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TOWARDS A COMPETITIVE
ELECTRICITY MARKET:
THE BERTHING OF ELIGIBLE CUSTOMERS

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One overarching objective of the Electric Power Sector Reform Act, 2005 (the “**EPSRA**”) and the privatisation of the Nigerian power sector is to introduce and advance a competitive electricity market. Many policy pronouncements since the privatisation - including the debateable declaration of a transitional electricity market in February 2015 - all point in this direction.

In setting the Nigerian Electricity Supply Industry (“**NESI**”) for competition, the EPSRA contemplates that the minister charged with the responsibility for power (the “**Minister**”) will declare a certain class of electricity customers as “eligible customers” who shall be entitled to purchase electric power from successor electricity generation companies and independent power producers (the “**Generation Companies**”).

To determine the consumers who qualify as eligible customers, the Minister is empowered to issue directives to the Nigerian Electricity Regulatory Commission (“**NERC**”) specifying the class or classes of end-users that may, from time to time, constitute eligible customers. In the exercise of this power, the Minister on May 15, 2017 issued a directive (the “**EC Directive**”) to the NERC specifying different categories of “eligible customers” in the NESI.

By the EC Directive, the NESI welcomed a new class of customers who are eligible to purchase electricity directly from the Generation Companies. In essence, these customers are now entitled to sidestep the electricity distribution companies (the “**Distribution Companies**”) and enter into direct contracts with the Generation Companies for the purchase of electricity.

Whilst this pronouncement was commended by some as a long-awaited step that signals another milestone in the journey towards a fully competitive NESI, others view the pronouncement as premature given that the pre-conditions necessary for a fully competitive market are lacking in the sector. The latter view is reinforced by the fact that the market is yet to be fully driven by contracts as expected in a truly competitive market. It is against these mixed reactions that we set out in this article the details of the EC Directive and its potential implications on the sector and the key players in it.

THE DESIGNATED CLASSES OF ELIGIBLE CUSTOMERS

The EC Directive establishes four broad classes of end-users who, based on their level of consumption of power and their point of connection on the network, qualify as eligible customers. The four categories are as follows:

- a) End-users registered with NERC whose consumption is no less than 2MWhr/h and are connected to a metered 11kV or 33kV delivery point on the distribution network subject to a distribution use of system agreement for the delivery of electrical energy.
- b) End-users connected to a metered 132kV or 330kV delivery point on the transmission network under a transmission use of system agreement for connection and delivery of energy.
- c) End-users whose consumption is more than 2MWhr/h on a monthly basis and are connected directly to a metered 33kV delivery point on the transmission network under a transmission use of system agreement. Eligible customers in this category must have entered into a bilateral agreement with the distribution licensee licensed to operate in the location, for the construction, installation and operation of a distribution system for connection to the 33kV delivery point.
- d) End-users whose minimum consumption is more than 2MWhr/h on a monthly basis and are directly connected to the metering facility of a Generation Company. Again, customers in this category are required to have entered into a bilateral agreement with the distribution licensee licensed to operate in the location for the construction and operation of a distribution line.

THE MARKET IMPACTS OF THE DECLARATION

The EC Directive has varying degrees of impact on different players in the electricity value chain. There are implications for the various licensees in the sector and for other consumers of electricity who may not themselves qualify as eligible customers. These multi-dimensional impacts are considered below.

A sunny day for the Generation Companies

The EC Directive was expressed to be very much anticipated by the Generation Companies given the potential positive implications on their businesses. In the light of the industry acclaimed low level of collections by the Distribution Companies, and the corresponding low remittances to the NESI by the Distribution Companies, the liquidity challenges in the NESI have exacerbated. This certainly does not augur well for the Generation Companies, their gas suppliers and other sector players who rely almost entirely on collections and remittances by the Distribution Companies.

We expect that the EC Directive is likely to increase the revenue of the Generation Companies as it opens up another stream of income arising from their direct sale of electricity to the eligible customers, separate from revenues expected under their long term offtake contracts with the Nigerian Bulk Electricity Trading PLC (“NBET”), or revenues that may be derived from the sale of electricity to Distribution Companies under different arrangements.

Closely linked to this is that the implementation of the EC Directive could result in more financing opportunities for the Generation Companies. Currently, although the NBET provides buyer credit

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support to the Generation Companies in the form of letters of credit, the Generation Companies have not, for various reasons (including pending litigation), been able to cash-in on the credit support provided by NBET. This, coupled with the overall liquidity challenges in the sector, has adversely impacted on the ability of the Generation Companies to raise additional financing for their operations. We therefore expect that, with the EC Directive, the Generation Companies may be able to sell their output to creditworthy eligible customers, and they can manage their payment and collection risks by obtaining adequate, easily assignable, enforceable and ultimately bankable credit support from such customers to backstop payment obligations. This will no doubt support their financing drive even if for a small percentage of their operations.

Incidentally, the above optimism could, to some extent, be adversely affected by the fact that the pricing regime for the eligible customers is benchmarked against the prices charged by the NBET for electricity supplied to the Distribution Companies (a point which is further discussed under a separate heading in this article).

Besides increased revenue and better assurance of payment, the Generation Companies will also be able to ramp up generation capacity as well as mop up their stranded capacity to trade with available eligible customers. This could also help address the reported practice of Distribution Companies rejecting load allocation by the system operator which in turn is constrained to – in a bid to maintain system stability – direct the Generation Companies to ramp down their generation capacity.

Further erosion of the Distribution Companies' bottom line?

Neither the law nor the licences issued to the Distribution Companies authorise them to operate exclusively or as monopolies in their distribution zones, although as a matter of practice, the Distribution Companies tend to generally operate as such. This seeming monopoly or exclusivity has been under attack in recent times especially when one considers the effects of the proposed mini-grid regulations, the licensing of independent electricity distribution networks, off-grid generators, and captive generators who sell their excess power directly to third parties consumers.

Unfortunately for the Distribution Companies, the EC Directive could immediately be perceived as another potential erosion of their customer base, and by extension their revenues. This concern stems from the fact that the classes of persons who qualify as eligible customers as declared by the Minister appear to be extensive, and also consist of “maximum demand” customers. The said classes comprise mostly of industrial electricity consumers and large residential estates with usually high electricity demand, and constituting a substantial part of revenue sources of the Distribution Companies. In the event that these customers opt for the direct supply of power from the Generation Companies, this could whittle away a significant chunk of the revenues of the Distribution Companies, thereby leaving the Distribution Companies with a customer base primarily comprised of the lower demand customers and further aggravating the low collection levels experienced by the Distribution Companies.

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The above notwithstanding, it is not likely that the Distribution Companies will lose out completely under the new regime. In some instances, the eligible customers (in particular those that are connected to a metered 11kV or 33kV delivery point on the distribution network) will be required to enter a distribution use of system agreement under which the Distribution Companies may still benefit from the tariffs; and the eligible customers that are directly connected to the metering facility of a Generation Company may enter into a bilateral agreement with a Distribution Company to construct and operate

distribution facilities. We expect that these options could substantially cushion the revenue loss for the Distribution Companies.

In addition, where the declaration of eligible customers is found to have resulted in decreased or inadequate revenue for a Distribution Company, the Minister is empowered by the EPSRA to issue further directives relating to the collection of “competition transition charges” from consumers and the eligible customers. The working of the competition transition charge is briefly discussed below.

OTHER IMPLICATIONS OF THE EC DIRECTIVE ON THE NESI

Apart from the above impacts of the EC Directive on the Distribution Companies and the Generation Companies, there are other issues raised by the directive which may only become clearer upon implementation. These include the following:

Competition transition charge

Generally, competition transition charges apply when a retail or wholesale energy customer switches from one supplier to another and a fee is levied to compensate the supplier for costs that the supplier may have incurred to make sufficient energy available to that customer. For the Distribution Companies, the competition transition charge could be justified on the basis that the Distribution Companies already made adequate infrastructure provisions to ensure the provision of electricity to the departing eligible customer.

Whilst allowing the Minister to declare eligible customers, the EPSRA requires that where the Minister, after consultation with the President, determines that the declaration of eligible customers will result in decreasing electricity prices to such an extent that a trading licensee or a Distribution Company would have inadequate revenue to (i) enable it to pay for committed expenditures; or (ii) earn permitted rates of return on its assets, despite the Distribution Company’s efficient management, the Minister may issue further directives to the NERC on the collection of competition transition charges from consumers and the eligible customers. The Minister is further empowered to direct the NERC on the manner of distribution of the competition transition charges as well as the duration for which the charges shall remain in place.

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The amount of the competition transition charges and the arrangements for its collection and distribution shall be established by NERC in accordance with the Minister’s directive.

Hopefully, the competition transition charges regime, if and when established, should compensate the Distribution Companies for their perceived losses. However, it appears that for the directive on competition transition charges to be issued, the Distribution Companies must demonstrate that the declaration of eligible customers has, despite their efficient management, resulted in inadequate revenues for their operations or a reduction in their permitted rates of return.

Higher electricity tariffs?

It is not unlikely that the EC Directive will lead to further agitations for increased electricity tariff for the Distribution Companies. This is because, under the existing industry multi-year tariff order, the residential consumer classes who pay lower tariffs are cross subsidised by the industrial

consumers who pay higher tariffs thereby stabilising the lower residential customer tariff. A large exodus of the high tariff paying consumers will expose the inadequacies in the tariff structure for the low income residential consumers, and thus leave the Distribution Companies with no option than to push for a higher residential tariff to meet their committed revenue requirements, support their operations and enable them remain profitable.

OTHER GENERAL MATTERS ARISING

Only new or stranded capacity may be sold

Subject to further clarifications from the NERC, it appears from the declaration that the Generation Companies can only sell their “new” or “stranded” capacity to the eligible customers. In other words, capacity which the Generation Companies have already committed to the national grid (to NBET or a Distribution Company) cannot be sold to eligible customers. The Generation Companies may have to expand their capacity or improve their operations so as to have capacity in excess of their already contracted capacity before they can take advantage of the EC Directive. This will certainly involve further capital expenditure on their part and may delay their realisation of the gains of the EC Directive.

Pricing regime for eligible customers

The pricing regime for the eligible customers is benchmarked against the prices charged by the NBET for electricity supplied to the Distribution Companies. Based on the EC Directive, the eligible customers are to be supplied power by the Generation Companies at a price not exceeding the average wholesale price that the Distribution Companies are charged by the NBET. In effect, the bilateral contracts between the Generation Companies and the eligible customers will be subject to a price cap based on the wholesale electricity tariff approved by NERC for NBET and the Distribution Companies. This price regulation for bilateral contracts could disincentivise the Generation Companies from actively procuring additional capacity for sale to eligible customers.

Off grid generators, beware!

The competition and apparent revenue erosion introduced by the EC Directive may not be limited to the Distribution Companies. The implementation of the directive could be far reaching.

Recently, there has been a significant increase in the number of off-grid projects targeted at large retail malls, residential neighbourhoods, industrial clusters and other big businesses. This surge is not unconnected to the fact that the grid is unstable and that the target consumers require steady and reliable power supply.

If the EC Directive is properly implemented, such off-grid projects may potentially be at risk. This is because their target consumers (who may qualify as eligible customers) may instead opt for supply from the Generation Companies if they are assured of efficient service levels, especially since the regulated price of power offered to eligible customers by the Generation Companies could be cheaper than the price offered by such off-grid generators. We therefore expect that improved service efficiency, competitive pricing and long term power supply contracts should be key considerations for off-grid generators, lest they risk losing their “eligible customers” to the Generation Companies.

Eligible customers – “end-users”?

By the provisions of the EPSRA, it appears that the eligible customers must be end-use customers. In other words, it is expected that the eligible customers will be purchasing the electricity for their own use. Barring any regulatory clarification, one wonders whether, for instance, a neighbourhood management company that purchases electricity for resale to residents in the neighbourhood will qualify as an “end-user” within the context of the EC Directive.

Absolute ministerial powers?

It appears that the EPSRA gives the Minister absolute discretion to determine the classes of eligible customers. This implies that the Minister may by declaration change or re-designate such class or classes at will thereby introducing some elements of uncertainty as to which consumers will be “eligible” and for how long. Interestingly, there is no requirement for the Minister to consult with the public or sector stakeholders prior to issuing such directive or any change thereof.

A running battle between the Government and the Distribution Companies?

The Minister as well as the NERC have in the past complained about the poor performance of Distribution Companies compared to the Generation Companies since privatisation, and also alleged that, most of the Distribution Companies have been retaining revenues to the detriment of other players in the sector. Various attempts on the part of the Government to help check this poor performance and ensure compliance by the Distribution Companies have, in most instances, been stalled or completely defeated by law suits and other actions of the Distribution Companies challenging or hindering those attempts by the Government.

In view of this, it has been suggested in certain quarters that the “sudden” issuance of the EC Directive by the Minister at a time when the NESI is supposedly not fully developed for such declaration could be an indication of the running battle between the Minister and the Distribution Companies on various key sector issues.

CONCLUSION

The EC Directive appears focused on ensuring delivery of power to the large base of industrial and other maximum demand customers by seeking to eliminate some of the issues associated with sourcing power from the Distribution Companies. We expect that if successfully implemented, the EC Directive would further deepen competition in the NESI.

However, as highlighted above, certain issues are bound to arise during the implementation phase. These issues range from (i) potential decline in the revenue of the Distribution Companies to the implementation of the competition transition charges; and (ii) the creditworthiness of the eligible customers to the bankability of the associated power purchase agreements.

As with other key players in the sector, we eagerly anticipate further policy and regulatory clarifications and directions by NERC in due course, as the success of the new regime is largely dependent on how these teething challenges are dealt with.

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