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Grid Decentralisation - Issues Arising

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Background

Decentralisation of the grid has been a topical issue in the country since the signing of the Electricity Act (Amendment) Act (EAAA) into law by the President of the Federal Republic of Nigeria. Commentators had argued that it was inefficient for the country to continue to maintain one central national grid as this was not going to aid the growth and development of the country's power sector. The signing of the EAAA was therefore considered a monumental event in the evolution of Nigeria's power sector.

This has led to clamour for State Governments to introduce a framework for the development of their respective State electricity market in order to attract the investments required to generate and distribute sustainable and reliable electricity within their domain. Several States have engaged consultants to assist them with this process while others are waiting to see the impact before determining how they move forward. The Enugu State Government became one of the first to formally notify the National Electricity Regulatory Commission (NERC) of its intention to take over the regulation of power within its domain, a right, which it now has by virtue of the EAAA. NERC has, as enshrined in the EAAA, affirmed that right, and therefore instructed the Enugu Electricity Distribution Company (EEDC) to incorporate a subsidiary for the purpose of conducting its distribution activities within the State. EEDC currently distributes power to all the 5 South Eastern States and will continue to do so under the terms of its current NERC licence. It is therefore essential that the entity which would be responsible for electricity distribution within Enugu State alone is different from that which has the licence to distribute across the other various States and does not come under the purview of the Enugu State Government. This is to ensure an orderly regulatory environment.

This development has also been greeted with enthusiasm by players in the industry as it heralds the first of many steps required to implement the decentralized grid that has been the clamour of many industry commentators. However, there are other issues that may arise consequently and it is yet unclear how those issues would be resolved. They include:

Source of Power for the Subsidiary

The legacy Distribution Companies (Discos) currently buy power predominantly from the Nigerian Bulk Electricity Trading Company (NBET). This power, which is sourced from the National grid, is transmitted to the various legacy Discos in an agreed proportion based on certain criteria including the size and need of their various franchise areas. The price at which the power is also sold is agreed by NBET and the Discos and approved by NERC. The question now is whether this same arrangement would apply to the subsidiaries created by the Discos in response to States taking regulatory control over their domain. Will the subsidiaries created seek to enter into a direct contracts with NBET or will they be sourcing their power from that sold to their parent company?

Given that the subsidiaries do not currently have a contract with NBET, and are distinct legal entities which cannot draw reliefs from established contracts to which they are not parties, it is likely that they would source their own power from their parent company at the initial stage. This therefore leads to another issue. At what cost will this power be sourced? Will the State Regulatory Commission review and approve that tariff? What methodology would be used in the review and approval of the tariff? It is obvious that long term, a sustainable State electricity market would require the development of generation facilities within the franchise areas but until that is achieved, there may still be a conversation around tariffs.

Transfer Pricing Considerations

Nigeria's Transfer Pricing (TP) Regulations seek to ensure that transactions between related parties are conducted at arm's length. This means that such transactions should be conducted at terms that would apply if both parties were unrelated. This therefore suggest that the parent company would struggle to justify why it is providing power to its subsidiary at the same cost at which it bought the power from NBET. The TP regulations will expect that the power would be sold at a mark-up which may then increase the cost of power for residents in the States where this structure has been adopted. However, given that the tariff would be approved by the State Regulatory Commission, would they be willing to approve a tariff that is higher than what obtains in other States that have not triggered the set up of their own decentralized electricity market?

Transfer of Tax Cost

Another issue is the potential transfer tax cost. There are potential indirect tax implications from the transfer of assets from one entity to another even if they are related parties. These indirect taxes include value added tax (VAT) and capital gains tax (CGT). We do not expect that the subsidiaries set up would be shell companies with only a distribution licence issued by the State in which they are set up. It is expected that the distribution facilities in the States where they are set up would also be transferred to them as these facilities would be under the jurisdiction and regulation of those States. It may be chaotic to retain infrastructure that do not facilitate inter-state supply of electricity in the parent company as that would mean that both the parent and the subsidiary would be subject to local regulatory authority thus defeating the objective of setting up the subsidiary in the first instance.

Nigeria's tax framework allows for transactions like this between related parties to be exempted from any transfer tax provided that the transfer takes place because of an ongoing re-organisation of operations. This activity would qualify as a re-organisation and so should enjoy the exemption. However, the framework only grants the exemption where the subsidiary has been a member of the same group of companies for at least 365 days. This therefore means that any State which attempts to set up its own Regulatory Authority may have to wait 365 days after the NERC directive for the set up of a subsidiary under the terms of the existing licence before they can have a fully functional subsidiary to regulate. Do the Discos and the States have this time or would they rather the Discos bear the brunt of the transfer tax?

Potential Tax Leakage

The Nigerian VAT Act exempts the sale of electricity from generation companies to distribution companies through the National grid and transmission lines from the application of VAT. The Discos though, are obliged to charge VAT to their customers and collect the tax along with the value of the service provided. The VAT Act does not address the situation where supply is between one Disco to another Disco. This therefore suggest that the supply of power from the parent to the subsidiary may be subject to VAT. The VAT paid by the subsidiary to the parent would be an allowable input VAT which can be recovered from that collected from customers, but it is a known fact that collection losses continue to plague the sector. It is conceivable that the value of VAT collected by the subsidiary may be lower than that paid over to the parent as a result of collection losses thus negatively impacting the cash flow position of the subsidiary and probably its ability to continue to invest in the development of its infrastructure.

Conclusion

Decentralisation is necessary to drive the continued growth and development required in the country's power sector. It is however important that we identify all the teething issues which may negatively impact the operationalization of this important policy and attempt to mitigate them. There are options under the existing framework to mitigate against some of these issues while some may require changes to the current framework. Government at all levels must continue to engage with the sector and experts to develop a framework that gives the sector the opportunity to grow and develop.

For further enquiries on the above and information on how KPMG can assist you, please contact:

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