NIGERIAN ELECTRICITY REGULATORY COMMISSION

CONSULTATION PAPER ON COMPETITION TRANSITION CHARGE

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Background

1. BACKGROUND

The Nigerian Electricity Regulatory Commission (NERC) issued the Eligible Customer (ECs) Regulations in November 2017 to govern the procedures for the supply of electric power to ECs pursuant to the Ministerial directives specifying the type of customers that shall constitute ECs. The Ministerial directive was made in compliance with the provisions of section 27 of the Electric Power Sector Reform (EPSR) Act 2005.

It is noteworthy that section 28 of the EPSR Act and the Regulations provides for a Competition Transition Charge (CTC) as one of the charges payable by an EC in compliance. Section 28 of the EPSR Act 2005 provides that "If the Minister determines, following consultation with the President, that a directive under section 27 will result in decreasing electricity prices to such an extent that a trading licensee or a distribution licensee would have inadequate revenue to enable payment for its committed expenditures or is unable to earn permitted rates of return on its assets, despite efficient management, the Minister may issue further directives to the Commission on the collection of a competition transition charges from consumers and Eligible Customers, the distribution of the funds collected to the trading licensee described in section 25 (a) and to the distribution licensees; and the duration of the competition transition charge." However, the decision is subject to public consultation by the Commission.

The CTC is the amount a Distribution Network Operator (DisCo) is entitled to collect outside its normal tariff to cater for loss of revenue or its inability to earn permitted rates of return on its assets arising from the exit of an EC from its network.

The EC Regulation has opened the Nigerian Electricity Market (NEM) to another phase of competition which will ultimately lead to full retail competition and full customer choice. Major issues arising from the introduction of retail competition, however, are the concerns related to "stranded costs" incurred in providing services to customers exiting the DisCo network and how to compensate utility in line with the provisions of the EPSR Act.

Stranded costs largely refer to investments in infrastructure by network operators that may not be recovered within the earlier projected life span of the financed assets arising from the transition from the traditional regulatory model being operated since the enactment of the EPSR Act in 2005 and the recent introduction of competition which now provides a window for Eligible Customers to switch supply from the DisCos to trading and generation license holders. Other stranded costs may include:

(i) Long Term contractual commitments such as Power Purchase Agreement (PPA) and Vesting Contract (VC),
(ii) Deferred expenses such as the amortization of Nigerian Electricity Market Stabilisation Fund (NEMSF)
(iii) Cross subsidy currently provided by the potential Eligible Customers to the market; and
(iv) Overhead transition costs.

2. OBJECTIVES OF THE DOCUMENT

Pursuant to the provisions of the EPSR Act, the Minister of Power had issued a directive to the Commission for the collection of a Competition Transition Charge (CTC) from Eligible Customers and the Commission is required to, under the provisions of the said Act, to determine the amount of CTC and the arrangement for its collection and distribution following a consultative rulemaking process. The Commission has developed this Consultation Paper with a view to seeking inputs from all stakeholders notably the potential ECs, DisCos, other network operators, generators, trading licensees, government and electricity customers. The introduction of competition into the industry will impact all the network operators (DisCos and Transmission Service Provider) as well as retail customers.

3. RATIONALE & OBJECTIVES OF COMPETITION TRANSITION CHARGE

With the issuance of the Eligible Customer Regulations by the Commission, a number of DisCo customers have indicated interest in acquiring Eligibility status thereby exiting the contract for supply from a DisCo in preference for a bilateral contract for supply of energy with a licensed generator or a trading licensee.

Section 76(1a) of the EPSR Act provides that utilities shall be given the opportunity to recover its efficient operating costs and a reasonable return on investment. The argument for CTC is on account of the possible inability of the DisCo, where justifiable, to earn its allowed return on capital on the assets it invested in the business, its allowed return of capital (depreciation) that would enable it recover the capital cost over the useful life of the assets and its efficient operating costs and overheads.

As a transitional mechanism, the CTC has been provided under the EPSR Act to allow the DisCos recover the loss of allowed revenue arising from the exit of EC from their network. These costs consist of stranded assets and liabilities that adversely impact on ability to recover approved revenue requirement. The Regulator has in conformity with regulatory compact provides the network operators with a tariff order designed to cover their prudent cost of doing business as well as a reasonable return on investment. The act of switching a

supplier by an EC is likely to leave a network operator with revenue deficit arising from assets may not be put in use and thus be stranded and liabilities that may not be recovered within the tariff cycle. It, therefore, becomes imperative for the utility to be compensated for these loss of revenue so as to enable it sustain efficient service delivery and provide for growth and new investment.

The aforementioned costs are not a permanent feature of the market but have arisen from the decision and choices made by customers. As the market continues to transit towards full retail competition, the regulator is required to ensure that the DisCos continue to maintain the opportunity to recover their allowed, efficient, verifiable and prudent costs. This is in consideration of the fact that the utility may have, prior to the commencement of the EC Regulation, made investments towards ensuring that the potential ECs in their franchise area were adequately served.

Under the proposed guidelines for CTC, the prospective Eligible Customer shall, upon exit, pay a compensation fee to cover the loss of revenue associated with delivering its previous energy consumption threshold under the previous service agreement with the DisCo that becomes undeliverable as a result of the switching of a supplier. However, the fee chargeable shall be subject to a verifiable proof of the DisCo's inability to get off taker(s) of a commercially comparable tariff class for the stranded power. However, aside energy that may be stranded there are other costs arising from investments in assets and liabilities which may result in the utility losing revenue and failing to recover its allowed revenue requirement. Furthermore, assets such as distribution and or transmission network that becomes stranded are further expected to be considered for compensation where it is demonstrated that the switching of supply has rendered the infrastructure stranded. The Commission further considers that deferred liabilities that the exiting eligible customer may have contributed to settlement over a period of time (for example settlement of NEMSF) through rates may be considered in filing a case for loss of revenue by the DisCo. The objective of the CTC may, therefore, be said to be designed to ensure that the introduction of the E.C regulation has not adversely impacted negatively on an efficiently operated Distribution Licensee's ability to generate adequate revenue to enable payment of their committed expenditure and also earn permitted rates of return.

4. DETERMINATION OF CTC.

The Commission is proposing that CTC should be computed based on the stranded costs attributable to EC's exit by unbundling the DisCo's costs and determining the actual revenue loss per each cost item. The major cost items under consideration are listed hereunder:

4.1 Cost associated with long term Power Purchase Agreements & Vesting Contract (VC) commitments:

Given the Universal Service Obligation (USO) placed on utilities through the regulatory compact, DisCos are required to procure and maintain sufficient capacity reserves to reliably meet current and forecasted customer energy demands. In this regard, the electricity distribution companies, with the approval of the industry regulator, have entered into a number of long-term Power Purchase Agreements (PPAs) with generation licensees and/or Vesting Contract commitments with the Nigeria Bulk Electricity Trading Plc for the purpose of serving customer needs under which parties have performance obligations under the contract. Noting that both the PPAs and VCs provide for "Take or Pay" contractual obligations for the off-take and payment of specified quantity of energy and capacity at specific prices, if a sizeable capacity of these Discos' energy contracted becomes stranded arising from exit of ECs from their network, the utility is likely to be exposed to liabilities (at least in the interim) on availability payments resulting from reduced volumes of energy sales than was procured by the DisCo. The current load allocation the DisCos is indicated in Table 1 hereunder.

S/N	DISTRIBUTION COMPANY	LOAD ALLOCATION
1	IKEJA ELECTRICITY DISTRIBUTION COMPANY PLC	15.0%
2	BENIN ELECTRICITY DISTRIBUTION COMPANY PLC	9.0%
3	ENUGU ELECTRICITY DISTRIBUTION COMPANY PLC	9.0%
4	EKO ELECTRICITY DISTRIBUTION COMPANY PLC	11.0%
5	IBADAN ELECTRICITY DISTRIBUTION COMPANY PLC	13.0%
6	ABUJA ELECTRICITY DISTRIBUTION COMPANY PLC	11.5%
7	JOS ELECTRICITY DISTRIBUTION COMPANY PLC	5.5%
8	KADUNA ELECTRICITY DISTRIBUTION COMPANY PLC	8.0%
9	KANO ELECTRICITY DISTRIBUTION COMPANY PLC	8.0%
10	PORT HARCOURT ELECTRICITY DISTRIBUTION COMPANY PLC	6.5%
11	YOLA ELECTRICITY DISTRIBUTION COMPANY PLC	3.5%
	T O T A L	100%

4.2 Regulatory Assets/Tariff Shortfalls:

Regulatory assets are a unique feature of regulated entities. In the electric power industry, a regulatory asset is essentially a promise from a regulatory authority to allow a regulated utility recover in the future a cost it has incurred by charging higher rates than it would otherwise. This concept (regulatory assets) reinforces justification for the regulatory compact that allows utilities and regulators to (somewhat artificially) deliver relatively stable (or lower) electricity prices in exchange for monopoly status, and assured opportunity to earn a fair return on prudent investments. If electricity rates are no longer regulated due to introduction of competition through eligibility or other means, the ability to earn such deferred revenues may be impaired, and the regulatory asset becomes worthless. In the Nigerian Electricity Supply Industry, the DisCos have accumulated substantial tariff shortfalls arising from decisions to sculpt tariff and also artificially freeze tariff with the intention of recovering the deferred revenues later in the future. It is, therefore, opined that ECs who may have benefitted from sculpted and/or frozen tariffs may also bear the cost attributed to the regulatory practice.

4.3 Legacy Costs

Legacy Costs are sector wide or DisCo specific costs that may have been created by virtue of the privatization transaction or the power sector reform agenda initiatives. Such costs were designed to be recovered over a specified period of time and assumptions relating to volume of energy delivery to various customer categories. Some of these legacy costs may include repayment of CBN-Nigerian Electricity Market Stabilization Facility (NEMSF), a NGN213Billion loan provided by the CBN to support the NESI with additional liquidity to settle legacy gas debts and applicable shortfall in revenue requirement arising from parameters in tariff model. Whereby the introduction of an eligible customer transaction distorts the legacy assumptions that underpin the commitments and consequently resulting in lower revenues than projected, an appropriate compensation to the utility may be necessary.

4.4 Unamortized Investments in Networks

A utility makes investments in network infrastructure for the purpose of providing service to consumers with “return on” and “return of” capital provided in the rates paid by consumers. The switching of a supplier by an eligible customer may result in some assets being stranded where such infrastructure provided to serve specific customers may not be easily diverted to serve other customers or salvaged for commensurate value within a reasonable timeframe.

It is hereby proposed that CTC shall include compensation to the utility based on the unamortised values of the stranded assets.

4.5 Overhead Transition Costs

This component of stranded cost is transient in nature. For instance, employee related expenses prompted by restructuring, such as the costs of offering early retirement or job training due to disruptive impact of the evolving Eligible Customer market. Unlike other types of stranded costs, employment costs are not capital costs but changes in utilities' operating costs. Like other stranded costs, however, they may represent payments made because of opening the Distribution segment to more competition. Therefore, provides a basis to seek compensation given its impact on Discos revenues.

4.6 Cross subsidy

This is a cost currently incurred by some classes of customers who by the tariff design of Discos subsidized other DisCo customers. However, with the exit of such customers from a Disco network, a Disco may have to realign its tariff by redesigning it with a view to ensuring recovery of its revenue requirement. As per section 76(f) of the EPSR Act cross subsidies should be phased out or substantially reduced. A gradual phasing out is proposed so as to reduce rate shock and the attendant social consequences. Thus the loss of customers that currently cross subsidized other customers in the network of a DisCo may also be a basis for CTC claim. The payment of CTC based on this consideration should only be for a maximum period of 5 years and on a declining basis after which it is expected that Cross subsidy should be abolished.

QUESTION.

NERC poses the following question for public response:

> **Are there other considerations aside those listed above that should be considered for the determination of stranded cost and subsequent computation of CTC?**

5. FILING OF CLAIMS FOR CTC

The Commission hereby propose the following guidelines for the filing of claims for CTC by distribution licensees.

5.1 Costs associated with PPAs and Vesting Contracts

Filing petition for compensation on this ground must be substantiated with clear basis and detailed analysis as required on the following:

a. Capacities already contracted under all PPAs and Vesting Contracts;
b. Load Demand study and DisCo's expansion plan providing details on:
    i. Network capabilities on serving current peak demand;
    ii. Unserved and underserved capacities limited by DisCo network constraints;
    iii. Unserved and underserved capacities limited by upstream (TCN & generation) constraints;
    iv. 5-10 years' expansion program of the DisCo to meet new and under-served load (demand).
c. Risk allocation principle/obligation applied in the various PPAs and Vesting contracts;
d. Penalties on Availability Events where capacities made available by Gencos and or TCN are not fully evacuated by DisCo;
e. Current and long-run annualized optimized capacity delivered to prospective eligible customers;
f. Estimates of available capacity to be stranded in the event of eligibility status due to inability to divert supply to existing or new customers;
g. Estimates of annualized sum-total of specific penalties on Availability Payments resulting from stranded capacities on account of eligibility status.
h. Estimates on relevant Transition Period, which is the timeframe it will take the DisCo to fully divert the stranded capacities to other customers during the remainder of the PPAs' lifespan;
i. Estimates of N/kWh CTC to be levied on eligible customer over the transition period based on annualized sum-total of specific penalties on Availability Payments resulting from stranded capacities and current/long-run annualized optimized capacity delivered to prospective eligible customers;
j. Estimates of loss of revenue arising from cross subsidies that may be lost due to the exit of the eligible customer

5.2 Regulatory Assets/Tariff Shortfalls:

A DisCo may file claims for CTC for the purpose of recovering accrued regulatory assets and tariff shortfalls attributable to prospective eligible customers. This can be determined by providing the following analysis and justifications in filing necessary claims:

a. Analysis of cost-reflective tariffs versus allowed tariffs by customer classes over the respective period;
b. Analysis of current and long-run annualized optimized capacity delivered to prospective eligible customers;
c. Regulatory asset/tariff shortfall recoverable from eligible customer based on current and long-run annualized optimized capacity in kWh/h;
d. Analysis on impact of cross-subsidies and proposal to spread recovery with other remaining customers;
e. Estimates on relevant Transition Period representing the timeframe required to fully recover the stranded regulatory assets in line with operating tariff order;
f. Estimates of N/kWh CTC to be levied on the eligible customer over the transition period based on annualized sum-total of stranded regulatory assets and tariff shortfall attributable to eligible customers and current/long-run annualized optimized capacity delivered to prospective eligible customers.

5.3 Legacy Costs:

The same principle applicable to stranded regulatory assets shall apply here.

5.4 Unamortised Investments in Network Infrastructure (Stranded Assets):

A distribution licensee seeking for compensation for stranded network assets specifically built to provide service to a prospective eligible customer may be supported with the following documentary evidence:

a. Details on network asset including date of commissioning, cost of funds used in procuring the asset, useful life allowed in tariff computation, book value, any other relevant information;
b. Analysis of salvage value and or cost associated with diverting the assets to other existing or new customers;
c. Analysis of Unamortised stranded cost of network asset to be recovered from the eligible customer;

d. Estimates on relevant Transition Period representing the timeframe required to fully recover the stranded network infrastructure cost in line with operating tariff order;
e. Estimates of N/kWh CTC to be levied on eligible customer over the transition period based on sum-total of stranded network infrastructure cost attributable to eligible customers.

5.5 Overhead Transition Costs:

A distribution licensee filing for CTC compensation for overhead transition costs arising from an eligible customer transaction may be supported with the following documentary evidence:

a. Basis for cost associated with restructuring of business operations including early retirement expenses where applicable due to impact of eligible market;
b. Long-run additional cost of restructuring net of savings from lay-offs not provided in the operating tariff order;
c. Estimates on relevant Transition Period, which is the timeframe it will take the Disco to recover additional overhead restructuring costs associated with the eligible customer market until the next major tariff review;
d. Estimates of N/kWh CTC to be levied on eligible customer over the transition period based on sum-total of additional overhead restructuring costs attributable to eligible customers.

5.6 Cross subsidy

A DisCo may file claim for CTC to cover for loss subsidy provided by an exiting EC to its existing customers by providing the following documentary evidence:

a. Its current tariff design and customer class classification and basis for the Cross subsidy
b. The number of customers in each tariff class as per verified customer enumeration exercise and their average load allocation
c. Analysis of the tariff charged to each customer class, the total projected revenue expected and what was actually collected in the last 3 years.
d. Analysis of the amount of cross subsidy provided by various classes of customers and the amount of subsidy enjoyed by subsidised classes per kWh
e. Analysis of N/kWh CTC to be levied on EC based on the actual average contribution he has been making to the network in the past three years.

6. PROPOSED PROCEDURE FOR OBTAINING AND COLLECTING CTC

a. A distribution licensee files for loss of revenue claim with the commission clearly indicating that despite its efficient management, it will be unable to meet its revenue requirement arising from the exit of an Eligible Customer(s). Such claim should be within a month of receipt of the prospective EC's notice of intention to exit network by the distribution licensee.
b. Commission reviews the claim to determine its veracity and hold consultations on the issue with relevant stakeholders involved in the transaction.
c. If the Disco's claim for loss of revenue is satisfactorily proven, Commission computes the charge and issue an Order for the payment by the EC.
d. The CTC shall be invoiced by the DisCo based on the actual meter reading of energy consumed by the EC.
e. The CTC payable shall vary to the extent of the recovery of stranded costs and deferred liabilities.
f. The EC shall post a Letter of Credit in favour of the distribution licensee covering three (3) months estimated.

7. PARTIES RESPONSIBLE FOR THE PAYMENT OF CTC

The EPSR Act provides that the burden of stranded cost may be allocated to consumers other than the EC for the purpose of collecting CTC. The Commission is however proposing that only the exiting EC should pay the CTC in accordance with costs causation principle of rate design whereby fairness demands that costs are apportioned to causative agents. the Commission expects that the proposed ECs whose departure from the grid may cause revenue shortfalls will be in a better position to cover the market gaps in the short-term pending when some of these costs may be redistributed to consumers in a major review. This is notwithstanding the long run benefit other customers may likely derive from the introduction of competition especially in terms of expected improvement in service quality from the DisCos.

The proposed regulation will ensure that DisCos do not suffer undue revenue gaps as a result of the exit of the Eligible Customers who originally formed part of their initial revenue

requirement determination as operators are expected to remain revenue neutral in the short term pending when all costs are realigned or defrayed.

QUESTION.

NERC poses the following question for public response:

Section 28 of the EPSR Act provides that consumers and ECs bear the burden caused by the exit of ECs by being charged CTC. Who should be the other consumers outside the EC that should be responsible for paying CTC?

8. THE DURATION OF THE COMPETITION TRANSITION CHARGE (CTC) PAYMENT

The Multi Year Tariff Order of 2015 determined the revenue requirements of the DisCos over a ten-year tariff trajectory with recovery through rates from all tariff classes. In the determination of the CTC, the Commission has identified long-term costs such as the legacy liabilities i.e. the CBN/NEMS facility, and costs of regulatory assets including historic market/tariff shortfalls which were market liabilities recoverable from all customers inclusive of prospective Eligible Customers. The Commission is proposing that these costs are recovered over their scheduled tenor while other overhead transition costs which may be short-termed recovered when the tariffs are realigned.

The Commission considers that long and short-termed costs may be settled by the proposed EC in a periodic or lump sum payment by the eligible customer with long-term costs off-set over the life of extant contracts in the market and short term costs realigned as soon as the tariff is reviewed by the Commission.

The Commission has also considered the impact of prospective Eligible Customers as major source of cross subsidy to other customer classes in the various DisCos and is at the same time conscious of the EPSR Act’s provision for phasing out or substantially reducing cross subsidies is therefore proposing that claims under cross subsidy should be phased out within 5 years and DisCos must within that period work towards removing cross subsidy from their tariff design.

QUESTION. **NERC poses the following question for public response:** **Should CTC be a one off charge payable by exiting customers to cover for all the identified stranded costs or should it be tied to the life span of the assets and liabilities?**

9. CTC EXEMPTION

It is proposed that there would be no applicable CTC for an electricity consumer whose power requirement had never been supplied by a DisCo, that is a consumer who has not been connected to the grid prior to his decision to take supply from a licensed generator or trader.

QUESTION. **NERC poses the following question for public response:** **Should a potential EC who chose to set up a captive plant and exit the DisCo network be exempted from defraying the costs and liabilities attributed to him while in the network and the burden thus taken over by other customer or must he like other ECs that exited to licensed traders and generators also bear the costs attributed to him?**