Appellate Tribunal for Electricity
(Appellate Jurisdiction)

Appeal No. 174 of 2009

Dated: 14TH 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
Bombay House, Homi Mody Street,
Fort, Mumbai-400 001 ... Appellant(s)

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 impugned order dated 28.05.2009, passed by the Maharashtra Electricity Regulatory Commission the Appellant has presented this Appeal. The facts are as follows.

3. The Appellant is a transmission company. Maharashtra Electricity Regulatory Commission (State Commission) is the Respondent herein.

4. The Appellant involved in the transmission business filed a Petition before the State Commission on 26.11.2008 for approval of the truing-up for FY 2007-08, for the approval of Annual Performance Review for the FY 2008-09 and for determination of tariff for the FY 2009-10.

The State Commission after issuance of notice and after holding Technical Validation Session passed the impugned order on 28.05.2009. Challenging some of the findings on certain issues, the Appellant has filed the present Appeal in Appeal No. 174/2009.

5. The Learned Counsel for the Appellant has raised the following issues with reference to disallowance of the various claims:

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

(2) Disallowance of administration and general expenses towards Tata Brand Equity Expenditure

(3) Wrongful treatment of income tax.

6. On these issues, the following arguments have been advanced on behalf of the Appellant.

(i) **The first issue is wrongful consideration of the difference between normative interest on working capital and actual interest on working capital as gains and sharing of 1/3rd amount with the distribution licensee**. On the issue of denial of rightful retention of the difference between normative interest on working capital and actual interest on working capital, the State Commission had used the difference between the normative interest on working capital and actual interest on working capital for computing the gains and loss and passed 1/3rd of such difference to the consumers. This has resulted in the denial of the cost of internal cash used for funding such additional working capital to the Appellant. Therefore, this Tribunal may direct the State Commission, reject this

methodology and restore the said amount passed on to the consumers to the Appellant. On this point, this Tribunal held in favour of the Appellant in its judgment dated 28.05.2009 in Appeal No. 111/2008 and in the judgment dated 15.07.2009 in Appeal No. 138/08.

(ii) **Disallowance of Administration and General expenditure towards Tata Brand Equity Payments:**

On this point, the Tribunal has already passed order in favour of the Appellant in respect of this issue in its judgment dated 15.07.2009 in Appeal No. 137/08. As such the issue has already been covered. Therefore, the State Commission may be directed to consider the issue in accordance with the Tribunal's judgment in this regard.

(iii) **The third issue is wrongful treatment of income tax**. The Appellant computed the income tax as Rs. 37.09 crores as against Rs. 33.33 crores approved by the State Commission in its earlier tariff order in respect of FY 2007-08. The income tax liability was computed by the Appellant by considering the actual profit before tax in its transmission business and then adjusting the same. In fact, Regulation 50.2 has provided that the actual income shall form the basis for computation of the income tax. This point also has been considered by this Tribunal in favour of the Appellant in its judgment dated 28.05.2009 in Appeal No. 111/08. The State Commission has computed the entitlement of income tax that may be recovered from its consumers as Rs. 23.30 crores only. The huge difference in the income tax entitlement as computed by the Appellant and the State

Commission is on account of the different approach adopted by the State Commission in its computation. Therefore, suitable directions may be issued to the State Commission to make the correct calculation in accordance with Regulation 50.2 and the order passed by the Tribunal in its judgment dated 28.05.2009 in Appeal No.111/08

7. We have heard both the Learned Counsel for the Appellant as well as the Learned Counsel for the State Commission. In the light of the above submissions the following questions may arise for consideration:

(i) Whether the State Commission is justified in denying the Appellant the cost of internal cash utilized for funding a part of its working capital required by considering the difference between normative interest on working capital and actual interest on working capital, out of which 1/3rd

amount has been passed on to the consumers?

(ii) Whether the State Commission is justified in denying legitimate Administration and General expenses towards the Tata Brand Equity Expenditure?

(iii) Whether the treatment of income tax decided by the State Commission is wrongful?

8. After hearing the Learned Counsel for the parties and also on perusal of its earlier judgments cited by the Appellant, there is no difficulty in deciding about the first 2 issues. With regard to the difference between normative interest on working capital and actual interest on working capital and also denial of Tata Brand Equity Expenditure, we conclude that on these two issues, the Tribunal has already passed orders in Appeal No. 138/08 dated 15.07.2009 and Appeal No. 111/08 dated 28.05.2009 in

favour of the Appellant. Further the State Commission itself has filed a counter affidavit admitting that the said issues have already been decided by this Tribunal in the judgments referred to above in favour of the Appellant and, therefore, suitable directions may be issued to the State Commission for reconsideration. Under those circumstances the findings rendered by the State Commission on these 2 issues are set aside. Consequently the State Commission is directed to consider these issues and pass an order in line with the findings rendered by this Tribunal earlier. Thus, the first and second issues are answered accordingly.

9. The third issue is in relation to the wrongful treatment of the income tax. According to the Appellant, the State Commission is required to adjust the regulatory accounts income to the taxation accounts, in particular the variations for allowances, disallowances, deductions and exemptions under the Income Tax Act, 1961 as

interpreted by this Tribunal in the judgment reported in 2009 ELR(APTEL) 560. It is also further contended by the Appellant that the State Commission has committed a mistake by taking Return on Equity as a starting point instead of computing the profit before tax as comprising of total revenue minus allowable expenses resulting in the wrongful reduction of the taxable income by Rs. 38 crore and consequent tax entitlement by Rs. 13 crore. On the other hand, the State Commission in its reply while reviewing the said argument has contended that the income is equivalent to the Return on Equity since income tax is allowed on the regulatory profit which is nothing else but the Return on Equity as all the other expenses are only being reimbursed through the ARR and there is no requirement to gross up income tax component with income tax rate.

10. In the light of the above submissions, we will now discuss this issue.

11. The issue of income tax relates to the fact that the State Commission deals with regulatory accounts of each licensed business. The State Commission is required to adjust the regulatory accounts' income to the taxation accounts. This could be done in 2 alternative methods. One by Profit Before Tax method and second by the method of Return on Equity. Profit Before Tax method is followed while truing up as details of all the elements are available by then. The second method is followed while submitting the details for APR or for tariff determination, as all adjustment details are not available at the point of submission. Therefore, for truing up, the Appellant has estimated the income tax liability by using the first method. While the State Commission has attempted to follow the first method, it has wrongly taken Return on Equity as profit before tax instead of computing the regulatory profit before tax by the method of revenue – permissible expenses. The difference in starting point

itself is Rs. 35 crores. If the State Commission wanted to start with Return on Equity, then it must have added the incentives and efficiency gains and grossed it up for tax to arrive at base income. Instead the State Commission has done neither but has ended up with hybrid of the two. The Appellant has explained the concept of grossing up in the following manner:

> To get a Net amount equal to ROE + Incentive + Efficiency gains retained, what is the tax that is to be allowed in the ARR. An hypothetical example will help.
>
> To get a net amount of Rs. 100, a Base income of Rs. 150 is to be taken (@ 33.33% tax rate)
>
> However if only 33% of Rs. 100 is given, then income tax authorities are going to charge tax on Rs. 133 (which is Rs. 44) and hence utility would be left with only Rs. 89 instead of the Rs. 100 it is entitled to.

The formula to arrive at Rs. 150 is = (Net amount/(1-tax rate). In the current example

	Correct		Wrong
Base amount	150	133	133
Tax payable @ 33%	50		44
Net Amopunt (ROE+incentive+Eff Gains)	100	100	89

12. Since the starting point is wrong, the tax entitlement which was worked out has dropped by Rs. 13 crores.

13. As per Regulation 50.1 Return on Equity is to be calculated @ 14% on the approved equity capital. Income tax on the income of the transmission business of the transmission licensee shall be allowed for inclusion in the annual fixed charges, i.e. given pass through effect as per Regulation 50.2.1. The Regulation 50.1 and 50.2.1 are extracted herein below.

> " 50.1 *Return on Equity*
>
> *50.1.1 The Transmission Licensee shall be allowed a return at the rate of 14% per annum in Indian Rupee terms, on the amount of approved equity capital".*
>
> *" 50.2. Income Tax:*
>
> *50.2.1 Income-Tax on the income of the Transmission Business of the Transmission Licensee shall be allowed for inclusion in the aggregate revenue requirement."*

14. The regulations provide that transmission licensee like the Appellant shall include the estimate of income tax liability of its transmission business along with the application for determination of tariff based on the provisions of Income Tax Act, 1961. Regulation 50.2.3 provide that benefits of any income tax holding credit for unabsorbed losses or unabsorbed depreciation, etc. shall be taken into account in calculation of the income tax

liability. Thus the intent of the Regulations is that the actual income tax paid by the transmission licensee in the business of transmission is included in the ARR and the licensee does not gain or lose on account of income tax which is a pass through in tariff.

15. The grievance of the Appellant is that in making this adjustment to arrive at the income tax they have not been allowed as a pass through. According to the Appellant, State Commission has committed a demonstrable mistake in denying this point. In the present case, instead of computing the Profit before Tax as comprising of total revenue minus allowable expenditure, the State Commission has taken the Return on Equity as the start point, thereby wrongly reducing the taxable income by Rs. 38 crores and consequently the tax entitlement worked out has dropped by Rs. 13 crores. On this point, this Tribunal in its judgment reported in 2009 ELR (APTEL) 560 has held as follows:

"*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 crores."

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 granted.

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"

16. Without following this principle laid down by this Tribunal and departing from its past practice which was based on the first method, namely profit before tax, the State Commission started the computation with Return on Equity and adjusted for items of first method, thereby

further depressing the income tax allowable. As provided in the Regulations 50.1 and 50.2, 14% Return on Equity is provided after giving the pass through of income tax effect on the income of the transmission business in the annual fixed charges.

17. The State Commission considered the Return on Equity as Profit Before Tax for the purpose of income tax. Such computation is based on working out tax which disregards annual income arising from incentives and efficiency gains. The Regulations of the State Commission envisage reimbursement of actual income tax. Therefore, it is to be concluded that the deviation made by the State Commission is without any reason, thereby denying the rightful entitlement of income tax.

18. While the State Commission has computed the tax by considering the Return on Equity equal to profit before tax, it has ignored the fact that such allowed income tax

would also be considered as revenue gains and the Appellant would have to pay tax on the same. In order to rectify the same, the State Commission ought to have grossed up the tax computed by it and pass the same to the Appellant. Thus the claim of the State Commission that it has reimbursed the actual tax and hence there is no case for allowing post tax Return on Equity is not correct. Therefore, it would be appropriate to direct the State Commission to compute income tax entitlement of the Appellant by replacing Return on Equity by regulatory profit before tax on the basis of income less permissible expenses. Accordingly ordered.

19. **SUMMARY OF OUR FINDINGS:**

(i) The State Commission had used the difference between the Normative Interest on working capital and actual interest on working capital for computing the gains and loss and passed on 1/3rd amount of such

difference to the consumers. This has resulted in the denial of the cost of internal cash used for funding such additional working capital to the Appellant. Hence the State Commission is directed to rectify this and restore the said amount, passed on to the consumers, to the Appellant.

(ii) In regard to disallowance of Administration & General Expenditure towards Tata Brand Equity Payments, this Tribunal has already passed orders in favour of the Appellant in respect of this issue. As such the issue has already been covered. Thus, State Commission is not justified in denying the legitimate Administration & General expenses towards Tata Brand Equity Expenditure. Accordingly, the State Commission is directed to consider the issue in accordance with this Tribunal's judgment in this regard.

(iii) In the claim towards payment of Income Tax, the Appellant computed the income tax as Rs. 37.09 crores as against Rs. 33.33 crores approved by the State Commission in its earlier order in respect of FY 2007-08. The income tax liability was computed by the Appellant by considering the actual Profit Before Tax in its transmission business and then adjusting the same. Regulation 50.2 has provided that the actual income shall form the basis for computation of income tax. The State Commission has computed the entitlement of income tax claim recovery from its consumers as Rs. 23.30 crores only. In the present case, instead of computing the Profit Before Tax method as comprising of total revenue minus allowable expenditure, the State Commission

has taken the Return on Equity as the start point, thereby wrongfully reducing the taxable income by Rs. 38 crores and consequently the tax entitlement worked out has dropped by Rs. 13 crores. As provided in the Regulations 50.1 and 50.2, 14% Return on Equity is provided after giving the pass through of income tax effect on the income of the transmission business in the Annual Fixed Charges. The State Commission ought to have included incentives and efficiency gains with ROE and grossed up the tax computed by it and passed on the same to the Appellant. Therefore, the State Commission is directed to pass the income tax entitlement of Appellant by replacing Return on Equity by regulatory Profit Before Tax based on income less permissible expenses.

20. In view of our above findings, we conclude that the findings on these issues challenged in this Appeal are liable to be set aside. Accordingly the same are set aside. Consequently, the State Commission is directed to pass the consequential orders in terms of the findings given by this Tribunal in this judgment and also in the earlier judgments referred to above.

21. The Appeal is allowed. No order as to cost.

(Rakesh Nath)
Technical Member

(Justice M. Karpaga Vinayagam)
Chairperson

Dated: 14.02.2011

REPORTABLE/NON-REPORTABALE