



NIGERIAN ELECTRICITY REGULATORY COMMISSION

CONSULTATION PAPER FOR THE REVIEW OF THE TRANSMISSION COMPANY OF NIGERIA (TCN) TARIFF UNDER THE MULTI-YEAR TARIFF ORDER METHDOLOGY FEBRUARY 2015

Background

1. The Nigerian Electricity Regulatory Commission (NERC) is an independent regulatory agency established by the Electric Power Sector Reform Act (EPSRA), 2005.
2. The Act provides the legal and regulatory framework for the electricity supply industry in Nigeria. It empowers the Commission to regulate the electricity sector in the country, including generation, transmission, system operations and distribution and trading.
3. NERC is at the centre of the genuine desire to transform the Nigerian Electricity Supply Industry into a market-based industry in line with the Federal Government's reform agenda for the country's economic, industrial and social development. Thus, the Commission was established by the Electric Power Sector Reform Act, 2005 to facilitate the introduction and management of competitive, safe, reliable and fairly-priced electricity in the country.

4. According to Section 76(1) of the Act, the following activities are subject to tariff regulation:
“(b) Transmission, distribution and system operation, in respect of which licences are required under this Act...”
5. Section 76 (2) provides for the Commission to adopt an appropriate tariff methodology that:
 - a. Allows full recovery of the efficient cost of operating, including a reasonable rate of return;
 - b. Gives incentives to sustain improvement in efficiency and quality;
 - c. Sends efficient signals to customers on costs they impose on the system; and
 - d. Phases out or reduces cross subsidies

The Transmission Tariff

6. The Multi-Year Tariff Order (MYTO) applied the building blocks methodology as a pricing principle in determining the revenue requirement for transmission. The standard building blocks used in this approach are:
 - a. **The allowed return on capital** – being the return necessary to achieve a fair (market based) rate of return on the assets necessarily invested in the business;
 - b. **The allowed return of capital** – associated with recouping the actual capital invested during the useful lives of the assets (depreciation); and
 - c. **Efficient operating costs** and overheads.
7. Vide Paragraph 4.1 of the MYTO Methodology, 2007TCN’s revenue shall incorporate charges for:
 - a. *A charge for new generators that covers the connecting costs to the high voltage network;*
 - b. *The covering of transmission losses at different connection points on the network by generators injecting enough power to cover their contracted amounts plus the associated transmission losses; and*
 - c. *A charge on distributors per unit of energy taken from the high voltage system at the bulk supply points.*

8. In order to calculate a reasonable annual revenue requirement for TCN that covers each of these building blocks, an estimate is required for:
 - a. The initial value of the NESI's capital stock;
 - b. A particular Weighted Average Cost of Capital (WACC) to be achieved each year;
 - c. A capital expenditure program developed from a forecast of feasible growth;
 - d. An appropriate method of depreciation;
 - e. An efficient level of operating expenditure and overheads; and
 - f. A rate of improvement in industry losses.
9. The annual revenue requirement for transmission determined by using the building block approach is then divided by the forecast level of energy transmitted on the TCN network each year to produce a TUOS charge per unit of transmitted energy.
10. The methodology ensures that:
 - a. Ensuring that new loads and generators locate in the most beneficial place by providing mechanisms to ensure that additional costs of transmission arising from their connection are paid by them (generators);
 - b. Supporting the development of transmission augmentations that may be necessary to maintain the performance of the existing system or to meet the needs of new connected parties;
 - c. The level of transmission charges are reflected directly to the need for cost recovery, and
 - d. The impact of the pricing structure on the achievement of the other objectives provides signals for efficient system operation and investment decisions.
11. The overall level of prices should enable the transmission company to recover its costs, but not exploit its monopoly power while providing incentives for improving performance.

The Weighted Average Cost of Capital (WACC)

12. The cost of capital included in the MYTO is intended to provide a return on existing assets and appropriate incentives for future investment. The cost of capital is an important component of the tariff and is included in the annual revenue

requirement calculation as a return on the value of capital invested. The regulated asset value at the start of a given year is calculated by taking the depreciated replacement cost of capital assets at the start of the immediate proceeding twelve months and adding the investments in new capital assets acquired during the same period.

13. The Capital Asset Pricing Model (CAPM) is used to estimate a WACC for the NESI. While this approach gives a method for estimating the average cost of capital in a sector and is widely used by regulators, it requires consideration of volatility of returns in the sector as well as the domestic cost of debt. Even in developed economies the calculation of a WACC frequently requires estimation of a number of the inputs.
14. This is the case in Nigeria and most of the inputs in the WACC calculation are, at this point, NERC estimates. The WACC is set at the level that attracts investment funds to the industry but is not sufficient to produce windfall profits. The CAPM provides estimates of the appropriate return on equity and the returns to equity are measured in relation to the risk premium on the equity market as a whole.
15. The company tax rate used is the statutory corporation rate of 30% plus 2% education tax.

WACC Estimate

16. The following are the main assumptions used in the TCN WACC calculations:

risk free rate	12%
nominal cost of debt	18%
gearing level (debt/equity)	70:30
corporate tax rate	32%

These assumptions provide the following WACC estimates:

Nominal pre-tax WACC	20%
Nominal post- tax WACC	13%
Real pre-tax WACC	11%
Real after tax WACC	7%

Return of Capital (Depreciation)

17. NERC has adopted the optimised depreciated replacement cost (ODRC) method to determine the value of TCN's assets. This value is then used to calculate the depreciation charge in the annual revenue requirement.
18. The depreciation schedule for regulatory purposes would be applied to each group of assets so that, to the maximum extent that is reasonable, it reflects the remaining economic life of the asset or group of assets. In the case of a regulated monopoly, such as the transmission network, technical life will usually approximate economic life as there are no competitive forces that might reduce the economic life of an asset in future. Similarly, the capital expenditure assumed in the tariff calculation has been developed as the appropriate expansion for the sales growth assumed.
19. The depreciation rates applicable to TCN assets are as follows:

Table 1 Depreciation Rates on TCN Regulated Assets

	(Existing) (Initial Capital Base Depreciation Rate)	Rate (New) Assets	Useful Life (years) - Existing	Useful Life (years) - New
Plant & Machinery	5.00%	2.86%	20	35
Land & Buildings	2.50%	2.00%	40	50
Furniture & Fittings	10.00%	10.00%	10	10
Motor Vehicles	20.00%	20.00%	5	5

20. The Commission now seeks comments from the general public to comment on the appropriateness or otherwise of the building blocks methodology used herein in the determination of the transmission tariff.

Transmission Company of Nigeria (TCN) Tariff Application

21. In line with Section 6.3 of the MYTO Methodology, the Transmission Company of Nigeria (TCN) has applied to the NERC to review its tariff up-ward. TCN claims that a number of significant changes have taken place or are expected in 2015/16 since MYTO-2 tariffs were determined 3 years ago. Particularly, TCN claims that:

- a. Existing MYTO 2 tariffs and billing collections are inadequate for TCN to finance its operations;
- b. There is an urgent need to enable TCN to adequately grow the infrastructure in step with expected expansion of generation and load;

- c. There is also an urgent need to maintain and operate the network to higher standards; and
- d. Lack of maintenance of the network over the past two decades has adversely impacted on system reliability and delivery.

22. The principal factors that have been taken into account in this tariff application are summarized below:

- a. Only 58% of needed operating expenses in 2015 is covered by MYTO and this must be increased to bring the system up to standard and maintain it at a higher level;
- b. Higher asset base resulting in higher depreciation on assets in service and an increased need for a return on capital employed arising mainly from:
 - i. The transfer of National Integrated Power Projects (NIPP) transmission assets (said to be valued at US\$ 2.0 billion) in October 2014 (this claim will be verified by NERC);
 - ii. Transfer of transmission assets (US\$ 464 million) recorded in Power Holding Company of Nigeria (PHCN) books;
 - iii. Transfer to TCN of World Bank-funded transmission investments (US\$ 151 million); and
 - iv. Investment in plant using internally generated funds.

23. The major increase in TCN's asset base brings with it an increase in maintenance cost, return on capital and in depreciation expense. Inclusion of these expenses will allow TCN to become self-sufficient and less dependent on grants and FGN financing, which is necessary if grid security/reliability is to be sustained.

24. TCN requests for the review of its cost components in three separate but interdependent departments – Transmission Service Provider (TSP), System Operations (SO) and the Market Operations (MO) in the following areas:

- a. Network/capital expenditure component;
- b. Operation expenditures; and
- c. Transmission losses

Network expansion/Capital expenditure for TSP

25. The TSP is responsible for providing electricity transmission services in a cost effective, efficient and reliable way. It carries out different maintenance activities in addition to planning, designing, procuring and implementing transmission grid expansion programme.

26. In view of the above responsibility, TSP views the following as reasons necessary for the expansion of the transmission network:

- a. The existing transmission system, which is capable of delivering about 7,000MW of generation to the distribution company (Disco) Trading Points, is inadequate to meet expected growth with NIPP and various IPP generation projects coming online;
- b. Nigerian Bulk Electricity Trading Company (NBET's) PPAs with Successor Company Gencos and new IPPs provide for a large amount of new and refurbished generation projects that will be developed in the coming years with the expectation that TSP will expand its network to wheel this new energy to the Discos;
- c. The existing system cannot support the anticipated growth in per capita usage and the expected substantial growth in customers in all classes. If the system is not expanded it will negatively impact the country's potential to increase its GDP;
- d. The system has limited redundancy in its design and experiences an unacceptable number of total system blackouts which impact customers, particularly commercial and industrial users, and is a major reason why Nigeria is a less attractive country to start a new business or expand an existing business, and why many large commercial and industrial users are almost entirely off grid; and
- e. Existing substations and lines are in desperate need of refurbishment, as past funding of TCN's capital requirements has not kept pace with the need for refurbishment.

27. Accordingly, TSP needs to implement an ambitious program of transmission improvements. A major refurbishment program for lines and substations is required in 2015-16 to restore existing facilities to full capability and address reliability issues.

28. In addition, new line and substation projects must be built to increase the loadcarrying capability of the network in line with the expansion of the generation sector. The primary targets are to increase the current capacity of the grid from 7 GW at present to 10 GW by 2017, and to 20 GW by 2020.

29. TCN with the assistance of DFID NIAF (see Audited Report) has conducted extensive planning and engineering studies to develop an optimal expansion plan to meet its targets. During 2015-16, TCN will focus mainly on refurbishing existing facilities to restore the network to its original capacity, finishing projects that are in various stages of construction, and initiating the construction of over 120 new lines and substations to expand the network to a total load carrying capability of 10,000 MW. Projects will be completed in phases according to the schedule shown in Table 2.

Table 2: TSP Targets for Transmission Refurbishment and Target Completion date

S/n	Item	USD Mn	GW Target	In Service
1	Capital Refurbishment	\$947		2015
2	Projects under Construction	\$989	7-8,000	2015
3	Expand to 10 GW; increase reliability	\$2,235	10,000	2017
4	Expand from 10 GW to 13 GW	\$1,570	13,000	2018
5	Expand from 13 GW to 16 GW	\$1,000	16,000	2019
6	Expand from 16 GW to 20 GW	\$1,000	20,000	2020
7	Total: 2014-18	\$7,742		

TSP Capital Budget

30. Table 3 shows the budgeted costs of TSP capital expenditures for 2014 to 2018 by program.

Table 3 TSP capital Budget 2015-19 ("N"Millions)

Capital investments In 2013 US\$ million	Actual 2014	2015	2014	2017	2018	2019	Total
Substation Refurbishment		568	237	47	47	47	947
New Lines and Substations		495	2,059	1,434	1,271	1,086	6,345
Land &		104	104	20	20	20	268

Capital investments In 2013 US\$ million	Actual 2014	2015	2014	2017	2018	2019	Total
Buildings							
Helicopters		37	0	0	0	0	37
Office Tools, Furniture & Equipment		11	12	4	3	3	34
Motor Vehicles		38	13	10	10	10	80
Total Investments		1,254	2,425	1,515	1,351	1,166	7,711
In Nominal NGN millions							
Substation Refurbishment		90,605	39,384	8,231	8,617	9,029	155,866
New lines and substation		79,027	342,671	249,421	231,359	207,071	1,109,549
Land and Building		16,589	17,306	3,478	3,641	3,815	44,830
Helicopters		5,767	0	0	0	0	5,767
Office Tools, Furn&Equipt		1,830	2,064	626	596	617	5,733
Motor Vehicles		6,057	2,188	1,695	1,775	1,860	13,575
Total Investments		199,875	403,613	263,451	245,988	222,392	1,335,320

TSP Operating Expenditure

31. TSP requires an operating budget for payroll, lines and substation maintenance, and other administration overheads. In addition to the above TSP envisaged having a Transformer Reclamation Workshop in the country. Table 4 below shows proposed operating expenditure of TSP.

Table 4 TSP Operating Expenditure 2015-16

Operating Expenditures		2015	2016
1	Payroll, repairs and maintenance lines	11,505	13,178
2	Substation, transformers & switchgear	5,378	6,689
3	Electrical & mechanical equipment	3,820	4,367
4	Communications and SCADA	75	85

5	Line traces & erosion control	1,876	2,257
6	Survey fees & expenses	352	418
7	Helicopter operation & maintenance	136	874
8	All other	425	480
9	Total repairs & overheads	17,403	21,403
10	Administration & overheads	3,308	3,516
11	Milestone Deliverables	616	675
12	Management Fees	555	598
13	Total operating expenses	33,386	39,369

32. Further to the above TSP budget on capital and network expansion, and operating expenditure, the Commission requests comments from industry stakeholders and the general public. Interested parties are to comment or send objections stating in detail their views on TCN's tariff application.

Capital expenditure for System Operations (SO)

33. The SO is saddled with the responsibility of integrating operations of the power system in Nigeria. The main responsibilities of the SO are as follows:

- Monitor systems parameters and security;
- Ensure integrated operation of the power system to deliver quality uninterrupted power;
- Facilitate merit order dispatch;
- Facilitate the operation of the power market through bilateral exchange;
- Undertake power system studies, comprehensive system planning and contingency analysis;
- Augmentation of telemetry, computing and communication facilities.

34. In carrying out the above functions, the SO has proposed the following capital expenditures shown in the table below:

Table 5 SO Capital Investment Plan 2014-18 (US\$Millions)

Capital investments	Actual 2014	2015	2016	2017	2018	2019	Total
SCADA restoration & expansion		0	34	0	0	0	34

Capital investments	Actual 2014	2015	2016	2017	2018	2019	Total
Telecommunications improvement		26	0	0	0	0	26
Other plants & machinery		0	0	6	6	6	18
Land & Buildings		0	40	0	0	0	40
Office Tools, furn. & Equip		3.4	2.0	0.6	0.6	0.6	7.2
Motor Vehicles		1.1	1.5	1.9	2.3	2.7	9.5
Total investments		30	76	7	7	7	127
In Nominal NGN millions							
SCADA restoration & expansion		0	5,603	0	0	0	5,603
Telecommunication improvement		4,181	0	0	0	0	4,181
Other plant & machinery		0	0	1,043	1,092	1,144	3,279
Land & Building		0	6,656	0	0	0	6,656
Office Tools, furniture & equipment		543	338	106	104	109	1200
Motor vehicles		175	250	330	419	515	1689
Total investments		4,899	12,847	1,479	1,615	1,768	22,608

SO Operating Expenditures 2015-16

35. Table 6 shows the SO operating expenditures by major cost item. Budgets for Office Tools, Furniture & Equipment and Motor Vehicles are developed using bottom-up method for 2015-16.

Table 6: SO Operating Expenditures 2015-16

Operating Expenses	Actual 2014	2015	2016
In Nominal NGN million			
Payroll, Repairs & maintenance		7, 161	10,650
Communication & SCADA		3,363	3,598
All others		259	292
Total repairs & maintenance		3,622	3,890
Administration & overheads		1,748	1,910
Milestone Deliverance		432	474
Management fees		389	420
Total operating expenses		13,352	17,344

36. In furtherance to the above SO proposed capital and operational expenditures, the Commission requests comments from industry stakeholders and the general public. Interested parties are to comment or send objections indicating detail position on the budget application.

MO Capital Budget

37. The Market Operator is the Nigerian electricity market administrator designated for the implementation of the Market Rules. The MO has been administering the Pre-Transitional Stage of the market since the formal inception of the organized electricity market in 2004.

38. The functions of the MO according to the Market Rules are as follows:

- a. Implement the Market Rules and draft and implement any and all requisite Market Procedures;
- b. Review the efficiency and adequacy of Market Rules and Market Procedures and propose such amendments as may be required to ensure their efficacy and adequacy;
- c. Admit and register Participants;
- d. Organise and maintain a Participants' Register;
- e. Centralise the information required for market administration, and organise and maintain the related data bases;
- f. Verify that each Connection Point where a Participant injects or extracts Energy has proper commercial metering related to physical exchange of Energy and other necessary commercial transactions;
- g. Calculate and recover Ancillary Service and Must Run Generation costs, when necessary;
- h. Centralise and process commercial metering data;
- i. Administer the Wholesale Electricity Market settlement process and Wholesale Electricity Market payment system; and
- j. Settle payments in respect of Ancillary Services and other costs.

39. The Market Rules require the MO to operate in a manner that guarantees efficiency, transparency and non-discriminatory market administration service to all participants.

40. The MO has proposed a budget for 2014 – 2015 to address the following:

- a. Improve telecommunications and website interface to automate and streamline business processes for meter data collection and settlements;

- b. Improve ICT in line with corporate governing structure, ICT policy and standards document to cover ICT operations across the enterprise network;
- c. Establish internal controls and security for market sensitive data;
- d. Create a special fit-for-purpose server room in a restricted part of the building with security arrangements, centralize server resources across the various sections and improve authentication for users;
- e. Fully implement AMR as the primary system for collecting grid meter data and feeding the data to the settlement system;
- f. Install redundant AMR (hub – ACTARIS System) to address risk of unplanned AMR hub outage;
- g. Create private built-for-purpose web portal for all energy data from the System Operator and all market data supplied to Market Participants;
- h. Hosted e-discovery services should be procured as part of the hosted e-mail service contact.

Table 7: MO capital budget 2015-16 (US\$Millions)

Capital investments	Actual 2014	2015	2016	2017	2018	2019	Total
Office tools, furn. & Equip		1.5	11.6	0.9	0.5	0.5	15
Motor vehicles		0.7	0.7	0.7	0.7	0.7	3.5
Total		2.2	12.3	1.6	1.2	1.2	18.5
In Nominal NGN millions							
Office tools, Furn. & Equip		239	1,982	151	97	101	2,570
Motor vehicles		111	116	121	127	133	608
Total investments		350	2,098	272	224	234	3,178

Table 8: MO Operating Expenditures 2015-16 ("N"Millions)

Operating Expenditures	Actual 2014	2015	2016
Payroll		461	593
Repairs & maintenance		21	24
Administration & overhead		315	369
Milestone Deliverables		32	36
Management fees		29	31
Total		858	1,053

41. In view of the MO proposed budget expenditure the Commission requests the general public and interested parties to comment on the above request by TCN.

42. The general public should also note that the Commission will, in accordance with EPSRA, in 2015 issue regulatory orders for the integration of SO and MO into the Independent System Operations (ISO). We observe, however, that there is no integration budget shown here, creating room to question TCN's preparedness for this next stage in TCN's evolution. It is therefore incumbent on TCN to provide a comprehensive plan and budget for the ISO before its tariff application is finalised.

Transmission Losses

43. The 2012 Tariff Order provides that, the marginal loss factor (MLFs) within the TCN network will be a uniform 0.915, reflecting the average technical losses on the system estimated at 8.05%. The Commission notes that during the past year, TCN has taken action and successfully brought transmission losses to 8%. In keeping with its recent decision to include "losses" as a Minor Review factor, the Commission hereby puts forward a proposal to establish TCN's loss reduction starting baseline at 8% as of 30th June 2015.

44. The Commission further proposes that TCN's allowable transmission loss will subsequently be reduced in the MYTO model by half a percent (0.5%) annually until 30th June 2017. Thereafter, TCN's allowable transmission loss will be reduced by 1% from 30th June 2017 until 30th June 2020 when losses are expected to be at 3.5%. At that time, the Commission will consider setting new standards for TCN loss reduction.

45. Table 9 shows baseline losses for year 2014 and TCN's proposed allowable losses for 2015 and 2016, which are to be used for setting future year tariff levels. Allowable loss factors are determined using a two-step process: 1) determine the baseline losses with reference to historic data, and 2) adjust for future efficiency improvements mandated by NERC.

46. However, the TCN has estimated the level of losses as shown in Table 9 segregated into three levels – technical, commercial and metering losses. According to TCN these losses arise due to the following factors:

- a. Technical Losses are caused by consumption of energy that is dissipated as heat in transformers and lines when electricity is wheeled through the system.
 - b. Commercial Losses occur when there is unauthorised consumption of electricity at the transmission level, including theft by direct serve customers and unauthorized connections to substations.
 - c. Metering Losses are caused by over-billing by generators for energy sent out at the generation trading points and under-billing of Discos for bulk supply delivered to the distribution trading points. Such losses are incurred when the billed quantities shown in market invoices are over-stated (in the case of generators) or under-stated (in the case of Discos), in comparison to the actual quantities delivered or consumed.
47. For tariff calculations, TCN proposes that NERC establish allowable loss factors for each component of losses (technical, commercial and metering) to determine the allowable aggregate losses that are charged to market participants. Allowable technical and commercial losses are proposed be charged to the Discos. Allowable metering losses are proposed to be charged to the market participant that is responsible for such losses.
48. Generators are therefore responsible for metering losses when they over-report quantities delivered at the trading points, and Discos will be held responsible when they under-report quantities measured at the trading points. The onus for such billing errors must be on the market participant, not the Market Operator, as the relevant participant owns the trading point meters and ultimately has the duty to correct quantities shown on the market invoices issued by the MO if such quantities are incorrect.

Table 9:Transmission losses 2015-16

Category	Baseline for 2014	Proposed Allowable for 2015	Proposed Allowable for 2016
Technical Losses	7.00%	6.75%	6.50%
Commercial Losses	0.30%	0.25%	0.20%
Metering Losses	4.84%	0.25%	4.30%
Aggregate	12.14%	7.25%	11.00%

Losses			

49. Stakeholders are now called upon to consider whether the Commission should consider transmission losses in the manner proposed by TCN hereinabove or maintain the status quo. A third option is as proposed by the Commission in paragraphs 43 and 44 above. All three options are put forward for consideration and comment by stakeholders.

50. This consultation paper aims at reviewing the TCN tariff for the year 2014 to 2015 to enable TCN be able to meet its responsibilities in transmitting electricity across the country without any constraints or impediments. As the Transitional Electricity Market (TEM) comes into effect, it is expected that TCN must acquire the necessary capacity and capability in terms of human and material resource to meet the enormous challenges associated with the new electricity market.

Conclusion

51. Accordingly, the Commission now undertakes this review of the TCN tariff application in line with extant tariff regulations and wishes to draw the attention of the general public to the said application by TCN, more particularly detailed in TCN's formal application and its various supporting documents, which are all to be found at the Commission's website at [www.nercng.org/...](http://www.nercng.org/)

52. Industry stakeholders, consumer groups, other parties interested and the general public are kindly requested to comment on the following:

- a. The appropriateness of using the building blocks methodology for the TCN tariff;
- b. The expansion plan proposed by the TCN;
- c. The capital budget proposed;
- d. The operating expense proposed and;
- e. The level of losses proposed by the TCN.

53. Reactions may propose either a modification or an alternative to the proposals, assumptions and expectations expressed by TCN and the Commission. for the

consideration of the Commission. All reactions, comments, queries and further enquiries should be sent for consideration by the Commission to:

info@nercng.org

with copies to

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Next Steps

54. This Consultation paper will be published on the Commission's website, www.nercng.org for xx weeks from this date. Thereafter, a public consultation will be held in April 2015 at which reactions to TCN's tariff application may be formally presented, questions made from TCN and Commission representatives who will be present and comments fielded.

55. All reactions and output from the public consultation will be considered by the Commission. This tariff-setting process will culminate with the Commission making relevant orders setting tariffs for TCN and providing for related or ancillary matters. These orders will be published to take effect from 1st July 2015.

DATED AT ABUJA THIS 16TH DAY OF FEBRUARY 2015

DR. SAM AMADI

CHAIRMAN/CEO