



THE PATH TO COST-REFLECTIVE TARIFFS IN THE NIGERIAN ELECTRICITY SUPPLY INDUSTRY – **KEY HIGHLIGHTS OF THE MYTO 2020.**

One critical function of the Nigerian Electricity Regulatory Commission (“NERC”) is to regulate electricity tariffs in the Nigerian Electricity Supply Industry (“NESI”), and to further ensure that the prices charged by licensees are fair to customers. Historically, the NERC has carried out this function by issuing a series of tariff orders known as the Multi-Year Tariff Order (“MYTO”) commencing from 2008 when it attempted to set the right tariff for the NESI.

Since then, we have had some reviews of the MYTO (one major review in 2012 and two minor reviews in 2015 and 2019). Those reviews notwithstanding, there have been calls by industry stakeholders for the NERC to undertake another major review of the MYTO to account for the growing impact of inflation, adjusted foreign exchange rates, gas price, and other key economic variables and indices. The ultimate objective being to provide the NESI with a stable and cost-reflective pricing structure that allows a modest return on investment to efficient industry operators.

To this end, the NERC recently issued the Multi-Year Tariff order 2020 (“**MYTO 2020**” or the “**Order**”). The MYTO 2020 took effect on 1 September 2020 and is expected to be in force until the issuance of a new minor review order, or an extraordinary tariff review order by the NERC.

OBJECTIVES OF THE MYTO 2020

According to the NERC, the MYTO 2020 was issued pursuant to an extraordinary tariff review application filed by the electricity distribution companies (“**Discos**”) seeking approval to review their end-user tariffs taking into account the

impact of diverse economic factors including their respective investment plans towards improving services to their customers. The MYTO 2020 seeks to ensure that the tariffs charged by the Discos are ultimately cost reflective and as such creates a path towards a fully service-based cost reflective tariff by July 2021.

The Order further re-delineates the previous classes of electricity customers and now classifies them into clusters based on their expected service levels from the Discos. It then makes provisions to ensure that the tariffs charged by the Discos for each customer band is reflective of the quality of service, availability of power committed to such customers and average response time to customer complaints. The Order similarly provides for an improvement of reliability and quality of supply by incentivising a Disco to off-take energy in accordance with its existing Vesting Contract and MYTO load allocation. The Order also confirms and retains the existing framework for enforcing discipline in respect of market remittances and managing future revenue shortfalls in the industry.

APPLICABLE INDICES USED FOR THE MYTO 2020

Consistent with previous reviews of the MYTO, the MYTO 2020 is based on the projected parameters of the Nigerian rate of inflation, exchange rate, US rate of inflation and gas price. The MYTO 2020 has the following assumptions:

1. **Nigerian Rate of Inflation:** The MYTO 2020 uses the inflation rate of 12.82% published by the Nigerian Bureau of Statistics as at July 2020. This is significantly higher than the rate of 8.3% which was utilised in reviewing the MYTO 2015.
2. **Exchange Rate:** The applicable Naira/USD exchange rate for the MYTO 2020 is the Central Bank of Nigeria (CBN) official rate of N380/USD1. However, it includes a 1% premium above the CBN exchange rate to arrive at N383.80/USD1.
3. **US Rate of Inflation:** According to the NERC, the data on the US rate of inflation was obtained from the website of the US Bureau of Labour Statistics for the month of July 2020 which was 1.0%. This has been adopted for the MYTO 2020.

4. **Gas Price:** The price of natural gas for the power sector has been regulated since the inception of MYTO in 2008. In this review, the NERC maintained the gas price of US\$2.50/MMBTU and gas transportation cost of US\$0.80/MMBTU which was the case in the MYTO 2015. The Order takes cognisance of the fact that other generation companies had contracted different gas prices outside the regulated price but does not take such differential into account.

It is not clear why the NERC recognises that some generation companies may have contracted outside the regulated price without taking this into account in the tariff review. Given that the end-user prices are regulated by the NERC, the ability of Nigerian Bulk Electricity Trading PLC (“NBET”) to pass through these higher gas prices to the Discos under their Vesting Contracts is limited and will likely compound NBET’s funding shortfall and capacity.

KEY HIGHLIGHTS OF THE MYTO 2020

1. Change in Tariff Design and Customer Classes

In line with the primary objective of the MYTO 2020 which is to ensure that the tariff is service reflective, the tariff is designed by classifying customers into five tariff ‘Service Bands’ reflecting the quality of service experienced by customers as measured by the committed minimum average hours of supply per day over a period of one month. These bands are as follows:

- a) **Band A** comprising customers receiving a minimum of **twenty (20) hours** of electricity supply per day;
- b) **Band B** comprising customers receiving a minimum of **sixteen (16) hours** of electricity supply per day;
- c) **Band C** comprising customers receiving a minimum of **twelve (12) hours** of electricity supply per day;
- d) **Band D** comprising customers receiving a minimum of **eight (8) hours** supply of electricity per day; and

- e) **Band E** comprising customers receiving a minimum of **four (4) hours** of electricity supply per day.

These bands are further divided into (i) non-maximum demand customers; (ii) low voltage maximum demand customers; (iii) medium/high voltage maximum demand customers; and (iv) lifeline tariff class.

2. **Protection of Designated Classes of Customers**

Given that the objective of the Order is the incentivisation of a continuous improvement of service, certain classes of customers are protected from the application of the new tariff. These are:

- a) **Customers experiencing less than 12 hours supply per day over a period of one month** - there shall be no tariff reviews for customers experiencing an average power supply availability of less than 12 hours per day over a period of one month.
- b) **Unmetered Customers** - unmetered customers enjoying more than 12 hours of electricity supply per day over a period of one month shall not be affected by the tariff reviews under the Order. Instead, they will be protected by the provisions of the Order on the Capping of Estimated Bills in the NESI and the Federal Government of Nigeria's intervention on accelerated metering of all customers. This essentially entails that the tariff for such customers will be as capped under the Estimated Billing and Capping Order of the NERC. The rationale appears to be the need to incentivise rapid meter roll-out for such customers.
- c) **Customers on lifeline tariff** – the Discos are required to continue to maintain the lifeline tariff of NGN4.00/kWhr for all customers consuming less than 50kWhr of energy per month as a safeguard for the less privileged members of the society.

3. **Tariff Freeze for Certain Classes of Customers**

The Order provides that there shall be a tariff freeze for customers in service bands D and E who shall continue to be charged the tariffs that applied prior to the commencement of the Order. This means that customers within those bands shall continue to enjoy their pre-existing tariff until the Discos make investments to improve their quality of service to those customers thus migrating them to higher bands, or until a subsequent order of the NERC states otherwise. While this might be a populist initiative, it raises some concerns. For instance, given that the tariff does not provide for CAPEX adjustment, the Discos are likely to resist this freeze on the basis that the non-adjustment of their CAPEX may affect their ability to fund the investment required to upgrade their services to such customers and migrate them to higher bands for an increased billing.

4. **Service Band Adjustment**

The Order provides that where there is failure to deliver on committed service level by a Disco over a period of 60 days, the rates payable by all customers in the affected load cluster shall be retroactively adjusted in line with the quality of service delivered over the same period, upon verification by the NERC. Again, while this provision looks attractive, its implementation requires strict and effective monitoring by the NERC, and the parameters for such verification and the means of triggering same at the moment do not appear clear.

5. **Retention of the Existing CAPEX Allowance and Load Allocation Formula**

MYTO 2020 retains the existing CAPEX allowance for Discos as contained in MYTO 2015 but allows for some adjustments to account for changes in the relevant macroeconomic indices. This retention is to be valid up to 31 December 2020. According to the Order, any verified and approved investment beyond the CAPEX allowances during this period shall

be recognised and applied in the tariff order commencing 1st January 2021. In other words, it is only with effect from 2021 that a Disco will have the opportunity to apply CAPEX that justifies its proposed investment in its network and quality of service assurance.

Retaining the CAPEX allowance at the 2015 level is, in our view, a disincentive to Discos that may immediately seek to expend capital in order to improve their networks and meet the service level obligations required to take the benefit of the tariff adjustments in the MYTO 2020.

Similarly, the existing MYTO load allocation formula in the MYTO 2015 is maintained under the MYTO 2020. This appears to be a draw back as most Discos and the Transmission Company of Nigeria (“TCN”) view the existing load allocation formula as sub-optimal given that it appears not to take cognisance of the load growth and increased capacities of the market participants.

6. Minimum Remittance Threshold

The MYTO 2020 establishes a Minimum Remittance Threshold (“MRT”) for the period of September to December 2020. The MRT retains the key initiatives of the Power Sector Recovery Plan (“PRSP”) for a gradual transition to cost reflective tariff with safeguards for the less privileged in the society. Under the PSRP financing plan, the Federal Government of Nigeria (“FGN”) committed to fund the shortfall between the cost reflective tariff, as determined by the NERC, and the actual tariff payable by end-users during the transition to cost-reflective tariffs.

In line with this, all FGN intervention from the financing plan of the PRSP for funding shortfall shall be applied through NBET and the Market Operator to ensure 100% settlement of market invoices as issued by market participants, and the Discos are expected to settle their market invoices in full, as adjusted and netted off by tariffs approved by the NERC.

Under the new Order, a Disco shall be availed the opportunity to earn its revenue requirement only after (a) fully meeting its repayment obligations under the CBN-NEMS Facility; (b) 100% settlement of the Market Operator’s invoice; and (c) full settlement of 75.3% of NBET’s monthly invoices, which shall be the MRT going forward. To ensure market discipline, a Disco shall be liable to penalties and sanctions (in line with its contract with NBET, the Market Rules and other applicable orders) for a failure to meet the MRT. To promote such discipline, the requirement for Discos to maintain unencumbered three months’ payment security in favour of NBET and the Market Operator remains under the new Order.

We note that the Order is silent on certain ongoing obligations of the Discos like the Meter Assets Providers (MAP) scheme. Whilst it may be argued that the Discos are contracting for these as part of their CAPEX allowance, it remains a risk that if customers, for some reason, default on their payment obligations, the Discos may be required to settle their MAP counterparts out of their revenue. This will have an impact on their ability to continue to meet other competing obligations including the requirements for minimum remittance contemplated in the Order.

7. External Funding for Failure to meet the MRTs

Under the MYTO 2020, where a Disco is unable to meet its MRT from its operations, such Disco is allowed to seek external financing through any available intervention fund by the CBN to cover its remittance deficit. Accessing such fund is, however, subject to (i) a submission to the NERC of the details of the market remittance ramp-up period, financing terms sheet, draw down period, any applicable moratorium and the repayment period of the loan; (ii) the parties agreeing and submitting the executed terms and conditions of the financing to the NERC; (c) submission to the NERC of the financial model of the

Disco showing the MRT ramp-up period and the projections for repayment of the loan.

Whilst this external funding option presents an opportunity for Discos to access funds to meet their obligations under the MRT, it raises some concerns. In particular, it is not clear whether most of the Discos can realistically increase their debt profile by accessing such funds to support revenue shortfall in an illiquid market. This concern is further accentuated by the recent 'general lien' placed by the CBN (through the CBN circular (BSD/DIR/GEN/LAB/13/064 of 16th September 2020) on all receivables of Discos. The CBN circular requires the banks to, amongst other things, treat all Disco customers payments as energy payments to be swept into a feeder collection account.

8. Capacity Payments

As noted earlier, the Order retains the load allocation in the Vesting Contracts in line with the 2019 minor review of the MYTO 2015. However, there is now a requirement for the TCN to pay capacity charge to a Disco where it is established that the TCN is unable to deliver a Disco's load allocation based on constraints on the TCN's network. The Discos are also expected to pay the TCN capacity charge where it is established that a Disco fails to take its load allocation due to constraints on the Disco's network. Given that most grid constraints issues are related to lack of adequate network infrastructure, it is not clear how this will be implemented in

the absence of significant capital investments to enhance the network infrastructure on the side of both parties.

CONCLUSION

Among other things, the MYTO 2020 essentially re-designates the classes of customers in the NESI, increases the tariff payable by customers in the different classes and introduces a tariff regime that is based on the level and quality of service provided by the Discos to their customers in the different classes.

While an increase in tariff is not a silver bullet for the problems of the NESI, the NESI can only thrive on fully cost reflective tariff, and the MYTO 2020 not only creates a path to achieving this, but also ensures that the interest of the customers and the Discos are fairly balanced. This balancing is achieved by the fact that the Discos are not allowed to arbitrarily increase the tariff of the end-users without a corresponding increase in service levels. In other words, to earn more revenue, the Discos must add more value.

While the timing of the increase introduced by the MYTO 2020 has received significant backlash from the public, it would appear that to sustain the NESI and gradually begin to redeem it of its illiquid status, such intervention was inevitable. As capitalist as it may sound, there is need for this policy to be sustained and seen through to the end as a relapse may take the NESI back to the shortfall conundrum. In this regard, we expect that the Discos will significantly improve on their service offering; that the next review of the MYTO 2020 will go on as scheduled; and that the review delays occasioned in the past without any cogent explanation will not occur going forward.

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