



**THE LEADING LIGHT IN SUBNATIONAL
POWER REGULATION:** AN INVESTOR-
FOCUSED ANALYSIS OF THE LAGOS
STATE ELECTRIC POWER SECTOR
REFORM LAW, 2018.



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About a year ago, the Lagos State Government launched an initiative primarily targeted at generating and delivering up to 3,000MW incremental off-grid power from private-sector-sponsored projects within a period of 6 years.

This first-of-its-kind initiative which is tagged the “Lagos State Embedded Power Programme” was approved by the Nigerian Electricity Regulatory Commission (“NERC”) less than two months after its launch. And in a swift move to commence the implementation, and to actualise, the objectives of that initiative, the Governor of Lagos State on 8 February 2018 assented to the Lagos State Electric Power Sector Reform Law (the “Law”), making the State the first State in Nigeria to enact a power sector reform specific legislation.

The ultimate objective of the Law is to improve electricity supply to support economic development by the implementation of a sustained initiative in power generation, distribution and evacuation through an embedded power scheme in Lagos State, the enforcement of consumer rights and obligations, and other related matters.

Quite apart from providing a legal framework for the implementation of the Lagos State Embedded Power Project, the newly approved legislation refines the existing institutional framework for the administration of electric power in the State, penalises power theft and other such infractions, and makes available State Government intervention and support in key areas of the power value chain.

With the circa 540MW first phase of the Embedded Power Programme scheduled to be commissioned in short order, the newly approved legislation heralds the much-needed enthusiasm. It is expected that the Law would see refreshed investment appetite in the State’s power sector, and further bolster the State’s objective of creating sustainable electricity within the State with the multiplier effect of generally attracting investment opportunities to its burgeoning economy.

In this article, we have provided brief highlights of the Law, discussed some related issues that may subsequently come to the fore in the implementation of certain aspects of the Law, as well as some general perspectives on what the next steps following the passage of the Law should be in the context of the Embedded Power Scheme.

KEY HIGHLIGHTS

The Key Market Players

At its core, the Law gives legal backing to the Embedded Power Scheme which would see the emergence of certain key market players. The first are NERC-licensed companies that will generate and sell power to the distribution companies within the State (the “Embedded Power Providers”). In a bid to ensure that the Embedded Power Providers are not starved of the necessary feedstock for their operations, the Law also recognises entities that would supply feedstock to the Embedded Power Providers (the “Feedstock Suppliers”) as well as duly licensed entities to be appointed by the State to procure and aggregate feedstock from the Feedstock Suppliers, and execute feedstock supply agreements with the Embedded Power Providers (the “Feedstock Merchants”). It is expected that the feedstock supply agreements would be entered into between the Feedstock Merchants and the Feedstock Suppliers on the one hand, and the Feedstock Merchants and the Embedded Power Providers on the other hand. The distribution companies can certainly not be left out of the scheme. The Law therefore recognises the two privatised distribution companies in the State: Eko Electricity Distribution Company plc and Ikeja Electricity Distribution Company plc and any other independent distribution network licensed by NERC to operate within the State.

Investors may therefore come in at any stage of the value chain that accords with their investment appetite and respective mandates. Some commentators have noted that the State would provide direct funding via equity investment in the Embedded Power Providers, but the strategy or framework for pursuing this is not yet clear.

The Lagos State Embedded Power Commission (the “Commission”)

Realising the potential issues in undertaking the Embedded Power Scheme without adequately synergising with appropriate regulatory bodies (including NERC and the Nigerian Electricity Management Service Agency) and relevant stakeholders, the Law establishes the Commission which shall among other things, be responsible for ensuring speedy disposition of projects under the Scheme, the implementation of cost reflective tariffs for projects under the Scheme, promoting competitive, fair and efficient market practices within the State’s power sector, enforcing electricity regulations – all in collaboration with NERC and other relevant government agencies – for the purposes of effective implementation of the Embedded Power Scheme.

Further, to ensure smooth take-off of the Embedded Power Scheme, the Commission will collaborate with the distribution companies to pre-qualify Embedded Power Providers, appoint the Feedstock Merchants, provide assistance to the distribution companies in customer enumeration and classification towards achieving sustainable tariff levels, advocate for the adoption of adequate mechanisms to support tariff collection as well as designate areas within the State for deployment of power generated by the Embedded Power Providers. We understand that certain areas within the State have already been identified for imminent deployment of embedded power, and that power audit exercises are either underway, or to be commenced in short order.

Bankability and Investment Incentives

To promote an initiative such as the Embedded Power Scheme, investors need to be wooed with adequate investor friendly policies and substantial assurances of return on investment aimed at improving the bankability of projects. In realisation of the foregoing, and as a direct intervention in the entire power value chain, the Law provides a framework under which the State Government may provide credit support to the front-end and the rear-end of the value chain.

The Law provides that the Ministry of Energy and Mineral Resources may, through the Ministry of Finance and the Lagos State Debt Management Department, and subject to the approval of the Governor, provide guarantees and indemnities to the Embedded Power Providers and the Feedstock Suppliers. This is a statutory departure from some existing laws in the State which tend to prohibit any financial guarantee from the State or any of its ministries, departments or agencies in public private partnership transactions.

With the State now putting its balance sheet on the table, there is no gainsaying the fact that providing such guarantees and indemnities could effectively impose a considerable level of contingent financial liability on the State. Depending on what mode or structure that the State ultimately adopts in issuing the guarantees and indemnities, investors will definitely need to concern themselves with an in-depth assessment of the sustainability or otherwise of those financial assurances vis-à-vis the State's other numerous financial obligations and liabilities.

It is also worth noting that to the extent that the payment obligations under any Feedstock Supply Agreements are predominantly denominated in foreign currency, questions may then arise around the ability of the State to, under current law, guarantee such foreign currency obligations without recourse to the Federal Government of Nigeria ("FGN"). In order to overcome such likely hurdles, it may be possible to consider structures whereby, although the payment obligations may be denominated in foreign currency, the Feedstock Suppliers may elect to be paid in the Naira equivalent. If that route were to be pursued, would the State be willing to assume the associated foreign exchange risks?

Approval and Implementation of Tariffs

According to the Law, the Commission would facilitate regular engagements with NERC to procure the approval of cost-reflective tariffs which adequately reflect exchange rates, inflation, interest rates and feedstock prices and make provision for the proper cross subsidisation of the tariffs for the low-income end users.

Some commentators have expressed concerns in this regard. Since the extant Multi Year Tariff Order was signed in 2015, there have been severe delays in tariff reviews which have occasioned substantial market shortfalls. It has been reported in some quarters that the delays were in part due to the non-constitution of the Board of NERC and perceived indecision on the part of the FGN to give its nod to a tariff increase resulting from the review in the "recession year". With NERC's pre-eminent involvement and the level of apparent FGN influence in the tariff review and implementation process, one wonders what the fate of the Commission's mandate to facilitate tariff review and implementation would be.

Without doubt, the process of tariff approval and implementation plays a major role in the bankability outlook of projects. Questions that may then arise would include whether the scope of the credit support to be provided by the State under the Law would cover any revenue shortfalls that may result from any delays on the part of NERC and/or FGN to approve tariff reviews.

Now, we understand that a proposed tariff of NGN52.52/kwh has been put forward under the Embedded Power Scheme, and that that tariff has received little or no push back. Would this translate to a speedy tariff approval and implementation by NERC? If so, how about the tariff reviews going forward?

Stakeholder Collaboration

To serve as a melting point for stakeholders within the State's power sector and to provide an avenue for stakeholder cooperation, the Law establishes the Lagos State Embedded Power Council (the "Council").

The Council is expected to consist of key stakeholders including a representative of Eko Electricity Distribution Company plc and Ikeja Electricity Distribution Company plc, representatives of relevant labour unions and interest groups, Feedstock Suppliers, Embedded Power Providers and so on. It is expected that the Council would present a forum for effective dissemination of information relating to the State's power policy, to address consumer complaints (subject to the NERC Consumer Forum requirements) and to provide input in the determination of cost reflective end-user tariffs.

Rural Electrification - The Commission vs. Rural Electrification Agency

The Commission is required to maintain a deliberate policy to foster electricity development and promote modalities for rural electrification projects within the State. The Governor shall on the recommendation of the Commissioner, designate communities in the State to be known as "Rural Areas" under the Law. The Law is, however, silent on any provisions relating to Rural Areas, and we expect that the policy to be put in place by the Commission would dictate the regime with respect to such Rural Areas.

Separately, the Electric Power Sector Reform Act 2005 (the "EPSRA") establishes the Rural Electrification Agency (the "REA") with a core mandate to establish and administer the Rural Electrification Fund for the purposes of promoting rural electrification programmes in order to, among other things, stimulate innovative approaches to rural electrification.

Further, under the EPSRA, the Minister of Power (in collaboration with the REA and NERC) was required to within one year from the commencement of the EPSRA, prepare and submit to the President, a Rural Electrification Strategy and Plan. The Minister of Power is also required under the EPSRA to conduct a periodic evaluation of the Rural Electrification Strategy and Plan, and to, on an ongoing basis, report the progress and achievement of the plan.

One wonders whether the Commission's functions in relation to rural electrification as contemplated under the Law would result in an overlap with respect to the rural electrification strategy under the EPSRA or, whether indeed, there would be actual lines of separation in the scope of their respective mandates flowing from effective collaboration between the Commission and federal agencies as is generally contemplated under the Law. It would also be interesting to see how the policy to be initiated by the Commission under the Law would interact with the Rural Electrification Strategy and Plan.

Deterrence Factor

It is no news that electricity theft and vandalism have in no small measure contributed towards crippling the power sector. Under current NERC regulations, in the event of an unauthorised tampering with the network and meters of distribution companies, distribution companies are empowered to, without notice, disconnect such unauthorised connections, and to impose administrative charges, reconnection costs and loss of revenue charges.

As a further deterrence measure, the Law creates stricter monetary penalties, sanctions and imprisonment terms for electricity theft, damage to electricity infrastructure, harassment to staff of generation, distribution or transmission companies, impersonation, unauthorised dealing with licensees' network, equipment and infrastructure and so on. In the case of offending companies, liability would extend to officers in control of the relevant company.

The Law also establishes a Power Task Force (the "Force") to enforce these criminal sanctions by, for example, arresting offenders. And in order to accelerate the wheels of dispensation of justice, offences are to be dealt with by special courts, away from the slower system under the regular criminal procedure in the High Courts.

Finally, the Law provides an incentivised whistleblowing policy to reward persons who report offences committed under the Law.

Tariff Collection

Tariff collection remains a major drawback to the success of power sector reforms. It is expected that the Commission will provide support in the collection of tariffs and revenue from embedded power end users. For one, the sanctions for electricity infractions already discussed would in this regard be a step in the right direction. It has also been reported that under the Embedded Power Scheme, the State will enter into joint ventures for the roll out of smart prepaid meters, and that the Distribution Companies would be assisted by vendors in the collection of tariffs for power supplied to their feeder stations. We understand that the vendors would be required to procure bank guarantees to backstop the payment of these revenues to the Distribution Companies. With the apparent reluctance of the banking sector to further increase their exposure to the power sector in Nigeria, and the widespread unwillingness of customers to pay for electricity, the market would be very anxious to see how these plans will be actualised.

Areas not covered by the Embedded Power Scheme

By repealing the Lagos State Electricity Board Law, the Law seeks to re-establish the Lagos State Electricity Board (“LSEB”). Under the Law, the LSEB would be responsible for establishing electric power stations in areas in the State not covered by the Embedded Power Scheme, and as was previously within its scope, generating, transmitting and distributing electricity to areas not covered by the national grid within the State. Historically, the Board was responsible for executing captive independent power projects (“IPPs”) to serve State utilities, and as part of the State’s wider Light Up Lagos Project, providing intervention in rural areas by the deployment of transformers and other distribution infrastructure, and promoting public lighting within the State with the use of the IPPs.

WHAT IS NEXT?

Expansion of Distribution Infrastructure

One of the key pillars on which the Embedded Power Scheme would survive is a reliable distribution network to which the Embedded Power Providers will connect. Thus, in order to deliver the incremental power under the Embedded Power Scheme to the end-users, it would be necessary for the distribution companies to improve on their metering plan and also expand, upgrade or strengthen their existing distribution infrastructure in order to accommodate the additional capacity. This is necessary to avoid a repeat of the now almost perennial claim by the Transmission Company of Nigeria that distribution companies are in the practice of rejecting load.

These expansion projects would require significant capital expenditure in respect of which the distribution companies have consistently maintained is not supported by the revenue requirement which forms the basis of the end-user tariffs. This constraint, according to the distribution companies has indeed impeded their ability to attract funding both locally and in the international market. And the market is keen to see how the much-required further investments for such projects would be obtained.

Evaluation of Fuel Sources and Availability of associated Infrastructure

The Law seeks to ensure the availability of feedstock by providing credit support under the Feedstock Supply Agreements. It has been reported that the State has finalised arrangements with leading gas suppliers to deploy a floating, storage and regasification unit to be moored offshore Lagos and interim arrangements for trucking of liquefied natural gas from Southern Nigeria. With much focus on gas as a primary feedstock, it is important that the long-term sustainability or otherwise of the proposed gas resources as well as other alternative sources be properly evaluated. Separately, from an economics perspective, it should also be noted that under the National Gas Policy approved last year by the Federal Executive Council, there appears to be a conscious drive to move away from the historic non-cost reflective gas pricing framework towards a wholesale market where power generators would pay the market negotiated wholesale price. Adopting such pricing framework would definitely have a significant tariff incremental impact.

Further, in order for the feedstock to be readily available for the targeted projects, concrete directions on the development of the associated transportation infrastructure is critical. The development of the associated infrastructure would also see very capital-intensive projects, and as such, ways to ensure that these projects are and remain bankable should be explored.

Execution and Delivery Risk

There are various moving parts to achieving the full implementation of the Embedded Power Scheme. Quite apart from the passage of the Law, it is important for all elements of the projects to be financeable by, among other things, ensuring that all aspects are driven by credible parties and that the critical contractual enablers correspond along the value chain.

Further Regulation

Just like other key players in the sector, we eagerly anticipate further policy and regulatory clarifications and directions by the Commission in due course. For example, the criteria for selection of the Feedstock Merchants is yet to be known, and we imagine that potential investors would have a keen eye on this.

Interplay with existing laws

Electricity is contained under the concurrent legislative list under the extant Nigerian Constitution, and therefore, the Law was enacted within the legislative competence of the State. That notwithstanding, the Law has made deliberate attempts to avoid conflicts with the EPSRA, which is the existing federal law on the subject. For example, the Law makes copious reference to compliance with existing laws and regulations. Notable matters in this regard are the requirements for the Embedded Power Providers to be licensed by NERC, and for tariffs under the various embedded projects or other initiatives to be in line with the tariffs established pursuant to the EPSRA. This could, in some instances, raise a number of potential issues from a project bankability perspective.

As stated elsewhere in this article, the fact that tariffs are required to be reviewed, approved and implemented by NERC may have an impact on the overall bankability outlook of projects under the Law. Further, considering the fact that licensing under the present framework is the exclusive preserve of NERC, the Embedded Project Providers will need to obtain licences from NERC. Apart from the administrative delays that may be associated with the licensing process (which could affect project timelines), it is not unlikely for certain grey areas under the EPSRA such as the duration of, and conditions for renewal of, licences to also have an impact on the overall bankability of projects under the Law.

Now, at interstate level, to the extent that the activities of the project developers under the Embedded Power Scheme remain confined to Lagos State, there should not be any territorial conflict(s). However, in the event that some of the activities or projects under the Embedded Power Scheme straddle between Lagos and its contiguous states, there could be potential conflict. And in that instance, there may be issues around the adequacy or otherwise of the Law to regulate such “cross border” projects given that such interstate activities may likely be regulated by federal law. This, no doubt, could result in some level of legal and regulatory uncertainty for some projects.

CONCLUSION

Although it remains to be seen how the likely increase in power supply will be mopped up by the distribution companies, the enactment of the Law in no small measure demonstrates the leadership of Lagos State in the development of investor friendly and ground-breaking policies aimed at attracting investment. We anticipate that other States will follow suit.

We also expect that investors would quickly take advantage of the opportunities presented by the Law because the Law provides a lucrative avenue for power sector investors to improve their footprint in the Nigerian space, diversify their portfolio away from the uncertainties and inadequacies of the national grid and tap into the potential goldmine that the embedded power generation market has to offer.

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