ANALYSING THE RECENT NIGERIAN ELECTRICITY REGULATORY COMMISSION ORDER ON THE TRANSITION TO COST REFLECTIVE TARIFFS IN THE NIGERIAN ELECTRICITY SUPPLY INDUSTRY

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1. Introduction and Context of the 2020 Order on the Transition to Cost Reflective Tariffs in Nigerian Electricity Supply Industry (NESI)

On 31 March 2020, the Nigerian Electricity Regulatory Commission (**NERC**) issued an Order concerning the proposed tariff increase which was to be implemented from 1 April 2020. The Order recognised the application by power distribution companies (**DisCos**) for an upward review of end-user tariffs, as well as the application by the Transmission Company of Nigeria Plc (**TCN**) for an upward review of the rates payable to the Power Generation Companies (**GenCos**) that provide the Ancillary Service of Spinning Reserve.

In compliance with the regulatory requirements for instituting a tariff increase, NERC held public hearings in the different franchise areas of the respective DisCos. These hearings resulted in the following findings:

i. end-users are willing to pay appropriate rates for electricity, dependent however, on the assurance by the DisCos of guaranteed hours of service, provision of quality power and metering of consumers;
ii. end-users are dissatisfied with the practice of estimated billing. The metering deficit, which presently stands at about 60% is a major impediment to tariff review and revenue protection for DisCos;
iii. COVID-19 has significantly impacted the ability of meter assets providers (**MAPs**) to meet the metering requirements due to restrictions and supply chain disruptions which have negatively affected the availability of the meter components that are imported;
iv. COVID-19 has also impacted the global economy and the average Nigerian; and
v. improvements in electricity supply at the DisCo level will require investments in reinforcing feeders, transformers and protection equipment.

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The Order noted a number of already existing initiatives which have been instituted to address some of the concerns raised in the findings:

i. On 20 February, 2020 issued an Order repealing the Regulation on Estimated Billing Methodology of 2012 and capping the energy billed for unmetered consumers in order to spur an increase in metering by the DisCos and to the curb the practice of estimated billing.
ii. Discussions are on-going between the NERC, the DisCos and MAPs on the revision of standards prescribed by the MAP Regulations and the service level agreements executed between the parties.
iii. NERC is taking necessary steps to direct the TCN to align and prioritize its investments toward resolving the transmission/ distribution interface bottlenecks and reducing the high incidence of tripping at 132/ 133 kV substations as part of the necessary investments to be made toward improving electricity supply in Nigeria. NERC intends to anchor TCN's operational performance on firm agreements with the DisCos, which will include key performance indicators and financial remedies for non-performance by either party.

In light of these findings, NERC issued the Order on the Transition to Cost Reflective Tariffs in NESI on 31 March 2020 (the Order).

2. Provisions and Analysis of the 2020 Order on the Transition to Cost Reflective Tariffs in NESI

The Status of the 2019 Minor Review Order

The Order provided that the 2019 Minor Review of the Multi-Year Tariff Order and the Minimum Remittance Order for the year 2020 (**2019 Minor Review Order**) shall be in effect until 30 June 2020. NERC issued the 2019 Minor Review Order to institute an upward review of electricity tariffs by recognizing and updating the changes to the macroeconomic indices that informed the tariffs set under the previously issued 2018 Minor Review Order. This tariff increase was to go into effect on 1 April 2020, a day before the Order was issued, halting the implementation of the new tariff rates.

As the 2019 Minor Review Order is being replaced, the new tariff order must consider that the macroeconomic indices that informed the previously issued orders have changed. For example, the exchange rate index against which the 2019 Minor Review Order was issued has been changed. This change will affect the cost of electricity and should be considered in the new tariff order that will follow.

New Submissions of Performance and Financial Plans by DisCos

Under the Order, NERC directs DisCos to submit detailed cost recovery plans, which expressly state their plans for the attainment of full recovery of prudent costs and an allowed return on capital. These cost recovery plans are to be submitted by 30 June 2021. DisCos are also to submit their revenue recovery and financial sustainability plans to NERC by 21 April 2020, which plans should include a path with timelines, for transiting customers to a higher quality of service. NERC also directs DisCos to submit revised Performance Improvement Plans (**PIPs**) no later than 21 April 2020. These plans are to emphasize the key objective of improvement in service for end-users and transition to full revenue recovery. The

objective requirements for the new plans show that NERC intends to emphasize both cost recovery and quality of service in setting tariffs. The Order states that the approved plans (PIPs and cost recovery plans) will form the basis for future tariff reviews and full cost recovery.

Halting the Increase in End-User Tariffs and the Future of Reviews of End-User Tariffs

The Order also indicates that no increase would be implemented to end-user tariffs on 1 April 2020, as was previously ordered. This is the NERC's palliative measure for end-users whose incomes have been affected by COVID-19, as well an opportunity to implement its intentions to tie tariff increases to quality of service. In addition, future, tariff reviews will also be based on consultations between DisCos and customer clusters with firm commitments on rates and quality of service. These firm commitments may be in the form of service level agreements to be executed between the relevant DisCos and the end-users within the customer clusters. Events of default under these agreements shall include failure on the part of the DisCos to deliver on their performance targets. The Order states that these agreements shall include compensation mechanisms for end-use customers to address a DisCo's performance-targets-based default.

DisCos are also required under the Order to disaggregate their respective service areas and/ or customers in accordance with quality of service. This disaggregation is to be supported by a proposal for '*service reflective*' tariff classes which shall be graduated by quality of service.

This '*service reflective'* tariff method may imply a change from or modification of the previously used cost-reflective method for determining tariffs. The previously used cost-reflective method aimed to balance the consumer concerns for fair prices and the DisCos' concerns that they operate efficiently and are able to recover the full cost of their activities and a reasonable return on their investments. This cost reflective method is represented in the considerations that regulate tariff methodologies under the Electric Power Sector Reform Act of 2005 (EPSRA). It is unclear how the new service reflective tariff method follows certain considerations listed in EPSRA, which include:

i. allowing holders of electricity licences (licensees) to operate efficiently to recover the full costs of its business activities including a reasonable return on the capital invested in the business;
ii. providing incentives for the continued improvement of the technical and economic efficiency with which the services are provided;
iii. providing incentives for the continued improvement of quality of services;
iv. giving economically efficient signals to consumers regarding the costs that their consumption imposes on the licensees' business;
v. avoiding undue discrimination between consumers and consumer categories; and
vi. phasing out or substantially reducing cross subsidies.[2]

These considerations point to a tariff methodology that emphasizes the importance of cost in setting tariffs and correlation between tariff and improved quality of service. In instituting this service reflective

[2] Section 76(2) of EPSRA.

tariff system, NERC may be placing quality of service on equal footing as cost recovery. The concern however from this position is that any improvement in quality of service is necessarily tied to cost. It is generally agreed that the present rates are not cost reflective and NERC issued the 2019 Minor Review Order to address this issue. Tying cost and service quality equally to tariff may result in neither the cost nor the quality of service being improved. This is because it may prove impossible for the DisCos improve the quality of service delivered where no tariff increases are instituted. If the DisCos are unable to improve the quality of service, it may in turn mean that no tariff increases will be instituted. This may lead to a catch-22 situation which may potentially leave a sector that is in dire need of investment, stuck in the status quo. A service reflective tariff system is only feasible after the industry has achieved cost reflective tariffs.

Financing for the Improved Quality of Service

In order to fund the quality of service measures, the Order states that DisCos are expected, in the short to medium term, to raise financing for the associated investment required to improve service by leveraging on, amongst several options, an escrow of the revenues for the ring-fenced service areas (the relevant customer clusters) and the opportunities of sub-franchising and embedded generation. These financing options fail to consider that facilities already exist, secured by Discos' assets, including those within the customer clusters. NERC may be encouraging DisCos toward more leveraged financing for the improvement of electricity supply to these customer clusters.

Disaggregating customers and entering service level compacts with them which provide for rates and quality of service may create new relationships within NESI and allow DisCos some level of freedom to contract for the sale of electricity at mutually agreed rates. It is however unclear how much oversight NERC will have in setting rates under these compacts. DisCos are encouraged to consider their cost concerns, the changes in macroeconomic indices for setting tariffs, as well as the path to improved quality of service in preparing the revised Performance Improvement Plans and Cost Recovery Plans.

Provision of Real Time Data to NERC

The Order also directs DisCos to provide smart meters at 11kV and 33kV feeders level with the capability of sending real time or near real time data to NERC. These meters are to be installed by 30 June 2002. This is most likely to allow NERC to monitor the hours and quality of service delivered at the distribution phase of electricity supply.

Federal Government's Tariff Support Measures

The Order notes that the Federal Government of Nigeria (**FGN**) will provide tariff support during the transitional period to full revenue recovery until 30 June 2021. This tariff support will be based on the under-recovery of the revenue requirement determined by NERC and shall only be within the context of funding available under the Power Sector Recovery Program (**PSRP**). For the purposes of transition to full recovery and application of tariff support, a DisCo shall be considered as having earned its revenue targets on the basis of the approved roll out plans.

The funding sources to be used to offset the revenue shortfalls occasioned by the use of non-cost reflective tariffs within NESI are the Central Bank of Nigeria's (**CBN**) Payment Assurance Facility (**PAF**), federal government budgetary contributions, and the World Bank performance-based loan. COVID-19 has resulted in the reassessment of fiscal considerations as well a reduction in the federal budget. These restructuring measures will affect how much funding is available from the FGN as tariff support during this transitional period to full revenue recovery. This is especially so given that the macroeconomic indices have changed, and this will affect the amount of support required from the FGN. NERC will have to consider a faster track to cost recovery to avoid over-burdening the FGN and the NESI. This fast track will necessarily involve an upward review of the present electricity tariffs.

Other Considerations from the Order

NERC unfortunately finds itself in the untenable position of determining what should be cost reflective tariffs in the middle of a pandemic with dire economic consequences for a sector that is in need of financial infusion. The Order mostly considers the concerns of the end-users to the detriment of the DisCos and consequently, the rest of the electricity supply chain in NESI. NERC has to adequately balance the concerns of all the stakeholders in the industry, including suppliers and consumers.

A staggered approach to cost and service reflective tariffs may be necessary. This staggered approach will allow DisCos enter into agreements with customer clusters for cost reflective tariffs pegged at an improved quality of service level. These customer clusters will act as test cases and the success, failure and adaptability of the cost and service mechanisms instituted under the service level compacts. DisCos and customer clusters should be given a high degree of freedom to determine cost and service quality and ensure that both of these standards are as true to market standards as possible. The results from these test clusters will assist NERC in determining better what an appropriate cost and service reflective tariff for NESI will be.

The Order also does not address how the metering deficit will be met in light of the market disruptions resulting from COVID-19, especially in light of the claims in the Order that the metering deficit is a major impediment to tariff review.

The language of the Order is also not indicative of when the *'service reflective'* tariff classes will be introduced but implies that this new class of tariff will be introduced from 30 June 2020. The purpose of introducing a service reflective tariff will be defeated if some of the obstacles across the entire gamut of the NESI is not removed from guaranteed gas to GenCos to the supply of meters by MAPs. Thus, cost reflective tariff should be adopted for the 30 June 2020 MYTO Minor Review Order while affording the DISCOs sufficient time to recover from the effect of COVID-19 and a weak currency on their businesses. Migrating to a *'service reflective'* tariff class may be more appropriate at the end of the transitional period as the NERC expects that the market should have been fully liberalized by this date - 30 June 2021.

3. Conclusion

The NERC Order on the Transition to Cost Reflective Tariffs in NESI is commendable in its desire to improve the quality of service and engage end-users in the determination of tariffs. From the findings from the customer hearings that NERC instituted, end-users have asserted their willingness to pay appropriate rates. NERC should push for further information campaigns with end-users and stakeholders in the power supply chain to ensure an adequate understanding of what 'appropriate rates' mean and how each stakeholder's cost is reflected in those rates while working to remove institutionally created barriers and impediments to the achievement of a fully liberalized market.