalization of the same.



Option -2 "Merger of Generation and Distribution business"

In second option, in addition to the first, it is recommended that the generation company of Puducherry should be merged with the distribution business. This option brings certain complexities in terms of merging an existing entity with newly formed company however it also aims to bring in synergies in the system like a strong balance sheet of the proposed Genco-Discom. The key advantages and disadvantages of the second recommended structure are:

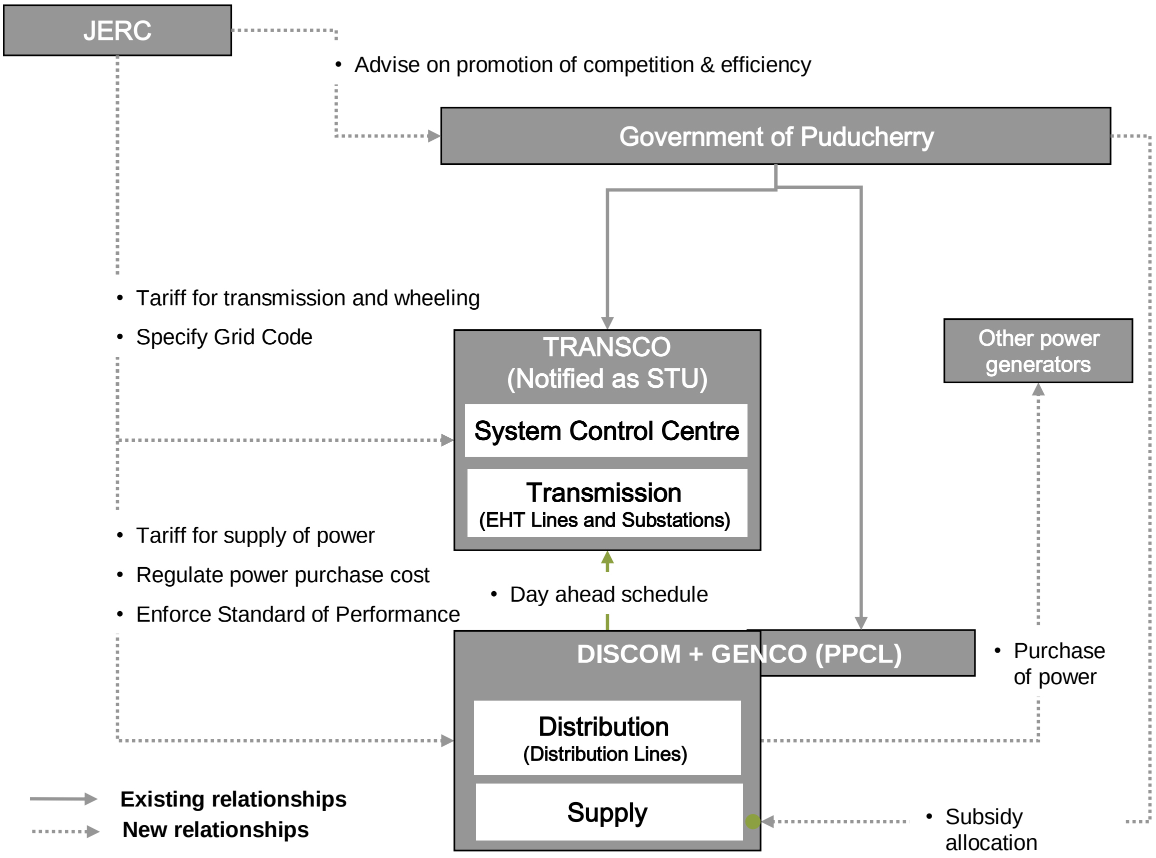
Advantage:

- The structure is complied with EA 2003
- Discom can take support of PPCL's balance sheet to finance some of its critical projects
- Large size balance sheet will help companies to approach market for expansion

Disadvantage:

- Since PPCL is already a separate entity, merger may create complications in organizational design
- Management may have challenge to administer two very different activities i.e. generation of power and supply of power to end consumer

The figure depicts the functioning of various entities in the recommended setup.



B. Conclusion

On the basis of discussions between the Consultants, PED stakeholders and the Steering Committee, it was decided that the optimal configuration for the post restructuring scenario would be Option A I.e. one Transmission Company (PETCO) and one Distribution Company (PESCO). While this would enable efficiency and optimal decision making, it would also avoid issues related to post merger integration of already discrete Distribution and Generation businesses. This was approved by the Steering Committee and all further planning (Financial, Technical and Organizational) has been done on this basis