

Power Sector Updates

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Value Added Tax (VAT) and its Impact on Uptake of Renewable Energy Products in Nigeria

The national grid has failed to provide the sustainable and reliable source of electricity supply for domestic and industrial consumers, which is required, to sustain a rapidly growing population and economy. The World Bank reports that though, about 55.4% of Nigeria's population is connected to the energy grid as at 2020, they are typically without power for about 85% of the time and almost nonexistent in certain areas¹. Over the past years, several off-grid power companies have emerged to try and bridge this gap. A number of these entities have typically used renewable energy sources which serves the dual purpose of supplementing the grid shortfall and assisting the country to meet its climate change obligations under the various international agreements. It is therefore important that Government develops policies which support the continued growth of these renewable energy companies (RECs).

Today, the bulk of the market for the RECs are in rural areas where several of them have set up mini-grids or focused the sale of their Solar Home Solutions (SHS). Pricing and affordability, therefore, remains a key issue. One of the key sources of air pollution in urban areas is small fossil generators in use by Small and Medium Scale Enterprises (SMEs). It is important that a pricing model is developed to encourage the transition of these SMEs from the fossil fuel generators to the various solutions provided by the RECs.

It is in view of the above, that the Government moved to exempt the sale of renewable energy equipment from

the application of VAT in the VAT (Modification) Order 2021 ("the Order"). However, the jury is out as to the impact of the exemption on the pricing and affordability of the available solutions.

We have therefore decided to review the concept of VAT, the provisions of the Order, and its potential impact on the various renewable energy solutions on offer by RECs.

The Concept of VAT

VAT is charged and payable at a flat rate of 7.5% on all supplies of goods and services in Nigeria other than those listed as exempt or zero-rated in the First Schedule to the VAT Act. The VAT Act defines *goods* as all forms of tangible properties, moveable or immovable, but does not include land and building, money or securities, and *services* as anything other than goods, or services provided under a contract of employment and includes any intangible or incorporeal (product, asset or property) over which a person has ownership or rights, or from which he derives benefit, and which can be transferred from one person to another, excluding interests in land and building, money or security.

A supply is deemed to take place, under the VAT under the following scenarios:

- i. At the time an invoice or receipt is issued by the supplier, or payment for consideration is due to, or received by the supplier in respect of that supply, whichever comes first;

¹<https://data.worldbank.org/indicator/EG.ELC.ACCS.ZS?locations=NG>

Review of the Various Energy Solutions by RECs and the Potential Impact of the Order on Pricing

We have discussed below, the various solutions/models in use by RECs and the potential impact of the Order on their pricing:

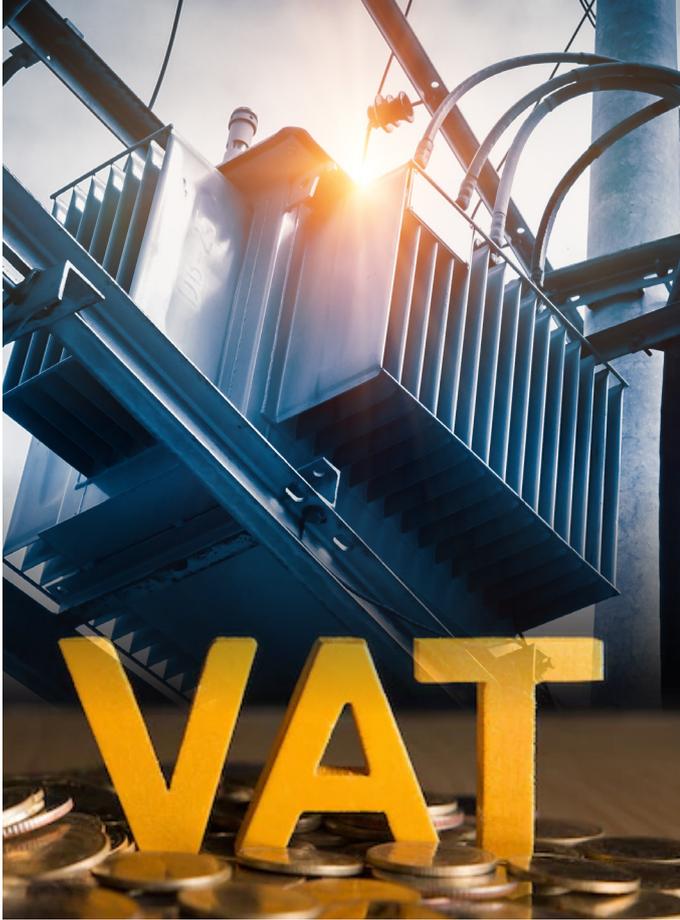
1. *Outright or Cash Sales*: This is the simplest implementation model. Here, the RECs sell equipment to end users. The customers pay in cash for their system, and ownership and risk are transferred immediately. The operation and maintenance of the system also become the responsibility of the customer although the REC may provide any requested maintenance service for a fee. In this model, the sales value of the SHS will be exempt from VAT in line with the Order which may have the potential of reducing the cost by 7.5%. However, the fee charged for maintenance and other services will be subject to VAT.

Only a few customers can afford the outright purchase of the equipment. There is a strong argument that the life cycle cost of these equipment compares favorably to that of any fossil fuel generator, though it is difficult to make this argument where customers can only relate to their immediate cash outflow rather than a life cycle cost. It is, therefore, debatable if the removal of VAT on the sale of the equipment will lead to improved uptake of the product through this means.

2. *Lease to Own Model*: Here, the equipment is provided to the customers under a lease agreement. There is in most cases, an intention to transfer ownership at the end of the lease period. However, financing considerations typically impact the classification of the lease into finance or operational leases. A lot of the RECs obtain funding from lenders who like to retain a lien over the equipment. Consequently, in a number of these cases, the equipment remains in the books of the REC until the customer completes its payment at the end of the lease period.

This therefore causes confusion as to whether this is a hire purchase transaction or purely a rental transaction. The key question has always been whether it is possible to sell a piece of equipment under a hire purchase arrangement whilst retaining the same asset in your books as a fixed asset on which capital allowance is claimed on an annual basis? Yes, the intention is to transfer ownership, but this does not happen until the last instalment of the agreed monthly lease rental is received. So, are the equipment inventory or fixed assets?

The sale of these equipment, whether they are classified as inventory or fixed assets, would be exempt from VAT under the Order, but would the monthly rentals where they are classified as fixed assets be treated as sales proceeds, rather than service fees which do not appear to enjoy the exemption provided under the Order? Given that there is a significant number of RECs which operate this model, it is important that this issue is given adequate consideration otherwise, the



ii. Where goods are supplied under any rental agreement or law which provides for periodic payments, they shall be deemed to be successively supplied for successive parts of the periods of the agreement or as determined by such law, and each of the successive supplies shall be deemed to occur when payment becomes due or is received, whichever is earlier;

iii. Where, and to the extent that, supply of taxable goods and services are progressively or periodically made under any agreement or law which provides for the consideration for that supply to be paid in instalments or periodically and in relation to the progressive or periodic supply, those supplies shall be deemed to be successively made, and each such successive supply shall be deemed to take place whenever any payment becomes due or is received or an invoice relating to only that payment is issued, whichever occurs first;

iv. Where goods are supplied under an instalment credit agreement, that supply shall be deemed to take place at the time the goods are delivered or the time any payment of consideration is received by the supplier in respect of the supply, whichever occurs first.

The Order, which has a commencement date of 30 July 2021, replaces the erstwhile VAT (Modification) Order 2020. It modifies the First Schedule to the VAT Act by expanding the list of exempt goods and services and updated the definition of some terms to ensure consistency with the amendments introduced to the VAT Act by Finance Act, 2020. One of the additions to the list of exempt goods under the Order is renewable energy equipment (REE). Consequently, the supply of REE became an exempt transaction for VAT purposes in Nigeria.

objective of reducing cost and therefore increasing uptake may not be achieved.

3. *Energy-as-a-service (EaaS)*: Here, the REC owns the system, and provides energy as a service to the customer, who pays a connection and periodic fees (e.g., monthly) to the REC or a fee per kWh. The customer is not responsible for the maintenance of the system and never becomes the owner. In the EaaS model, the periodic fees should be liable to VAT as it does not qualify as a sale of REE under the Order. This is also similar to what we have with grid power where power sold by the Distribution Companies (Discos) to final consumers are liable to VAT.

However, this raises the question again of pricing and affordability. Given that a number of mini grids are in under-served or unserved areas which are mostly populated with low income earners, would it make sense to extend the VAT exemption to cover these set of consumers specifically? This is especially because the source of power in a lot of these mini-grids are renewable and sustainable so we are able to achieve the dual goal of extending energy access whilst meeting our climate change obligations.

Conclusion

The objective of improving energy access and meeting our climate change obligations require that we consistently evolve innovative solutions. We need to do things differently to achieve these objectives. Addressing the VAT challenge in the sector is one of the issues we need to resolve to unlock more of the potential in the renewable energy sector. Dealing with the challenges highlighted above is a good way to start. We may not be able to resolve the issue of high cost of equipment as long as we continue to import a significant portion of these equipment, but we can make little changes which helps in addressing the overall cost and improve uptake of these renewable energy solutions as means of improving energy access through sustainable means.



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

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