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The Value Added Tax Challenge in Nigeria's Electricity Industry

– A Review of the Draft VAT (Modification) Order, 2018

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Introduction

Liquidity is arguably the most important issue in Nigeria's fledgling power industry. It is, therefore, no surprise that stakeholders have spent significant amount of time brainstorming on how this issue can be resolved. A number of reasons have been adjudged as responsible for the liquidity challenge, but only rarely is the impact of Value Added Tax (VAT) discussed.

Nigeria's VAT Act provides for input VAT to be recovered against output VAT, only when incurred on stock-in-trade used in the direct production of a new product or on goods purchased for re-sale. A significant percentage of the energy generated in Nigeria today comes from gas-fired power plants whose key stock-in-trade i.e. natural gas, is liable to VAT. Generating Companies (Gencos) should therefore be able to recover the VAT paid to gas suppliers from that collected on energy sold (a new product) to the Distribution Companies (Discos) or to the bulk trader, the Nigeria Bulk Electricity Trading Company (NBET). The Discos should also be able to recover the input VAT paid to the Gencos (or NBET) from that collected from customers. Consequently, VAT should not be an extra burden for the industry as all players are able to transfer that cost to the final consumer (transmission/wheeling charges do not qualify for input VAT recovery). However, this is not the case. Poor collection rate is still a significant issue for Discos that may struggle to recover any VAT paid. This will also have a knock-on effect on the value chain as Discos that have struggled to pay for power taken may not be able to pay any VAT charged by the Gencos; thus limiting the Genco's ability to recover the VAT paid to gas suppliers. This ultimately worsens the liquidity issue.

In June 2018, the Federal Executive Council (FEC) approved two Executive Orders and five Amendment Bills, which seem to address the tax issues in key sectors of the economy. The Minister of Finance stated that this was a show of commitment towards reducing the tax burden and improving the ease of doing business. One of the two Executive Orders[1] was a Value Added Tax Act (Modification) Order, which exempts from VAT, residential property leases or rentals, transport services for use by the general public and life insurance premiums. While this will come as a relief to the real estate, transport and insurance industries, it was surprising that the electricity industry – arguably one of the most important – was left out. This is especially as another draft Executive Order on the modification of VAT, which is expected to resolve the issue, is still yet to be gazetted.

Overview of the Draft VAT (Modification) Order, 2018

KPMG had organized a joint technical session with the Federal Inland Revenue Service (FIRS) in February 2017[2] to review some of the tax issues faced by the industry, including the VAT issue. The discussions at the session led the FIRS to prepare a draft VAT (Modification) Order, 2018 ("The Order") which is expected to address the VAT issue in the electricity industry. The Order provides for the following:

(i) Gas supplied to Gencos will be exempted from the application of VAT.

(ii) Electricity sold by Gencos **and purchased by the NBET** will be exempted from the application of VAT.

(iii) Electricity transmitted by the Transmission Company of Nigeria (TCN) to Distribution Companies (Discos) will be exempted from VAT.

The Order states that the above is meant to ensure that VAT is only collected at a single point – the final customer.

Potential impact of The Order

The Order, when signed, will significantly address the VAT issue in the industry as outlined below:

(i) The cost of gas, including VAT, is factored in determining the current feed-in tariff. Therefore, there should be a positive impact on the tariff. The potential impact may, however, pale in comparison to the negative impact arising from the significant deprecation of the Naira compared to the United States Dollars (USD)[3] about 2 years ago.

[1] These Orders, although approved by the FEC, are yet to be signed and gazetted.
[2] Click **HERE** to read KPMG's Newsletter that summarized these discussions.
[3] The feed-in tariffs for Gencos are indexed in USD.

However, in an industry gasping for breath, any little benefit matters.

(ii) It helps clarify VAT accounting by all parties. The VAT Act provides that all companies supplying VATable goods should issue VAT invoices showing the VAT charged separately from the cost of the goods. This has not been the case in the industry, except between Discos and the final consumers. However, under pressure from the tax authorities, some Gencos have taken to issuing memorandum invoices to NBET showing a VAT charge which it never collects. Most therefore do not maintain a VAT payable or receivable account.

(iii) Discos would be able to save potential VAT that should ordinarily be paid on charges from the TCN, which they cannot recover from the VAT collected from customers. While the invoices issued by NBET have not typically included this VAT, it is not exempted (this is what The Order seeks to address), thus creating a potential significant tax risk for the industry.

Matters Arising

There are however a number of issues which The Order, if signed and gazetted in its current form, may not have addressed. They include:

(i) The Order appears to focus on the traditional electricity supply value chain – electricity supply from Gencos to NBET/Discos via TCN. However, the Nigerian Electricity Supply Industry (NESI) is constantly evolving. At the time when the initial discussions and drafting took place, the Eligible Customer Regulation, 2017 ("The Regulation") was yet to be issued. The Regulation creates a framework for Gencos to sell power directly to any customer of its choice, including the final consumer. It may or may not use the network of the TCN or a Disco. Will this supply of power be subject to VAT? If the Genco uses the network of TCN and or a Disco, will the wheeling charges be subject to VAT? The Order seems to suggest that only transactions that are specifically mentioned will enjoy the exemption. However, the types of transactions in the Sector are more varied than that specifically stated in The Order.

(ii) There is no mention of the operators of mini-grids. The operators in this instance act as both Gencos and Discos with the overall cost charged to the final consumers. Will that also be liable to VAT?

(iii) The Order does not state its potential date of commencement. Therefore, it is likely that this may be taken as the date when it is signed by the Minister of Finance. However, this may create issues as to how the industry should treat the prior period. Should TCN now issue VAT invoices to the Discos for its wheeling charges? Will there be any liability for the prior period considering the peculiar liquidity challenges? The same also applies to Gencos and NBET. This may, therefore trigger some back duty assessments, which may bring the industry to near breaking point. Therefore, shouldn't The Order have an effective date from the date of handover of the assets to private investors?

Conclusion

The Order states that its aim is to ***"..provide for a single point of VAT collection at the end of the entire value chain, when Discos sell power to final consumers…"*** This extract encapsulates the inconsistency in The Order in its current form. The NESI, as of today, is beyond Disco's selling power to final consumers. Therefore, if the aim is to provide for a single point of VAT collection at the end of the value chain (which is what it should be), then it may be necessary to update The Order to reflect this. This may be done by either expanding the scope of transactions covered or by not listing specific transactions in The Order. A more generic exemption may be what is required so as to keep up with a sector that is constantly evolving.

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

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