THE NIGERIAN ELECTRICITY REGULATORY COMMISSION ("NERC") CONSULTATION PAPER ON THE DEVELOPMENT OF A REGULATORY FRAMEWORK FOR ELECTRICITY DISTRIBUTION FRANCHISING IN NIGERIA DATED 12 APRIL 2019:

AN OVERVIEW

Introduction

On April 18 2019, the Nigerian Electricity Regulatory Commission ("NERC"), published a consultation paper on the development of a regulatory framework for electricity distribution sub-franchising in Nigeria (the "Consultation Paper").The Consultation Paper was published to intimate the general public of NERC's unwavering intention to improve Nigerians' access to efficient power supply. Interested parties were to provide comments on the Consultation Paper to NERC no later than May 6, 2019. The writers understand that, the precursor to the proposed regulatory framework was a particular electricity distribution company which wanted to undertake a pilot, in relation to sub-franchising and in its wisdom; NERC sought to have a comprehensive framework for the entire distribution arm of the entire electricity value chain.

According to the United States Agency for International Development (USAID) Fact Sheet on Nigeria (last updated March 12 2019), only 36% of people living in rural areas have access to electricity, while 55% of people living in urban areas have access to electricity. Additionally, the Nigerian Power Baseline Report 2015 (developed by the Advisory Power Team, Office of the Vice President, Federal Government of Nigeria in conjunction with Power Africa) estimated that 95 million Nigerians (approx. 55% of the population) have no access to electricity and those who are connected to the grid face extensive power interruptions.

The Power Generation Report dated February 28 2019 released by the Federal Ministry of Power indicates that the peak power demand for the country currently stands at 23,960 mw (per day) with data from the Office of the Vice President showing that about 4,002 mw (per day) was generated during the month of April 2019.

This power deficit has necessitated NERC, as the regulator of the Nigerian Power Sector, to consider alternative options to bolster access of Nigerians to electric power supply. The Consultation Paper issued by NERC, sets out the regulator's strategy to increase the number of Nigerians with access to electricity. The aim of this paper is to set out the elements of the Consultation Paper and consider its potential impact on the Nigerian Electricity Supply Industry ("NESI").

As a starting point, it is pertinent to note that the Consultation Paper is a precursor to the regulation which is to be implemented by NERC upon receipt of comments from interested parties and further consideration of the theme of the Consultation Paper. As such, the Consultation Paper is not law, but is merely indicative of what can be expected in the substantive regulation to be issued by the NERC.

2. Key Elements of the Consultation Paper

a. Disco Franchising Structure & Exclusivity

The Consultation Paper sets the tone for sub-franchising of Distribution Companies (Disco) operations to improve efficiency. According to the Consultation Paper, sub-franchising means "the business model applied by a Disco to authorize a 3rd party to provide electric distribution utility services on its behalf in a particular area within the Disco's area of supply". The franchising arrangement, thus, contemplates that Discos may engage 3rd parties to undertake activities which ordinarily be within the Discos scope such as electricity supply, metering, billing and collection. This franchising arrangement may be initiated by either the Disco itself or the community (through a registered association) within the Disco's area of operation.

The franchising arrangement may include the following:

i. The Disco supplying electricity to the franchisee at an identified injection point for a pre-determined fee;

ii. The franchisee supplying power to identified customers of the Discos at a tariff approved by NERC;

iii. The franchisee may undertake metering, billing and collection activities or manage the distribution system (including operations, maintenance and upgrade) of the Disco's system;

iv. The franchisee retaining a portion of the revenue collected from the consumers after the franchisee has paid the full cost of bulk energy to the Disco;

v. The franchisee shall work within the ambit and restrictions of the Disco's licence;

vi. The franchisee may also procure additional generation from off grid sources to augment the Disco's power from the Grid; and

vii. The franchisee may also sell surplus power to the Disco

Prior to the issuance of the NERC Eligible Customer Regulations 2017, the Discos were under the assumption that the areas allocated to such Discos in their licence terms and conditions was to be their exclusive preserve. As such, only they could deal with such customers with respect to electricity transactions. Following the enactment of the Eligible Customer Regulations, many of the Discos had claimed that it would not be feasible to comply with the projects and estimations in the Performance Agreements they executed with the Federal Government.

With the Consultation Paper, there is a possibility that the Discos may further clamour that their ability to inject CAPEX and OPEX to undertake their obligations under the Performance as well as reap sufficient revenues may be impeded by the Consultation Paper. However, there is no provision in the law or the licences of the Discos which grants them exclusivity. The Consultation Paper further confirms that the Discos have no exclusivity in terms of the customers within their area of operation. Thus, the appropriate response to this would be that to the extent that the Consultation Paper contemplates that the franchisee would pay the Disco the full cost of bulk energy, the Disco's revenue stream would be sufficiently protected.

b. Franchise Models

The key franchise models which NERC is proposing for the purpose of the Distribution Franchising, as stated in the Consultation Paper are:

i. Model 1: Metering, Billing and Collection (MBC): This Distribution Franchising Model contemplates that the metering, billing and collection of a 33kV or 11kV or a cluster of feeders may be outsourced to a third party, with a view to supplying electricity to rural, semi-urban or urban areas.

ii. Model 2: Total Management of Electricity Distribution (TMED): Under the TMED Model, the franchisee is allowed to maintain the electricity distribution system. Responsibilities of the franchisee under this arrangement include maintaining meters, distribution transformers, breakers, and MBC functions, amongst others. The franchisee would also be required to undertake rehabilitation and upgrade of the distribution system by investing its own funds and recovering same via a Project Agreement executed with the Disco

iii. Model 3: Distributed Generation based Electricity Distribution (DGED): With respect to DGED Model, the franchisee can undertake procurement of more energy either through bilateral arrangements over the transmission network or embedded at local distribution networks level to meet the electricity deficit of customers within the franchise area.

It is essential to understand how these 3 models will be implemented (particularly Model 1 and Model 3), in view of other extant NERC Regulations. With respect to Model 1, there is already the NERC Meter Asset Regulation 2018 which permits Discos to appoint Meter Asset Providers for the purpose of providing metering services which may include meter financing, procurement, supply, installation, maintenance and replacement. In the light of this, it may be argued that there is overlap between the Model 1 and the MAP Regulations.

It is crucial for NERC to clarify if the MAP Regulations have been rendered redundant, since the Disco can franchise the role of the meter asset provider to a franchisee. However, it must be noted that the provisions of the MAP Regulation may be blended with Model 1 such that meter asset providers may be able to qualify as franchisees and undertake metering, billing and collection on behalf of the Disco.

In respect to Model 3, the Consultation Paper seems to imply that the franchisee can indeed supply power to the Discos. Section 62(2) of the Nigerian Electric Power Sector Reform Act 2005 ("EPSRA") prohibits any person from owning or operating a power generation facility without obtaining a licence from NERC. Thus, where the franchisee is supplying the Disco with power above 1mw, such franchisee will be required to obtain a generation licence from NERC (except if NERC grants a derogation in this regard). If this is the case, we are of the view that the licensing regime under the Consultation Paper may be blurred and create uncertainty among prospective investors.

It is also crucial to note that even if a franchisee obtains a generation licence, the licence terms and conditions under generation licences prohibit generation licensees from engaging in distribution activities. Thus, from a legal perspective, it may not be workable for the franchisee who obtains a generation licensee to supply power to the Disco to also undertake its obligations as a "mini-distributor" under the franchise arrangement. NERC should take note of these dynamics and potential conflicts that may arise from the implementation of Model 3.

c. Franchising Contractual Framework

According to the Consultation Paper, the Franchise Agreement would provide for

i. Performance delivery/ performance parameters;
ii. Asset register;
iii. Ownership of assets;
iv. Investment plan;
v. Frequency and mode of payment;
vi. Payment guarantee;
vii. Default events and conditions of termination;
viii. Other parameters inclusive of contract period, baseline data, energy

NERC is yet to issue a draft/template Franchise Agreement which would provide potential investors with more clarity as to the how the franchising contracting structure would work. In order to ensure industry contribution to the proposed franchising arrangement, NERC should invite members of the NESI to comment on the draft Franchise Agreement so as to tackle any bankability issues arising therefrom.

d. Competitive Procurement of Distribution Franchisees

The Consultation Paper indicates that the distribution franchisees will be engaged through a competitive procurement process which will culminate in a franchisee being issued a Franchise Permit. However, in view of Model 1 (described in item b above), it is necessary for NERC to clarify whether meter asset providers will be required to also obtain franchise permits in order to participate in the franchise arrangement.

e. Other Considerations.

i. Franchisees and Independent Electricity Distribution Networks

The Consultation Paper indicates that the distribution franchisee will be required to operate and maintain electricity distribution infrastructure as well as invest in distribution infrastructure. Section 62 of the EPSRA provides that, where any entity is to undertake the distribution of power of 100kw or above, such entity shall obtain a distribution licence from NERC. Thus, to the extent that the distribution franchisee is obligated to install, operate and maintain distribution infrastructure, it will be essential for the Regulator to confirm if the Franchisee would be required to obtain distribution licenses when distributing power of more than 100kw.

Additionally, we observe that the franchise arrangement is similar to the Independent Electricity Distribution Networks ("IEDN") permitted via the NERC IEDN Regulations 2012. Under the IEDN Regulations, an IEDN is defined as distribution network not directly connected to a transmission system operated by the system operator. By section 6 of the IEDN Regulations, NERC may grant a licensee the exclusive right to construct, own, operate and maintain a distribution system in a designated geographical area within the area of operations of a Disco (please note that IEDN is also permitted to have its own generation component).

The IEDN framework and the franchise arrangement have very conspicuous similarities in that both concepts are geared towards encouraging investment in distribution infrastructure to unserved and under-served areas within the Disco's area of operation. Thus, the franchise arrangement when promulgated into law would cast doubt as to the relevance of the IEDN structure. To avoid a duplication of frameworks, NERC would have to consider the applicability of both concepts in the NESI.

ii. Tariffs

The Consultation Paper states that the NERC shall approve Multi Year Tariff Order ("MYTO") tariffs for areas covered by the Distribution franchisees with the Franchisee being able to gain a premium where it provides additional power to the Disco.

It will be essential for NERC to undertake adequate customer sensitization for customers who would be paying for electricity within franchise areas particularly as such customers may be paying more tariffs than other customers not covered by a franchise arrangement.

3. Implications of the Consultation Paper on the NESI

i. Sale of Stranded Power:

The Generation Companies have accused the Discos of rejecting power supplied to the Discos as result of the Discos not having adequate evacuation infrastructure. This has led to the grid having excess stranded power and as a result, inefficient collection and loss of tariffs across the power sector value chain.

With the Consultation Paper, NERC is seeking to bridge the gap between the Discos and the consumers by ensuring that the latter is provided with improved access to electricity and eventual purchase of such stranded generation capacities.

ii. Improved Generation Capacity

The Consultation Paper seeks to increase the generation capacity of the country by encouraging distribution franchisees to also sell generation capacity to the Discos. The implication of this is that the Disco will have more power which can be supplied to a larger number of off-takers (provided that the distribution infrastructure is put in place). Additionally, in the event of grid failure/system collapse, the Disco have alternative off-grid sources of power which can be supplied to customers. We envisage that small thermal plants as well as renewable power plants would play a major role in this regard.

iii. Improvement in NESI Liquidity:

The illiquidity issues running across all levels of the NESI are mainly based on collection losses and inadequate remittances from the Discos. It is reported that for the year 2018, the average rate of disco remittance to the Nigerian Bulk Electricity Trading Company stood at 25.5% per cent monthly for power sold to such disco. To the extent that the aim of the Consultation Paper is to improve access to electricity as well improve metering and collections, the franchise arrangement could potentially improve the rate of collections of the Discos. However, the risk of collection and payment would be transferred from the Discos to the distribution franchisee and as such the franchisee would to come up sufficient measures to ensure efficient collection of revenues.

iv. Uncertainty as the role of the Meter Asset Providers and the IEDNs:

The Consultation Paper appears to make redundant, the roles of the Meter Asset Providers and the IEDNs since the distribution franchisees can undertake and perform the obligations of both entities. Justifiable concerns on duplication and redundancy would make investors wary of their investments in those two entities and as such, it will be crucial for NERC to clear outline what the roles of the Distribution Franchisee would be under this framework.

v. Blurred Lines between Generation/Distribution Licences and Franchisees:

The Consultation Paper seems to create an uncertainty regarding the ability of the franchisee to sell and distribute power (above 1mw/100 kw respectively) without the need to obtain a generation or distribution licence (as applicable). It would be essential for NERC to address this point from a regulatory standpoint to avoid any conflicts in this area,

4. Conclusion

Whilst the franchise arrangement seeks to achieve a "Win-Win" situation for the Discos, the Franchisee, the customers and the NESI, it remains to be seen, however, how the industry stakeholders, particularly, Discos and the customers will react to this development. Unarguably, the electricity sector requires more funding and infrastructure, there is some tendency for Discos to treat this development with great suspicion. Additionally, the uncertainties created by the Consultation Paper would also need to be addressed in the regulation to be released by NERC.

This notwithstanding, it is quite commendable that the franchisees are required to have electrical distribution management expertise and the capacity to invest resources into the upgrade as well as expansion of the distribution system. One can only hope the Distribution Franchise Model, if and when allowed to finally come into operation, will be given the right business environment to thrive, without jeopardising the interests of Discos, while taking into account the concerns of all other stakeholders.

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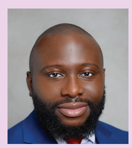

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