Current Tax and Regulatory Challenges in the Nigerian Electricity Supply Industry

Power Sector Watch | Special Edition

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This publication highlights specific tax considerations for players in the Nigerian Electricity Supply Industry (NESI or "the Industry"). Private players did not begin to participate in the NESI until about 15 years ago. Prior to then, it was completely under the control of the Government, so tax was not necessarily a big issue. However, with the introduction of private companies into the Industry, tax has become a burning issue. The new entrants and tax administrators are still trying to understand the peculiarities of the Industry and the peculiar tax challenges associated with it.

We have summarised a few of the recent issues below:

1. The impact of Value Added Tax (VAT) (Modification) Order, 2021 on operations of NESI

VAT has been a contentious issue in the power sector since privatisation. The conversation started from whether electric power qualifies as a *good* on which any input VAT incurred, can be recovered from the output charged and collected. It subsequently moved to the ability of Distribution Companies (DisCos) to recover any VAT paid for the supply of electricity to the Nigerian Bulk Electricity Trading Company (NBET) given the high collection losses in the sector. Collection losses are still very high in the Industry; therefore, DisCos lose a significant amount of value including the corresponding VAT. They may therefore be in a position where they constantly pay out of pocket as they are unable to collect sufficient output VAT to enable them to recover any input paid. This is without prejudice to the argument of whether any input VAT is paid to NBET in the first instance.

There was also the issue of Generating Companies (GenCos) which use gas as a feedstock being unable to recover any VAT paid to the gas producing companies as any VAT charged on invoices issued to NBET would be deducted at source as NBET qualifies as a Government agency obligated under the law to do so.

The VAT issue was however not restricted to grid power. It is a stated fact that Governments all over the world have been looking for ways to diversify the global energy mix in favour of renewables. Nigeria is not left out, as Government has put in place policies to help drive that change. One of such policies was the exemption of certain renewable energy equipment from duty at the ports. The lack of clarity as to which equipment was covered by this exemption as well as the form in which that equipment ought to be brought into the country was a source of concern for players in the Industry.

It was therefore a thing of relief when the VAT (Modification) Order, 2021 ("the Order") amongst others exempted the following from the application of VAT:

a) Gas supplied by gas producing companies to GenCos,

b) Electricity generated by GenCos and supplied to National Grid or NBET,

c) Electricity transmitted by Transmission Company of Nigeria (TCN) to DisCos, and

d) Renewable energy equipment

The issuance of the Order though, has brought up a few additional questions:

1. Will the supply of power from GenCos directly to eligible customers through the TCN qualify as the supply of power to the National Grid which is exempt from VAT?
2. If yes, what is the difference between this and entities which currently operate distributed generation systems used in providing *"power as a service"* to customers? Is there a logical argument to support the difference in treatment?
3. The Order contains very specific Common External Tariff (CET) codes for renewable energy equipment. What happens to items that qualify as such but do not fall under the CET codes? Will they continue to pay VAT at the ports and charge same when they sell to their customers? A few players have already expressed those same concerns.
4. How will companies with already imported items on which VAT was paid at the ports treat those items? Will they be allowed to charge and recover that VAT from customers or are they expected to immediately stop charging VAT?

These questions need to be answered as they are fundamental to the smooth running of the NESI, post the issuance of the Order.

2. Treatment of Interest of Unpaid NBET Bills by GenCos and DisCos

During the 20th Power Sector Stakeholder's meeting in January 2015, NBET announced the introduction of an interest charge on outstanding bills from the DisCos in a bid to encourage prompt remittance of unpaid bills to GenCos. Consequently, DisCos are charged compounding interest on unpaid NBET debt, while the GenCos recognise a corresponding interest receivable.

Given that the DisCos have continued to experience liquidity challenges due to collection and technical losses, it is uncertain when and if they can offset these significant finance costs in their books. Relatedly, the GenCos have significant interest receivable from the DisCos which they may never recover due to collection challenges that have plagued the industry.

Questions are now being asked as to how DisCos and GenCos treat the interest expense and income respectively for tax purposes. Can DisCos continue to take a tax benefit for these amounts even though there are doubts when they will be paid? Also, is it fair and reasonable to expect GenCos to account for taxes on this income stream given that there are no guarantees of when and if it would be received?

It is important to note that income and expense recognition follows the accrual rather than the cash basis, therefore recognition is not subject to when cash is received or paid. However, given the peculiarities of the Industry, the question is, how do these entities treat this issue? Furthermore, is it possible for DisCos and GenCos to treat the matter in a different manner given that it affects both in about the opposite way?

What options are available under the law to the players in the Industry?

3. Minimum Tax (MT) for Companies Operating in the Power Sector

The MT regime is one of the anti-tax avoidance provisions in the Companies Income Tax (CIT) Act that ensures that companies operating in Nigeria pay a minimum amount of tax annually. A company is required to pay MT when it has no taxable profit or tax payable which is less than the computed MT. The MT rate is 0.5%[1] of the gross turnover of the Company less franked investment income.

Based on the operating model of the NESI, collection of revenue for all the parties is done at the point of the DisCos. The tariff is designed to include the revenue due to the GenCos, TCN, NBET and Market Operators which are collected by the DisCos when bills are issued to the consumers. Therefore, the revenue reported by the DisCos will include revenues for the other players in the value chain. Given that MT is computed on gross turnover less franked investment income, the DisCos will be required to pay MT on the entire revenue of the NESI. Therefore, the question of if this is a fair position and what exactly qualifies as revenue for the Discos, has been at the front burner.

[1]The FA,2020 temporarily reduced the rate to 0.25% for tax returns that falls due between 1 January 2020 and 31 December 2020 both days inclusive.

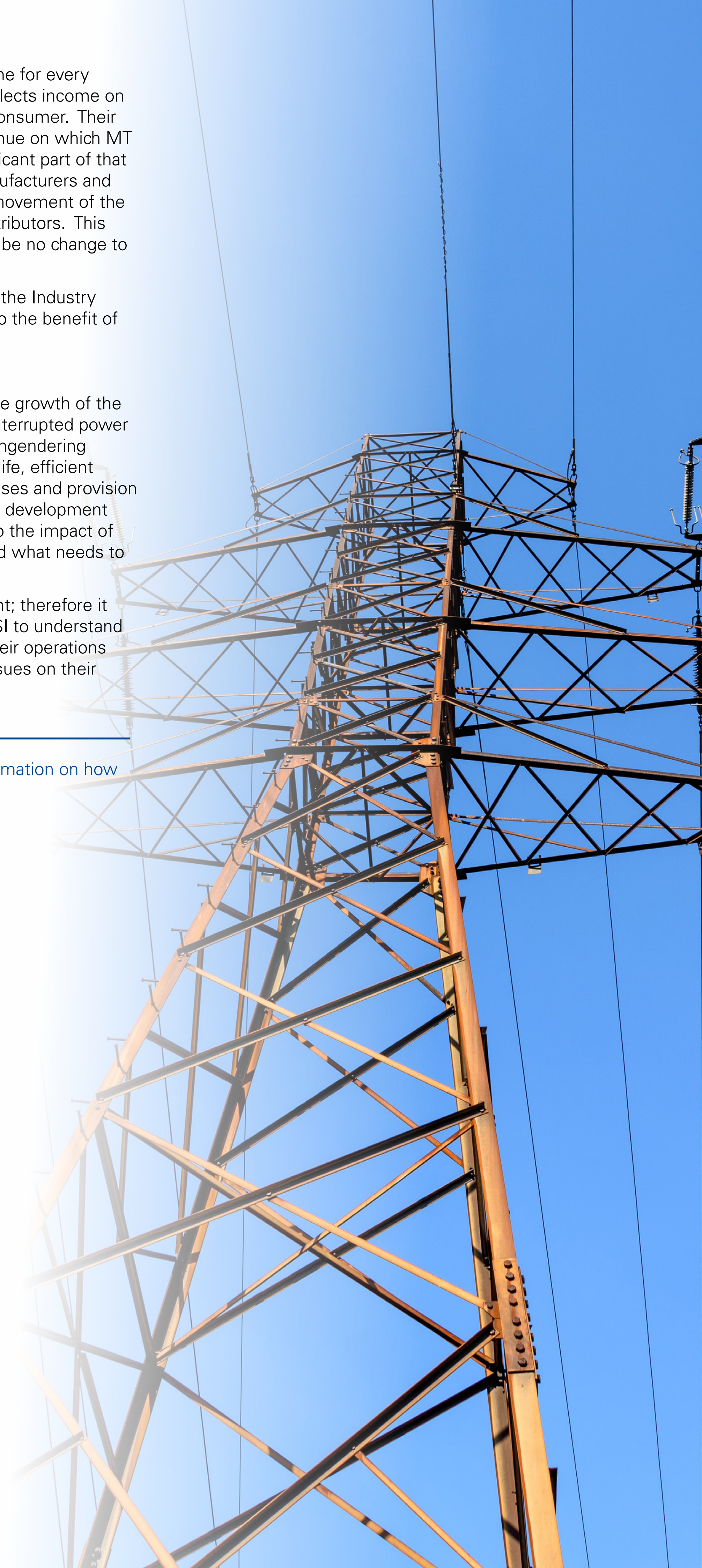
Others have also argued that it is the same for every trading or distribution company which collects income on behalf of the entire chain from the final consumer. Their gross sales would form part of their revenue on which MT would be computed even though a significant part of that revenue would be transferred to the manufacturers and logistics companies which facilitate the movement of the goods from the manufacturers to the distributors. This group therefore argues that there should be no change to the basis for the computation of MT.

However, will the status quo aid or derail the Industry and its desire to become more efficient to the benefit of Nigeria and Nigerians.

Conclusion

The power sector is a critical industry for the growth of the country. This is because adequate and uninterrupted power supply are indispensable pre-requisite for engendering economic growth, improving the quality of life, efficient agricultural and industrial production processes and provision of essential services. It is therefore a good development that we constantly have conversations as to the impact of policies and happenings on the Industry and what needs to be done to help the Industry improve.

Tax policies and issues are no less important; therefore it is the responsibility of all players in the NESI to understand these issues and how they can structure their operations to mitigate any negative impact of these issues on their operations.



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