

# REVIEW OF NIGERIAN ELECTRICITY REGULATORY COMMISSION'S GUIDELINES FOR SECONDARY ESCROW ACCOUNT MANAGEMENT FOR BILATERAL TRANSACTIONS BY ELECTRICITY DISTRIBUTION LICENSEES



## INTRODUCTION

Following the transfer of the Power Holding Company of Nigeria's (PHCN) successor companies to private participants on 1 November 2013, the Nigerian Electricity Supply Industry (NESI) has been attended by a liquidity crisis resulting from several factors, including high baseline Aggregate Technical Commercial and Collection (ATC&C) losses than what was projected under the Multi-Year Tariff Order (MYTO)<sup>1</sup> and the absence of cost reflective end-use tariffs.

Research shows that for the Second Quarter of 2022 (Q2 2022), ATC&C losses for the eleven (11) distribution companies (DisCos) averaged 44.15%, in contrast with the target of 20.27% set under the Multi-Year Tariff Order 2022 (MYTO 2022).<sup>2</sup> High ATC&C losses and the absence of cost reflective end-user tariffs made meeting payment obligations to financiers and other market obligations difficult, prompting the Federal Government of Nigeria (FGN) to intervene through mechanisms like the Central Bank of Nigeria- Nigerian Electricity Market Stabilization Facility (CBN-NEMSF).<sup>3</sup>

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1. Central Bank of Nigeria, Circular to All Deposit Money Banks dated March 4, 2015 "Terms and Conditions for Participation by Deposit Money Banks (DMBs) in the Implementation and Execution of Nigeria Electricity Stabilization Facility ("CBN-NEMSF").

2. Nigeria Electricity Regulatory Commission, Quarterly Report: Second Quarter 2022, p.43.

3. *Supra* (n 1).

But the CBN-NEMSF was only a loan advanced to DisCos and other market participants for the purpose of settling of all legacy gas debts owed to the Nigeria Gas Company Limited (NGC) and gas suppliers on the one hand and other debts incurred by market participants on the other.<sup>4</sup>

To deal with the absence of cost reflective electricity tariffs, FGN set up the Power Sector Recovery Programme Financing Plan (**PSRP Financing Plan**) to fund the revenue gap resulting from the difference between cost reflective tariffs determined by NERC and the actual end-user tariffs during the transition to cost-reflective tariffs.<sup>5</sup> The revenue loss resulting from tariff shortfall is to be applied through the Nigerian Bulk Electricity Trading Plc (**NBET**) and the Market Operator (**MO**) to ensure 100% settlement of invoices issued by other market participants to DisCos.<sup>6</sup>

To aid repayment of the CBN-NEMSF, revenue received by DisCos from the market are required to be paid into a Principal Collection Account (**PCA**) set up and managed by the NESI Stabilization Securities LTD (**NESI-SSL**). The CBN-NEMSF and other intervention mechanisms by the CBN provide for a first charge on DisCos' market revenues, after all statutory deductions have been made.<sup>7</sup> In accordance with the MYTO 2022, DisCos are required to satisfy their obligations in the following order:

- a) Repayment of CBN-NEMSF;
- b) 100% settlement of MO's invoice subject to "regulatory net-offs" approved by NERC; and
- c) Full settlement of Minimum Remittance Requirement of NBET's monthly invoices being the minimum remittance threshold prescribed in the MYTO 2022 plus/minus "regulatory net-offs" approved by NERC.<sup>8</sup>

Only after these obligations have been settled are DisCos permitted to earn profits for disbursement to investors. This has led DisCos to argue that the payment waterfall and disbursement of funds from the PCA make it difficult for DisCos to enter bilateral contracts and draw in external investment to the distribution networks as well as related areas to drive performance improvements to reduce ATC&C losses.<sup>9</sup>

To deal with the above concerns, NERC has issued the Guidelines for Secondary Escrow Account Management for Bilateral Transactions by Electricity Distribution Licensees (the **Guidelines**) which provides an arrangement by which DisCos may directly enter bilateral transactions with trading partners and specially dedicated Secondary DisCo Account Escrow Arrangements (**SDAs**) are set up to administer the funds received by DisCos from the market with respect to these transactions. In this newsletter we discuss the Guidelines, critically examining its likely impact on scaling up DisCos' revenue and the corresponding increase of investments in the networks and consequent reduction of ATC & C losses along the distribution value chain.

4. See: *Multi-Year Tariff Order 2020 (MYTO 2020)*.

5. *MYTO 2020; MYTO 2022*.

6. *Ibid.*

7. *NERC, Guidelines for Secondary Escrow Account Management for Bilateral Transactions by Electricity Distribution Licensees, May 2023 p. 1*.

8. *Clause 17 (g) MYTO 2022*.

9. See: *NERC, Guidelines pp.1-2.*

## THE GUIDELINES IN PERSPECTIVE

The objectives of the Guidelines are to<sup>10</sup>:

- 1) guide DisCos and their counterparties on the implementation of bilateral transactions in their franchise areas;
- 2) facilitate the adoption of SDAs to securitize bilateral transactions;
- 3) provide comfort to NESI-SSL and other market participants that the implementation of approved bilateral transactions shall not adversely impact payments to the market;
- 4) ensure proper accounting of collections from the bilateral transactions;
- 5) support improved energy offtake by DisCos;
- 6) provide reliable power supply to targeted customers;
- 7) improve third-party investment in the DisCo's networks; and
- 8) supplement collections to PCA to meet market obligations.

For this purpose, approved Secondary Escrow Collection Accounts (**SCA**) are to be set up into which revenues derived from the market with respect to bilateral transactions entered by DisCos are to be paid. Thus, in accordance with the Guidelines, DisCos may enter:

- a) Island bilateral transactions; and
- b) Non-Island bilateral transactions.

Each of these are discussed respectively below.

### A. *Island Bilateral Transactions*

In accordance with the Guidelines, island bilateral transactions may either be transactions which involve direct connection to a generation plant or transactions involving indirect connection to a generation plant. For transactions with direct connection to a generation plant, a DisCo will execute a bilateral contract with a generation company (**GenCo**) where a feeder emanating from the GenCo feeds directly into a DisCo's dedicated feeder(s) or customer clusters from where the power is

distributed to consumers. Concerning non-island bilateral transactions, the DisCo's feeder(s) or consumer clusters are not directly connected to the generation plant.<sup>11</sup>

For both kinds of island bilateral transactions to be approved, DisCos must establish to NERC that:

- 1) the proposed transaction will improve the DisCo's overall liquidity and enable it to meet its market obligations;
- 2) all collections made by the DisCos must be paid into the PCA and the SCA with the NESI-SSL having oversight for effective monitoring;
- 3) a minimum of 30% of the collections from any SCA shall be made to the PCA before the DisCos settle the monthly energy invoices.<sup>12</sup>

In addition, for island bilateral transactions not connected to a GenCos feeder, independent trading meters at injection/trading points are to be installed and read by the MO as part of the monthly market settlement.<sup>13</sup>

As regards the SCA into which revenues derived from the market with respect to island bilateral transactions are to be swept, the Guidelines provide the following minimum requirements:

- 1) approval by NERC of the island bilateral transaction;
- 2) execution of a Secondary Account Escrow Agreement (**SAEA**) between the parties to the island bilateral transaction and the NESI-SSL;
- 3) DisCo compliance with the terms and conditions of the SAEA; and
- 4) DisCo compliance with the reporting requirements of the transaction as prescribed by NERC.<sup>14</sup>

10. *Ibid* clause 4.

11. *Ibid* clause 5 of the Guidelines.

12. *Ibid*.

13. *Ibid* clause 5.2(d).

14. Clause 6 of the Guidelines.



## B. Non-Island Bilateral Transactions

Bilateral transactions in which DisCos aim to obtain extra electricity, but the supply is not designated to a particular feeder(s) or customer clusters within a DisCo's network, are known as non-island transactions.<sup>15</sup> Where a DisCo intends to pool the energy from a non-island bilateral transaction with the supply of energy contracted with NBET, it shall take the following steps:

- 1) provide a Bank Guarantee (BG) in favour of NBET covering the estimated remittance gap for three months, to be determined by NERC;
- 2) state reasons why the proposed transaction will improve the DisCo's liquidity position and enable it meet market obligations;
- 3) independent trading meters at injection points for supply are to be installed and read by the MO as part of the monthly market settlement.<sup>16</sup>

## OUR THOUGHTS

In accordance with the market model being utilized in the NESI, GenCos trade directly with the NBET for the bulk supply of electricity, with DisCos off-taking from NBET and selling to final consumers. This is because the NESI has not advanced to a stage where GenCos can trade directly with DisCos due to insufficient capitalization of the latter.

We note however that the goal of the Guidelines is to promote increased competition in the NESI. According to Joskow, when speak of increased competition in wholesale or bulk power markets, we are referring to the

arrangement by which "short-term and long-term contracts between a utility with retail distribution franchises and competing third party suppliers would become viable substitutes for the traditional complete vertical integration of distribution with generation and transmission."<sup>17</sup> Thus, the Guidelines endorse the arrangement by which DisCos may trade directly with GenCos, subject to conditions.

The advantage of increased transactions in the NESI through direct bilateral arrangements between GenCos and DisCos is the potential for additional investments in the distribution networks and the corresponding reduction of ATC&C losses over the course of time as investments are made with a view to reducing losses.<sup>18</sup>

Although the exact mechanics by which increased transactions in the NESI will play out as set out in Guidelines remain unclear, traditionally there exist four ways by which any enterprise, including DisCos may increase revenue: (1) increasing customer base; (2) **increasing average transaction size**; (3) **increasing the frequency of transactions per customer**; and (4) raising prices.<sup>19</sup>

As hinted above, the first line charge of the CBN-NESMF over the revenues of DisCos and the payment waterfall contained in the MYTO restrains investors from investing in DisCos. These Guidelines encourage increased transactions by providing a modality by which revenues from such transactions are to be dealt with while providing comfort to other key players within the sector.

15. *Ibid* at clause 7.

16. *Ibid* clause 7(a)-(c).

17. Paul Joskow, "The Evolution of Competition in the Electric Power Industry" (1998) 13 *Ann. Rev. Energy*, 215 at 229.

18. NERC (n 2) p. 43.

19. Josh Kaufman, *The Personal MBA: Master the Art of Business*.

20. *Ibid* at 43.

Further to increased transactions and investments, if a DisCo outperforms its allowed ATC&C loss (i.e., has a lower actual ATC&C loss than the target), it will earn more returns on its set tariffs. On the other hand, where a DisCo fails to take advantage of the arrangements proposed by the Guidelines it is likely to underperform relative to its allowed ATC&C loss (i.e., has a higher actual ATC&C loss than the target) and consequently be unable to earn the expected returns on its set tariffs and could risk long-term financial constraints.<sup>20</sup>

Despite the laudable goals of the Guidelines, we query the modality by which NERC has determined that **30%** of the collections from the SCA shall be made to the PCA before DisCos settle their monthly energy invoices under


island bilateral transactions. It is also unclear if all disbursements made to DisCos resulting from these bilateral transactions (or from the market resulting from the bilateral transactions) will be paid to the SCA.

In conclusion, we note that in accordance with section 231(3) of the Electricity Act 2023 (EA), these Guidelines will only be deemed valid if not inconsistent with the provisions of the EA.

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