



## NIGERIAN ELECTRICITY REGULATORY COMMISSION

### CONSULTATION PAPER FOR THE REVIEW OF MYTO METHODOLOGY

MAY, 2017

#### 1.0 Introduction

##### 1.1 Purpose:

This document sets out, for consultation, proposed changes to the Multi Year Tariff Order (MYTO) Methodology with a view to incentivizing the Transmission Company of Nigeria (TCN) and the Distribution companies (Discos) to deliver safe, reliable and sustainable electricity services to consumers; enabling them to finance required investment in a timely and efficient manner; and put in place mechanisms to reward/penalize them according to their performance.

1.2. This proposal is the second in the series of amendment(s) to the MYTO Methodology and will be considered in line with the provision of Section 76(2) of the EPSR Act 2005 which states that the methodologies adopted by the Commission to regulate tariff shall:

- a. Allow a licensee that operates efficiently to recover the full cost of its business activities, including a reasonable return on the capital invested in the business;
- b. Provides incentives for the continued improvement of the technical and economic efficiency with which the services are provided;
- c. Provide incentives for tire continued improvement of quality of service;
- d. Give to consumers economically efficient signals regarding the costs that their consumption imposes on the licensee's business;
- e. Avoid undue discrimination between consumers and consumer categories; and
- f. Phase out or substantially reduce cross subsidies.

- 1.3. In particular, we are setting out here for consultation the following proposed changes:
- a. Reduction in the time period for conducting minor reviews to update tariffs from every six month (semi-annually) to monthly or quarterly;
  - b. Reviewing the frequency of updating end-user tariffs with the minor review results as well as accounting for over/under recoveries recorded between minor reviews from semi-annually to monthly, quarterly or annually;
  - c. Make provision to include Revenue Decoupling Mechanism in the form of annual energy adjustment clause to track variances between actual and allowed revenues and make periodic true ups annually or more frequently (semi-annually, quarterly, monthly). Customers/utilities (TCN & Discos) will be compensated for net changes in actual generation capacity in relation assumed projections.
- 1.4. The Commission will take into consideration responses to this document and other issues that may be raised through wider stakeholder consultation workshops before setting out the Commission's final decision on these issues.

## 2.0 **Legal Authority**

- 2.1. The Nigerian Electricity Regulatory Commission (NERC) is an independent regulatory Commission established by the Electric Power Sector Reform Act (2005) with a clear mandate to regulate all aspects of the electricity business in the country. Its principal functions, amongst others, include:
- a. To create, promote and preserve efficient industry and market structures and to ensure optimal utilization of resources for the provision of electricity services
  - b. To ensure that prices charged by licensees are fair to consumers and are sufficient to allow the licensees to finance their activities and to allow for reasonable earnings for efficient operations.
  - c. To ensure that regulation is fair and balanced for licensees, consumers, investors and other stakeholders.
- 2.2. Section 76(1) of EPSRA subjects the following activities to tariff regulation:

- a. Generation and trading, in respect of which licenses are required pursuant to this Act, and where NERC considers regulation of prices necessary to prevent abuse of market power; and
  - b. Transmission, distribution and system operation, in respect of which licenses are required under this Act.
- 2.3. Section 76(2) of the EPSR Act (2005) stipulates that electricity tariffs shall be regulated according to one or more methodologies adopted by the Commission.
- 2.4. Specifically, Section 76(9) provides that if it appears to the Commission that a tariff methodology should be changed, the Commission shall give notice in the official Gazette, and in one or more newspapers with wide circulation of the proposal to change the methodology, indicating the period within which representation in respect of the proposal may be made.
- 2.5. In the same vein, Section 76(10) provides that in changing the methodology, the Commission may, after taking into account any objection or representations received in response to the notice issued under Section 76(9), confirm the proposed changes to the tariff methodology;
- 2.6. In addition, by virtue of Section 76(11), every person upon whom any function has been conferred or imposed in connection with setting tariffs, shall be bound by a tariff methodology that has come into operation.

### 3.0 **Context**

- 3.1. Following the procedures set out in Section 76 of the EPSR Act 2005, NERC in 2008 established the Multi-Year Tariff Order (MYTO) as the framework for determining the industry pricing structure with a view to delivering a viable and robust tariff policy for the Nigerian Electricity Supply Industry (NESI). The MYTO methodology provides a 15 year tariff path with major reviews every five years, and minor reviews annually to consider changes in the following parameters:
- a. Inflation;
  - b. Exchange rate; and
  - c. Gas price.

- 3.2. The building blocks methodology was used by the Commission to determine the MYTO tariff path. This is a hybrid between a rate of return and a price cap regulation. The regulated utilities have an incentive to do better than the performance levels built into the tariff path as the price formula applied in-between regulatory reviews allows them to keep the benefits of efficiencies they achieve (until the next regulatory review).
- 3.3. Not long after the commencement of the MYTO implementation, stakeholders expressed concerns with certain provisions of the Order. In particular their concerns were majorly with the following:
- a. The significant delay (one year) in aligning tariffs with prevailing costs which impacts negatively on the business operations of the utility, especially taking into consideration the volatility of macroeconomic indices in Nigeria;
  - b. Difficulties in forecasting expected generation capacity with the desired precision which poses significant risk on Discos' and TCN's ability to recover their allowed revenue requirements.
- 3.3.1 As part of the consultations made during the development of MYTO-2.0 Tariffs that preceded the privatization transaction, therefore, NERC in line with the provisions Section 76(9-11) of the EPSR act 2005 amended the MYTO-Methodology in 2012 to:
- a. Introduce flexibility in the methodology for determining wholesale generation prices;
  - b. Reduce the period for conducting Minor Reviews from annually to semiannually;
  - c. Include the following variables as part of the parameters to be considered in updating the tariffs semiannually;
    - i. System planning output generated by TCN;
    - ii. Available generation capacity; and
    - iii. CAPEX requirement required to evacuate to evacuate and distribute the said available generation capacity.
- 3.3.2. Despite the 2012 amendment, industry stakeholders, especially the licensed utilities and financiers (local and international) continued to express their concerns on the Minor Review framework as it relates to cost reflectivity of tariffs and cash-flow profile of the industry.
- 3.3.3. Since the commencement of the Transitional Electricity Market (TEM) in February 2015 and corresponding application of contract terms in market

settlement/invoicing in the NESI, these concerns have become more pronounced. Particularly, Discos are concerned that the Power Purchase Agreements (PPAs) they executed provides for a monthly indexation formula where the monthly changes in the exchange rates are reflected in the energy invoices issued to them. This is quite different from the provisions of the MYTO Methodology where indexation is applied semiannually during the Minor Review process. This disparity has created undue stress in the sector given the contract provision that Discos are expected to settle 100% of their energy invoices without consideration to the time lag in the adjustment of end user tariffs.

3.3.4 Similarly, in the course of consultations made during the extraordinary tariff review that resulted in MYTO-2015 Tariff Order, TCN argued that an annual energy adjustment mechanism needs to be put in place if transmission tariffs continue to be linked to energy throughput. Any under or over recovery of TCN's fixed costs (basically all of TCN's revenue requirements) arising as a result of variances between estimated and actual wheeled energy should be accounted for in the subsequent year's tariff setting as a Rate Rider during Minor Reviews. TCN further posited that the current volumetric approach used for transmission cost recovery in Nigeria is inequitable and unsustainable, especially in the current environment in which the quantum of energy wheeled is unpredictable and has persistently underperformed relative to expectations.

3.3.5 It is imperative to note that the vulnerabilities adduced by TCN on the linkage of tariffs with energy throughput equally apply to the Discos. In consideration of these concerns, NERC included a provision for True-ups/down to account for efficient over or under recoveries connected with energy throughput in the MYTO-2015 tariff orders of the TCN and the Discos. The provision also penalizes Discos if they fail to take supply from the grid for any reason other than SO's instruction. Likewise, TCN will be penalized by way of making imbalance payment to Discos where TCN is unable to deliver allocated energy to Disco as a result of grid limitation.

#### **4.0 Proposed Changes**

Based on the above, NERC poses the following three (3) questions for general public's response:

#### **4.1.0 Question 1:**

**Should Minor Reviews be conducted monthly or quarterly as against the current practice of semiannual reviews, with a view to reducing the time lag in reflecting PPAs and other tariff/cost assumptions which adjust monthly?**

#### **4.1.1 Merits of Reducing Time Lag between Minor Reviews:**

- a. It immediately provides a credible basis for the recognition of regulatory assets/liabilities where there is a lag before retail tariffs are adjusted;
- b. It provides incentives for continued improvement in services even where the results of the review are not immediately reflected in end-user tariffs;
- c. It provides a basis to secure finance to deliver on expected services given the formal recognition of the real trajectory of tariffs by the regulator;
- d. May deliver stable prices to consumers where end-user tariffs are not expected to change immediately.

#### **4.1.2 Demerits of Reducing Time Lag between Minor Reviews:**

- a. Consumers may not be fully aware of the costs they impose on the licensee's business where end-user tariffs are not adjusted immediately;
- b. May lessen utilities' incentive to manage risks associated with macroeconomic changes in the economy;
- c. May deliver higher tariffs to consumers in the long run resulting from associated finance costs where retail tariffs are not adjusted immediately;
- d. May demand additional resources on both the regulator and the utilities.

#### **4.2.0 Question 2:**

**Should the frequency of updating end-user tariffs with the minor review results as well as accounting for over/under recoveries recorded between minor reviews be reviewed from semiannually to monthly, quarterly or annually?**

#### **4.2.1 Merits of Frequent Update of End-User Tariffs**

- a. It allows operators recover their full efficient cost almost immediately without pushing it to a future date;
- b. Improves the liquidity position of utilities;
- c. Reduces incidence of rate shock and guarantees lower cost of electricity services to consumers over the long term due to low impact of finance costs;
- d. Better appreciation of efficiency gains by consumers due to positive correlation of loss reduction efforts with nominal end-user tariffs;

- e. Gives to customers economically efficient signals regarding the costs that their consumption imposes on the licensee's business;
- f. Provides incentives for the continued improvement on service delivery.

#### **4.2.2 Demerits of Frequent Update of End-User Tariffs**

- a. Consumers may not be receptive to the idea of their bills being reviewed frequently on a monthly or quarterly basis;
- b. Electricity consumers will immediately bear the full brunt of risks associated with macroeconomic changes in the economy;
- c. There are arguments that a reduced regulatory lag may diminish utility's incentive to control costs.
- d. Consumer education on operating tariffs may be compromised;
- e. Susceptible to more disputes.
- f. May demand additional resources from both the regulator and the utilities.

#### **4.3.0 Question 3:**

**Should provision be made to include Revenue Decoupling Mechanism in the form of annual energy adjustment clause to track variances between actual and allowed revenues and make periodic true ups annually or more frequently (semi-annually, quarterly, or monthly)?**

#### **4.3.1 Merits of Revenue Decoupling**

- a. Decoupling is one way to provide revenue stability for the utility, without introducing rate design elements such as high fixed monthly charges, in the form of a Straight Fixed/Variable rate design, that remove the appropriate price signals to consumers;
- b. Provides stability of bills to consumers where reviews are conducted less frequently (e.g. annually);
- c. Decoupling reduces the frequency of general rate cases and can significantly reduce regulatory costs;

#### **4.3.2 Demerits of Revenue Decoupling**

- a. Revenue decoupling tends to shift full risks associated with volumetric energy throughput to consumers where necessary safeguards are not provided;

- b. May reward utilities inefficiencies where transmission and distribution companies are not penalized for constrained energy resulting from their lapses;
- c. Decoupling may give rise to inter-generation inequity especially when applied on a medium to long-term (more than one year) basis.

## **5.0 Response to consultation**

- 5.1 NERC has prepared this document in order to facilitate as open consultation as possible and has provided the merits and demerits of the proposed changes as well as the potential impact of the changes on the retail tariff. At the same time we have provided the Government policy on tackling the impact of a retail tariff hike. Accordingly, in line with the provisions of Section 76(9) of the EPSR 2005, the Commission fixes 30 days from the publication of this notice for comments, objections and representations on the tariff methodology from all stakeholders and the general public.
- 5.2 Respondents may propose either a modification or an alternative to the proposals, assumptions and expectations expressed by NERC for further consideration by the Commission. A Public hearing on the proposed review will be held at the expiration of the response period.
- 5.3 At the end of the consultation process, the Commission's decision on the proposed amendments to the MYTO-Methodology will be issued in an Official Gazette and shall fix the date on which the amended methodology shall come into operation in accordance with the provisions of Section 76(8) and (10) of the EPSR Act 2005.
- 5.4 All reactions, comments, queries and further enquiries should be sent for consideration by the Commission to [info@nerc.gov.ng](mailto:info@nerc.gov.ng) with copies to:

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**Next Steps**

This Consultation paper will be published on the Commission's website, [www.nerc.gov.ng](http://www.nerc.gov.ng) for 4 weeks from this date. Thereafter, a public consultation will be held in June 2017 at which reactions to changes to the MYTO methodology may be formally presented.

All reactions and output from the public consultation will be considered by the Commission. This tariff-setting process will culminate with the Commission coming up with a revised MYTO Methodology for the sector. This methodology will be published at a later date.

DATED AT ABUJA THIS 30<sup>TH</sup> DAY OF MAY 2017

**Sanusi Garba**  
**VICE CHAIRMAN**