

Review of the **Order** on **Bilateral Contracting** within the Nigerian Electricity Supply Industry

OALP P&I NEWSLETTER

INTRODUCTION

On 25 July 2024, the Nigerian Electricity Regulatory Commission (NERC) issued the “Order on the Transition to Bilateral Trading in the Nigerian Electricity Supply Industry” (the **Order**)¹ effective immediately (the **Effective Date**). This Order marks a pivotal moment in the transitioning of Nigeria’s electricity sector, into a more competitive bilateral trading model from a centralized bulk trading system.

The successful implementation of this Order is anticipated to significantly address longstanding challenges within the industry such as liquidity issues, exacerbated by non-cost reflective tariffs and poor billing and collection practices by the electricity distribution companies (the **DisCos**). Additionally, the Order will also act as a key factor in reducing the fiscal burdens on the Federal Government of Nigeria (FGN), as it decreases its exposure to risks within the electricity sector through the gradual phasing out of the Nigerian Bulk Electricity Trading PLC (NBET)’s role as the primary intermediary.

Furthermore, the Order reflects NERC’s strategic effort to align Nigeria’s electricity market with global best practices, as outlined in the Electricity Act 2023 (the **Electricity Act**), by phasing out the reliance on government interventions and subsidies, and transforming the electricity market into a true marketplace where commercial agreements drive supply and demand

dynamics, and electricity trading reflects true market values.

In this newsletter, we outline the key provisions of the Order and its likely impact on the Nigerian Electricity Supply Industry (NESI).

BACKGROUND TO THE ORDER

Following the privatization exercise, Nigeria shifted from a vertically integrated, publicly owned electricity network to an unbundled electricity market model, with the generation and distribution segments of the NESI value chain largely owned and managed by the private sector. However, the transmission segment remains under the control and management of the FGN.

NBET was subsequently established on 29 July 2010, in accordance with the provisions of the Electric Power Sector Reform Act 2005 (EPSRA or the **Repealed Act**) as one of the unbundled successor companies to engage in the bulk purchase of electricity and ancillary services from generation companies (**GenCos**) and independent power producers (**IPPs**) (the **Generators**) for resale to DisCos in Nigeria.

Given the nascent state of the reformed NESI, NBET’s initial role was to serve as a central counterparty in the electricity market and to provide payment assurance to Generators through bankable power purchase agreements.

1. The Order can be accessed here: <https://nerc.gov.ng/wp-content/uploads/2024/07/ORDER-ON-THE-TRANSITION-TO-BILATERAL-TRADING-IN-NESI.pdf>

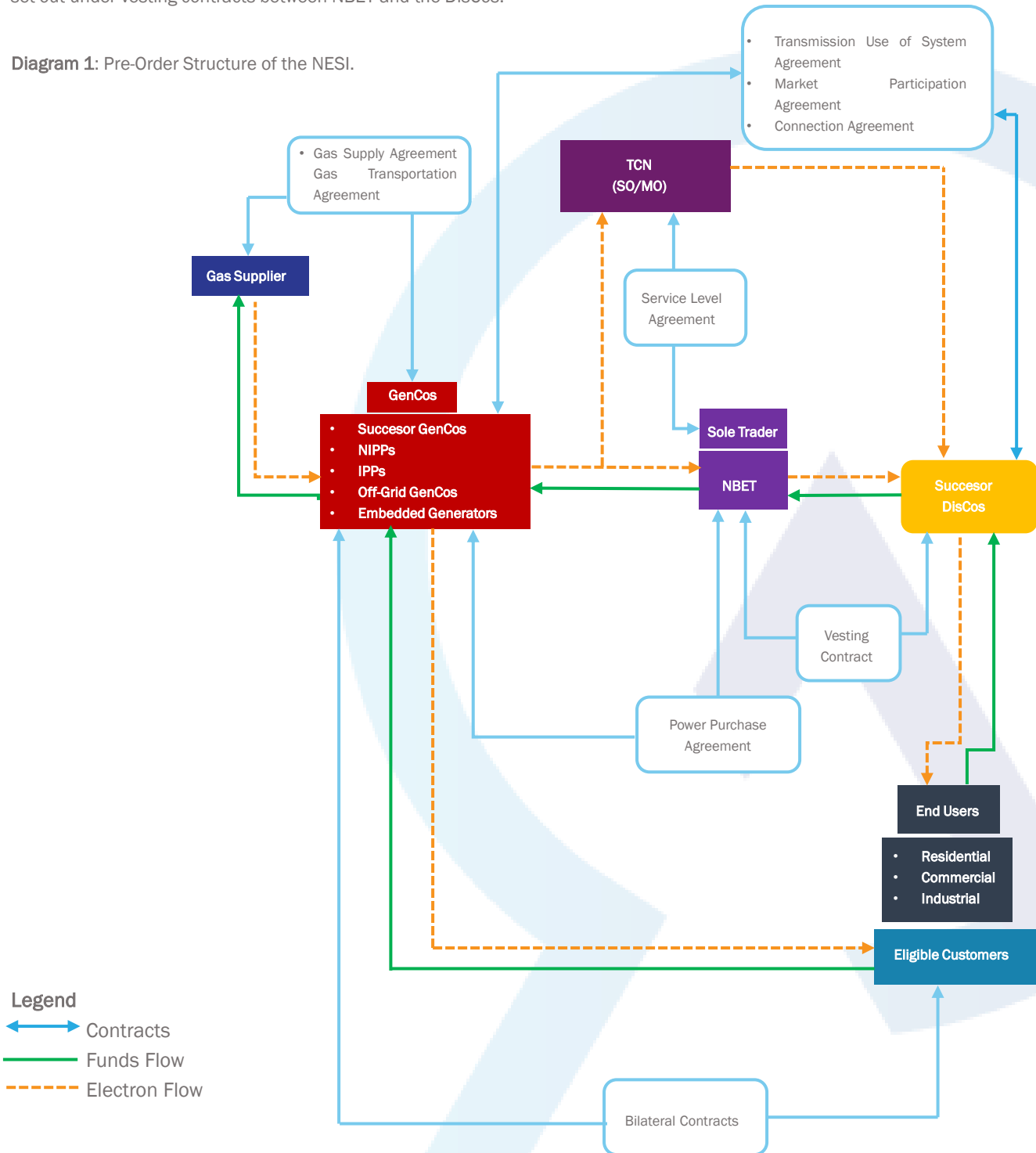
2. The handover of majority of the eighteen (18) successor companies to private investors, in which eleven (11) were electricity distribution companies, six (6) were electricity generation companies and the last company was the Transmission Company of Nigeria which was to be owned and controlled by the FGN. All eleven (11) Discos and four (4) of the GenCos were acquired by way of equity sale. The private investors purchased a sixty percent (60%) and one hundred percent (100%) stake in the Discos and GenCos respectively. The remaining two (2) GenCos, which are the only two (2) operational hydro power generation plants, were ceded to the private investors by way of a 30-year concession arrangement

This was crucial in the short term because, following the transfer of the successor companies to private investors, it was anticipated that DisCos would not have sufficient liquidity to meet their payment obligations to Generators.

In this regard, EPSRA envisioned that once a more competitive market was established in NESI, NBET would be phased out and replaced by other existing licensees engaging in direct and bilateral power trading. According to section 68(2) of EPSRA, the license issued to NBET was meant to be temporary, and Section 26(1)(a) of EPSRA further stipulated that once a more competitive market was declared by the Minister of Power, NBET should cease entering into new contracts for purchasing electrical power or ancillary services and begin novating its existing rights and obligations to other licensees.

Subsequently the market structure was for NBET to purchase electrical energy from GenCos under power purchase agreements (PPAs), which is subsequently vested onto DisCos based on the guaranteed share of the purchased capacity as set out under vesting contracts between NBET and the DisCos.

Diagram 1: Pre-Order Structure of the NESI.



The Electricity Act acknowledges NBET's continued existence in Section 6(f) and empowers NERC, as per Section 7(2)(d), to issue directives specifying when NBET should stop entering into contracts for purchasing and reselling electricity and ancillary services and transfer its contractual rights and obligations to other licensees.

With NERC taking the view that the Nigerian electricity market has sufficiently matured, and the NESI is prepared for a transition to a more competitive market, it has now issued the Order which among other things prohibits NBET from entering into new contracts, and mandates market participants to commence bilateral trading.

TRANSITION PROVISIONS UNDER THE ELECTRICITY ACT

Prior to examining the provisions of the Order, it is essential to highlight the provisions of the Electricity Act which empower NERC to issue the Order.

Section 7(2) of the Electricity Act sets out certain actions to be undertaken by NERC in preparation for the initiation of the medium term and long-term electricity markets including to:

- monitor and ensure that all participants fulfil their duties and meet deadlines as stipulated under the act and market rules, and imposing penalties for non-compliance;
- monitor and ensure that all market participants fulfil their obligations in relation to the preparation of the medium term and long-term electricity markets, meet deadlines in relation thereto, and impose sanctions for non-compliance;
- prepare and submit annual reports to the Presidency and the National Assembly on the market conditions, including on the end of the transitional electricity market and establishment of the medium term and long-term market;
- **direct NBET to cease to enter into contracts for the purchase and resale of electricity and ancillary services and novate its existing contractual rights and obligations to other licensees.**

Based on the above, Section 7(2)(a) - (d) of the Electricity Act empowers NERC, as part of the preparatory activities to be carried out for the transition to the medium term and long-term electricity market, to issue the Order.

OBJECTIVES OF THE ORDER



The Order seeks to:

1. steer the electricity market towards bilateral contracting for energy and capacity between GenCos and/or trading licensees (TraderCo) with DisCos thus limiting the fiscal exposure of the FGN to market risks.
2. foster a more competitive market structure as envisioned by the Electricity Act by repositioning NBET from its current role as the sole bulk electricity trader in the NESI.
3. provide an equal opportunity for all hydro GenCos and thermal GenCos with existing “take-and-pay” contracts with NBET to reduce their contracted capacities by trading directly with DisCos on a bilateral basis.
4. transition the contractual framework for bulk energy trading in the NESI to “take-or-pay⁴” contracts thereby fostering increased certainty and market discipline among market participants.
5. allow DisCos to explore opportunities for increased optimisation/firming up of their wholesale energy off-take, and a reduction of their vesting contract capacity with NBET for “take-and-pay⁵” PPAs, thus providing certainty of availability of generation and the improvement in quality of supply to end-users.⁶

4. A “take-or-pay” obligation in a PPA is a contractual clause that requires the buyer to either take a specified minimum amount of electricity from the seller or pay for that amount, regardless of whether the electricity is actually taken or utilised by the buyer.

5. A “take and pay” obligation in a PPA is a clause that requires the buyer to take delivery of the electricity supplied and pay for the amount of electricity contracted and supplied..

6. Paragraph 18 of the Order.

HIGHLIGHTS OF THE ORDER

Cessation of entry into New Contracts by NBET

Pursuant to the terms of the Order, NBET is required to cease entering into new contracts for the purchase and resale of electricity and providing ancillary services in the NESI. The Order further provides that, any contract executed by NBET, in contravention of this directive, shall not be approved by NERC, and such action shall be treated as an infraction which is subject to regulatory sanction⁷.

Interim Administration of the Fully Effective PPAs

The Order specifies that in the interim, NBET will continue to administer the fully effective PPAs with the following five (5) GenCos:

- Azura Power West Africa Limited (**APWAL**);
- Omotosho Power PLC;
- Olorunsogo Power PLC;
- Nigerian Agip Oil Company Limited; and
- Shell Petroleum Development Company of Nigeria Limited, (collectively, the **NBET Firm Contracts**).

The NBET Firm Contracts are to be administered based on the minimum "take-or-pay" capacities in relevant PPAs or the average available capacity of the GenCos specified in the Order (the **NBET Firm Capacity**¹⁰). The capacity from the NBET Firm Contracts will accordingly be vested to DisCos based on the guaranteed share of capacity outlined in their respective vesting contracts¹¹.

However, the Order is silent as to the length of this interim period – whether it is for a specific period of time, or until the expiry of the NBET Firm Contracts.

The System Operator¹² (the **SO**) is also instructed to dispatch APWAL at a baseload equivalent to its "take-or-pay" capacity, and where other on-grid GenCos fail to fulfil their contracted obligations, the SO may instruct APWAL to increase its generation, serving as a supplier of last resort

for the affected GenCos. NBET will subsequently invoice the affected GenCos for the energy supplied by APWAL on their behalf¹³.

Administration of PPAs for Omotosho and Olorunsogo Power Plants

The Order sets out a special dispensation for the administration of the PPAs with Omotosho Power PLC and Olorunsogo Power PLC (the **Pacific Energy PPAs**). Paragraph M provides that in the absence of a bank guarantee from NBET supporting its payment obligations under the Pacific Energy PPAs, the DisCo payment waterfall shall rank this payment obligation *pari passu* with the bilaterally contracted energy by DisCos, ensuring payment assurance.

Furthermore, the SO must ensure that the Olorunsogo and Omotosho power plants, are dispatched at no less than their "take-or-pay" capacity of 186MW, ensuring a minimum level of production from the plants.

The Order also mandates Pacific Energy Limited (**PEL**) to, within **six (6) weeks from the Effective Date**, provide evidence of securing a firm "take-or-pay" gas supply agreement (**GSA**) covering its capacity delivery obligation of 186MW under each of the Pacific Energy PPAs.

Consequently, from 01 October 2024, PEL will be responsible for the combined mechanical and gas availability of both plants, and if either plant fails to achieve an average availability of 186 MWh/h over a calendar month, it will result in the payment of liquidated damages to NBET as outlined in the respective Pacific Energy PPAs¹⁴.



7. Paragraph 19 (a) of the Order

8. APWAL, Omotosho Power PLC and Olorunsogo Power PLC.

9. Nigerian Agip Oil Company Limited and Shell Petroleum Development Company of Nigeria Limited.

10. Per the Order, the firm capacity of NBET with respect to five GenCos are as follows: APWAL 416MW, Omotosho and Olorunsogo Power PLC 186MW respectively, Nigerian Agip Oil Company Limited 311MW and Shell Petroleum Development Company of Nigeria Limited 314MW. However, we note that in the Order, there are interchangeable references to the APWAL firm capacity being 416MW or 360MW.

11. Paragraph 19 (B) of the Order

12. In our June newsletter, we discussed the NERC Order establishing the framework for the incorporation of an Independent System Operator (ISO) Under this new arrangement, the system operation functions previously handled by the Transmission Company of Nigeria (TCN) will now be transferred to the ISO. Pending the completion of the transfer, TCN will continue to perform market and system operator functions in the NESI. The newsletter can be accessed here: <https://www.olaniwunajayi.net/blog/wp-content/uploads/2024/06/Review-of-The-Nigerian-Electricity-Regulatory-Commission-Order-June-2024-OALP-Power-Infrastructure-Newsletter.pdf>

13. Paragraph 19 (C) of the Order.

14. Paragraph 19 (M) of the Order.

Bilateral Trading

One of the key directives in the Order is the requirement for all other on-grid GenCos (the **Market GenCos**) that have contracted with NBET based on “take and pay” PPAs or interim energy sales agreements (**Interim Agreements**) to negotiate and enter into bilateral contracts with DisCos for the sale and purchase of energy within **sixty (60) days from the Effective Date**. The contract capacity under the bilateral agreements is to reflect the historical available generation of each Market GenCo, which is specified under the Order and generated based on NERC’s review of each Market GenCo’s performance in Q1/2024.¹⁵

The GenCos are subsequently required to notify NBET of the capacities which have been traded bilaterally with DisCos and/or eligible customers, no later than **30 September 2024**, and obtain NERC’s approval for all the relevant bilateral arrangements. This notification ensures transparency and allows NERC to monitor the new market contracts to be entered into vis a vis the capacity of the national grid.

The residual capacity of the GenCos, which is the capacity that is not traded with DisCos (the **Residual Capacity**), are to be traded with NBET on an interim agreement basis, maintaining the same commercial terms contained in the current PPAs/Interim Agreements with NBET. This arrangement provides a temporary solution for utilizing excess capacity, allowing NBET to distribute this energy to meet market demand.

The gross residual capacity from all the GenCos shall accordingly make up the pool of energy to be traded through NBET on a take and pay basis, which represents the NBET interim pool (the NBET Interim Pool). This trading mechanism allows for flexible energy procurement, ensuring that DisCos have access to additional energy supply as needed. The SO is required to manage the dispatch of GenCos in the NBET Interim Pool according to the demand from DisCos and the electricity market. This ensures a responsive system where energy supply can adjust to fluctuations in demand, thus maintaining market stability.



The hydro power GenCos on the other hand are required to equitably allocate their current contracted capacity with NBET to DisCos, in accordance with the shared capacity outlined in their applicable vesting contracts. This allocation must ensure that the net capacity being traded (MWh/h) is not less than the average capacity supplied to the DisCos by the hydropower GenCos in 2023¹⁷.

Maximum Bilaterally Tradeable Energy

Pursuant to Paragraph 19 (H) of the Order, DisCos have a maximum capacity that they can trade in the bilateral market (the **Bilaterally Tradeable Energy**), which is the difference between its energy offtake as contained in the July 2024 MYTO Order (the **MYTO Allocation**), and its share of the “NBET Firm Capacity”, i.e., the capacity allocated from the NBET Firm Contracts.

In the event that the total capacity contracted by the DisCos from the NBET Firm Capacity and bilaterally is lower than its MYTO Allocation, the deficit capacity is to be fulfilled from the NBET Interim Pool.

Prioritization of Dispatch

The Order directs the SO to prioritize the dispatch of energy that is contracted bilaterally, along with the NBET Firm Capacity, over the Residual Capacity in the merit order dispatch of generation plants. Dispatch from the NBET Interim Pool on the other hand shall be based on demand in the market from DisCos and other licensees. This approach aims to optimize the efficiency and reliability of energy distribution, ensuring that firm commitments are met before other commitments ¹⁸.

15. Paragraph 19 (D) of the Order. NERC conducted a performance review of the Market GenCos in Q1/2024, which revealed an average plant availability factor of 23.25%, which indicates the percentage of time the power plants were operational and able to produce electricity during the period. The low availability factor suggests that these plants have significant downtime or operational inefficiencies. Due to the disparity between the contracted capacity with NBET and the actual available generation capacity, the Order specifies a new contract capacity for each Market GenCo as detailed in Schedule 1. This adjustment aims to align the contractual obligations with the realistic operational capabilities of the power plants.

16. Paragraph 19(K) of the Order.

17. Paragraph 19 (G) of the Order

18. Paragraph 19 (J) of the Order

Firm GSA Requirements

In ensuring more predictability in generation and gas availability, the Order provides that within three (3) months of the commencement of bilateral contracting, all the capacities of the Market GenCos under the bilateral contracts must be supported by effective GSAs on a "take-or-pay" basis. Further, the GSAs are to include provisions for the payment of liquidated damages where the gas supplier fails to supply gas in accordance with the GSAs, which will help maintain the stability and reliability of the bilateral market¹⁹.

Priority in Revenue Allocation

Based on the directives set out in the Order and the proposed restructuring of the contracting model in the power sector, the disbursement waterfall from the escrowed DisCos' revenue collections account for energy and capacity payments has been amended as follows²¹:

- a) **Bilateral Contracts:** escrowed DisCo revenue will first be allocated to payment for energy traded bilaterally between DisCos and GenCos. Payments based on capacity vested from the Pacific Energy PPAs shall also rank equally and be paid concurrently.
- b) **NBET Firm Contracts:** the next payment obligation to be fulfilled is from the capacity vested from the NBET Firm Contracts (except under the Pacific Energy PPAs which have been settled in priority under paragraph (a) above).
- c) **NBET Interim Pool:** the last line item on the payment waterfall will be for the satisfaction of any payment obligations from energy contracted through the NBET Interim Pool.

The above structure essentially means that payments under the bilateral contracts entered into by DisCos shall take priority over the settlement of NBET's invoices with respect to energy delivered pursuant to the NBET Firm Contracts (excluding under the Pacific Energy PPAs). This structure may however present challenges to certain GenCos under the NBET Firm Contracts who previously enjoyed priority of payments, as this new payment waterfall may have implications for such GenCos' financial

and commercial arrangements which rely on full and prompt payments from NBET each month.

Furthermore, we note that with respect to bilateral contracts, the Order does not make provision for payments under bilateral contracts between the DisCos and other licensees including TraderCos, embedded generators, etc., (the **Other Bilateral Contracts**). Therefore, our assumption is that payment under those contracts will continue to be made in accordance with the 2023 NERC Guidelines for Secondary Escrow Account Management for Bilateral Transactions by Electricity Distribution Licensees (**Secondary Escrow Account Guidelines**), which provides for an arrangement whereby DisCos may enter bilateral transactions with trading partners and specially dedicated Secondary DisCo Account Escrow Arrangements are set up to administer the funds received by the DisCos from the market with respect to these transactions.²²

Alignment with End-User Tariffs

The Order, in ensuring market discipline by all parties, provides that a DisCo must ensure that its contracted capacity aligns with the recoverable generation costs from its end-user tariffs. This alignment aims to reduce the risk of default by ensuring that DisCos can meet their payment obligations under the bilateral contracts based on the tariffs received from consumers.

The implication of the foregoing is that DisCos need to ensure that the amount of electricity they buy (contracted capacity) matches what they can afford to pay using the revenue from collections from customers through electricity bills (end-user tariffs). By doing this, DisCos are less likely to run into financial trouble as there will (presumably) be sufficient revenue from customer payments to cover the costs of the electricity purchased and the likelihood of payment default to GenCos will be reduced²³.

NERC will also continue its monthly tariff reviews to accommodate changes in macroeconomic indicators, and ensure that the DisCos' allowed tariff is sufficient to cover the costs associated with its Bilaterally Tradeable Energy.²⁴

19. Paragraph 19 (L) of the Order

20. Given the liquidity challenges facing the NESI arising from technical and commercial losses, tariff and revenue shortfalls, leading to insolvency of the DisCos and inadequate funding (despite regulatory interventions from the CBN through the CBN Nigerian Electricity Market Stabilisation Facility), the CBN designed a draft escrow payment structure for DisCo's accounts allowing cash inflows but restricting outflows, which is to be controlled by CBN on a priority basis. NERC subsequently issued the Order on Securitization of Contracts and Payment Waterfall in the NESI in July 2022, which prescribed the payment waterfall structure for the monthly market obligations of the DisCos.

21. Paragraph 19 (N) (i) of the Order

22. In our July 2023 Newsletter, we reviewed the guideline and provided our thoughts on its implementation. This Newsletter can be accessed at <https://www.olaniwunajayi.net/blog/wp-content/uploads/2023/07/Newsletter-on-REVIEW-OF-NIGERIAN-ELECTRICITY-REGULATORY-COMMISSIONS-GUIDELINES-FOR-SECONDARY-ESCROW-ACCOUNT-MANAGEMENT-FOR-BILATERAL-TRANSACTIONS-BY-ELECTRICITY-DISTRIBUTION-LICENSEES.pdf>

23. Paragraph 19 (N) (ii) of the Order

24. Paragraph 19 (N) (iii) of the Order

However, in the event that the allowed tariff of a DisCo provides revenues for the generation component of its revenue requirement in excess of its Bilaterally Tradeable Energy, NERC is required to provide regulatory direction on the amount payable to NBET under the vesting contracts. This ensures fair distribution of excess funds and maintains financial stability.²⁵

Furthermore, if tariff reform policies by the FGN lead to increased revenue by the DisCos, the affected DisCos will be instructed by NERC to contract for additional capacity on a firm basis from the NBET Interim Pool²⁶.

OUR THOUGHTS

The initiatives introduced by the Order marks a transformative step for the NESI, poised to bring it in line with global best practices. The Order indicates that NERC has, since 2022, issued trading licenses to ten (10) private companies interested in bilateral electricity trading with DisCos and eligible customers, and this development is a positive shift from the current single utility bulk-trader model, which was originally intended as a temporary measure until the conditions for a competitive wholesale market were met.

Despite the anticipated benefits of this Order for the NESI, it is crucial to address certain issues related to its implementation, as set out in the diagram 2 on page 8 below.

Is the Market Ready for Bilateral Trading?

The preparedness of the NESI for bilateral trading is a query that requires critical consideration, particularly as regards whether the market is ready for a transition to a medium term/long term market.

First, Rule 6.4 (*Preparations for initiation of the Medium Term Market*) and Appendix 1 of the Market Rules for Transitional and Medium Term Stages of the Nigerian Electricity Supply Industry (the **Market Rules**), issued in December 2014, includes legal, physical, financial and technical conditions to be met in preparation of the initiation of a medium term market, which is the market stage in which it is anticipated that the shift to a bilateral contracting system would occur.

However, based on the current structure of the electricity market, it appears that a number of the design components and pre-conditions for bilateral trading have yet to be met. Key questions include: whether the DisCos are sufficiently creditworthy, if there is an adequate energy/accounting settlement platform to facilitate bilateral trading, and whether the grid infrastructure can support increased market activities and whether the NESI infrastructure is equipped with the necessary metering and information technology to support and monitor increased market trade.

For the bilateral market to operate effectively and achieve the desired results, many of these conditions must be satisfied, including but not limited to adequate generation capacity, reliable grid infrastructure, and efficient metering and billing systems. Current challenges, such as grid unreliability and liquidity constraints, could impede the immediate success of the implementation of the Order.

Has NBET fulfilled its role in the electricity market?

Another critical consideration with respect to the implementation of the Order is whether NBET has successfully fulfilled the objectives for which it was established – as a credit worthy offtaker in the NESI managing risk and ensuring the bankability of projects.

A question which now bears consideration is whether NBET has succeeded in these objectives and if the market is ready to function without its central role. With respect to providing liquidity in the market, NBET has, over the years, struggled with funding its payment obligations to the GenCos and gas suppliers, relying on insufficient monthly remittances from DisCos and intervention loans from the Central Bank of Nigeria (CBN), guaranteed by the Federal Ministry of Finance. Reports indicate that, except for a few months after the CBN intervention loan, NBET has never fully settled GenCos' invoices for purchased energy.²⁸

On the other hand, the presence of NBET as an FGN-backed entity has led to the successful implementation of certain IPPs in Nigeria (e.g. the Azura IPP project), as investors have been wary of engaging directly with the DisCos as contractual offtakers. This is especially as NBET is able to provide payment assurances backed by the FGN and there is increased transparency in its payment administration.

25. Paragraph 19 (N) (iv) of the Order

26. Paragraph 19 (N) (v) of the Order

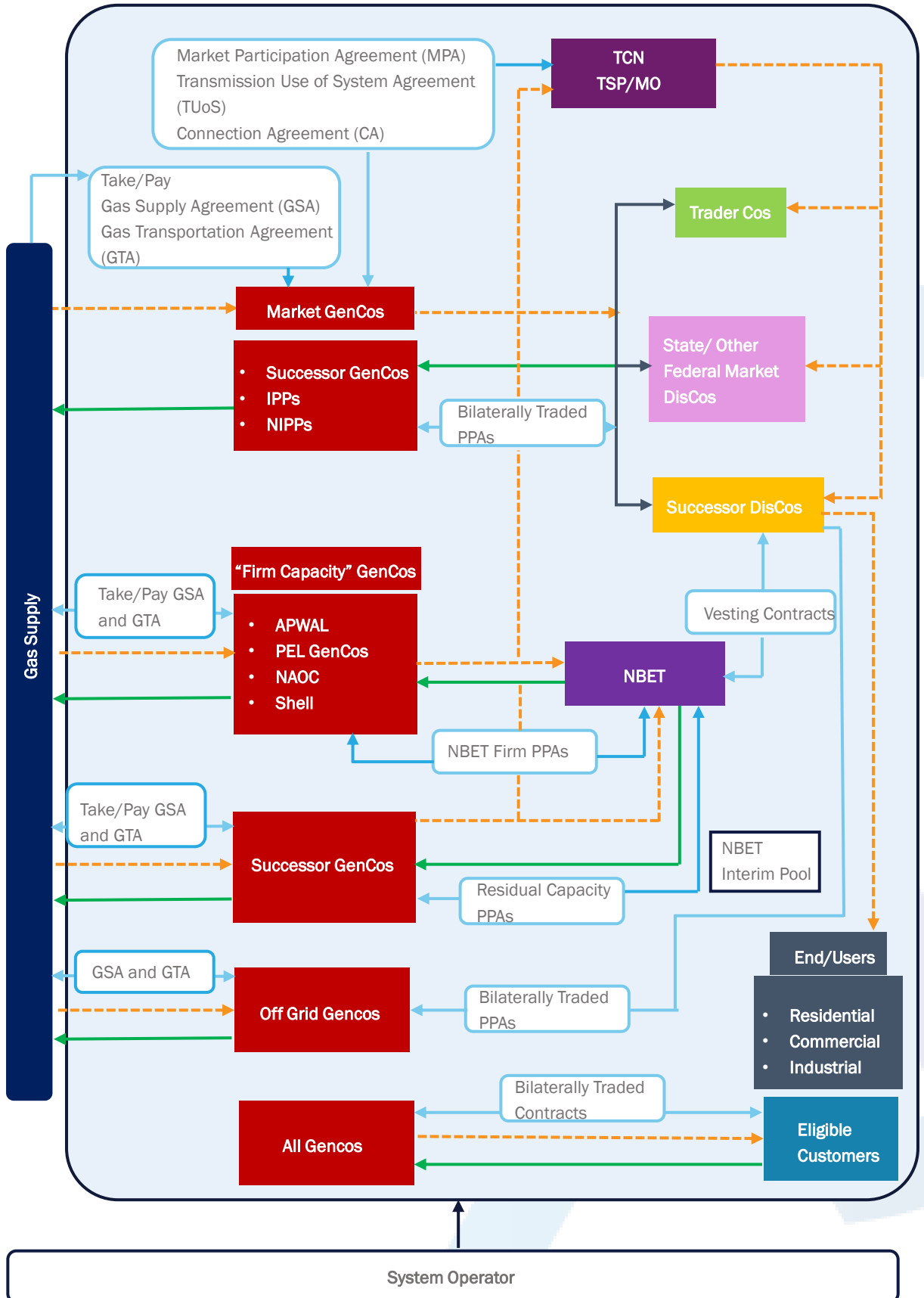
27. See diagram on the next page

28. See: <https://www.premiumtimesng.com/opinion/484853-to-renew-or-not-analysing-the-nbet-trading-licence-by-odion-omonfoman.html>; <https://punchng.com/gencoms-in-financial-quagmire-dont-get-full-payment-for-supplied-electricity-ogaji/>.

Diagram 2: Post-Order NESI Structure²⁷

Legend

- Contracts
- Funds Flow
- Electron Flow



However, despite NBET's efforts, payment defaults and arrears continue, partly due to inefficiencies in revenue collection by DisCos and the gap between cost-reflective tariffs and actual consumer payments.

Therefore, the question of whether the economic benefits of NBET being the offtaker under the PPAs has been realized is not clearcut. Nevertheless, whilst NBET's central role in the market has been critical, in order to foster a more competitive market, it is acknowledged that the phasing out of its role must commence.

The approach under the Order therefore strikes a balance between ensuring that NBET remains in the market as a supplier of last resort, and as a guide to the market participants on the sale and purchase of electricity, but also ensuring that every market participant's primary mandate is to seek to enter into bilateral contracts with each other.

Transition Procedure under the Electricity Act

As discussed above, the Electricity Act provides that in preparation for the initiation of the medium term and long-term electricity markets, NERC is required to direct NBET to cease to enter into contracts for the purchase and resale of electricity and ancillary services and novate its existing contractual rights and obligations to other licensees.²⁹ In this regard, what is contemplated under the Electricity Act, and what was contemplated under the Repealed Act, was for NBET to completely exit the market and for licensees to trade bilaterally.

Furthermore, the Electricity Act specifically requires that all existing NBET contracts be novated to other licensees. The section does not however clarify which "other licensees" are referred to. Section 232 defines a "licensee" as any person who holds a license or is deemed to hold a license issued under Part VI of the Electricity Act or under any other relevant provision of the act. Further to the provisions in Part VI, NERC may issue the following categories of licenses to potential investors in NESI: electricity generation; electricity transmission; electricity distribution; electricity supply; electricity trading; or system operation.

Through the process of elimination, we can deduce that the "other licenses" in Section 7(2)(d) can only be construed to mean either DisCos or TraderCos. Accordingly, the expectation is that NBET will novate the PPAs to DisCos/TraderCos for bilateral trading with the

GenCos, whilst the vesting contracts shall be terminated.

However, the implementation of Section 7(2)(d) of the Electricity Act as set out in the Order is starkly different. The Order does not contemplate the novation of NBET's existing contracts and is in fact silent on the status of the contracts. The Order instead requires that:

1. NBET retains the implementation of the NBET Firm Contracts;
2. the DisCos and the Market GenCos trade bilaterally with each other and other licensees; and
3. only the NBET Firm Capacity and the Residual Capacity will be traded through NBET.

We understand that this approach may have been adopted based on the difficulties which may arise from the novation contemplated under the Electricity Act, and NBET's complete exit from the market, including:

- **FGN's Obligations:** dealing with the fall out of terminating the NBET contracts which have been entered into on the expectation of NBET, an FGN entity, as the single offtaker for the project. In this regard, if the relevant NBET contract is transferred to a DisCo/TraderCo, this could lead to significant liabilities for the FGN including under a put call option agreement and the partial risk guarantee provided by the World Bank.
- **Capacity of Transferee:** where a novation of the PPAs is to be undertaken, it is likely that the GenCos may require that the proposed transferee meet certain technical, legal and financial capacity criteria as a condition to the grant of their consent, which certain DisCos may be unable to meet. This may therefore delay or outrightly impede the implementation of the novation process before the date of expiration of NBET's license in November 2024.
- **Dealing with Legacy Liabilities:** where NBET completely exits the market, this would leave a lacuna as to how NBET's existing liabilities in the market are to be dealt with. Where a novation is contemplated, the relevant transferee may request for the contracts to be transferred free of NBET's existing liabilities and the existing counterparties on the other hand may require the settlement of all existing liabilities prior to granting its consent to the novation.

29. Section 7(2)(d) of the Electricity Act.

Accordingly, the approach adopted by NERC in the Order may be informed by the need to avoid the bottlenecks which may arise from a sudden exit of NBET in the market, given NBET's pivotal role as a credible counterparty for over a decade.

Nevertheless, we understand that certain stakeholders in the market, for the reasons canvassed for the extension of NBET's license in 2021, are of the view that the market is not ready for GenCos and DisCos to trade bilaterally and NBET's role should be retained. It remains to be seen how such stakeholders will react to the seeming differential between the specific provisions of Section 7(2)(b) of the Electricity Act and the manner in which NERC has now implemented same.

To those with reservations on the manner of implementation by NERC, it is perhaps useful to note that it may also be contended that the practical approach adopted under the Order serves the overall principal purpose and intendment of Section 7 of the Electricity Act which imbues NERC with the *"continuing responsibility...to ensure the development of the Nigerian electricity market from its current transitional electricity market stage to the Medium Term and Long-Term Electricity Market stages."* It is against this background that the Electricity Act then proceeds to set out some of the specific functions of NERC in Section 7(2) of the Electricity Act.

Furthermore, it may be posited that in addition to the purposive approach of legislative interpretation highlighted above, NERC does have the power to determine the manner of implementation of its functions under Section 7(2)(d) of the Electricity Act, as Section 10(2) of the Interpretation Act provides that an enactment which confers power to do any act shall be construed as also conferring all such other powers as are reasonably necessary to enable that act to be done or are incidental to the doing of it. Given the constraints identified above with respect to a strict implementation of the provisions of the Electricity Act, the approach adopted under the Order appears more aligned with practical realities as to the manner in which NBET may be phased out of the electricity market.

Treatment of the Existing NBET Contracts

As a result of the disparity highlighted above with respect to the implementation provisions under the Electricity Act and the Order, certain uncertainties arise as to the treatment of the existing contracts entered into by NBET

with the DisCos and GenCos (the **Existing NBET Contracts**), as the Order has not provided sufficient clarity in this respect. For instance, the Order provides that the Residual Capacity shall be traded by the Market GenCos with NBET on an interim agreement basis maintaining the same commercial terms contained in their existing contract with NBET. However, it is not clear whether the intention is that the existing PPAs/Interim Agreements between NBET and the Market GenCos shall be terminated, and trading will commence on the basis of new interim agreements which largely reflect the same terms as the previous contracts, or the PPAs/Interim Agreements will simply be amended to reflect the new trading terms.

Furthermore, given that only the NBET Firm Capacity shall be traded on a firm basis with the DisCos, it is unclear whether the vesting contracts will need to be amended to reflect the firm capacity set out in the Order, and provide for the terms upon which NBET will supply from the NBET Interim Pool on a take and pay basis.

In addition, given that the Order represents a change in the legal and regulatory landscape of the electricity sector in Nigeria, the directives thereunder, may be considered a supervening "change in law" event, which, where the relevant Market GenCo incurs any loss in relation to its implementation, may require NBET to compensate any such loss, which is an additional liability of NBET under the contract.

Moreover, the relevant Market GenCo may have entered into financial arrangements with lenders on the basis of its PPA, and any termination or amendment of the commercial terms of the PPA, may be a termination event under its other project documents and finance documents.

Thus, whilst the Order provides clarity as to the requirement to enter into new bilateral contracts, market participants will need to keenly review and obtain further guidance on their existing contractual arrangements under the Existing NBET Contracts, particularly in a manner in which additional liabilities shall not be incurred.

The Interim Period

Paragraph 19(B) of the Order provides that NBET shall, in the interim continue to administer the NBET Firm Contracts. However, there is no clarity as to the duration of the referenced

interim period – whether this will be until the termination of the relevant NBET Firm Contract, or until the expiry of NBET’s license in November 2024 or until a further date where NERC provides guidance as to the treatment of the NBET Firm Contracts.

Furthermore, given NBET’s continued role in the market, no clarification has been provided as to whether NERC intends to renew NBET’s license before its expiration, and whether NBET’s license will be renewed indefinitely, or for a specific period of time where NERC determines that the electricity market no longer requires NBET’s presence

Investment and Competition in the Electricity Sector

One of the key benefits of the Order is potential increased investments in the power sector, as the shift to bilateral trading will necessitate infrastructure improvements. This influx of capital and expertise enhances liquidity and reduces financial bottlenecks, ensuring that funds flow more freely throughout the market. With more market participants, the financial risks are distributed among various entities, reducing the burden on any single player and improving the overall stability of the electricity market.

Furthermore, the GenCos are not limited to trading their contracted capacity with only DisCos; they can also trade with other offtakers, such as TraderCos and eligible customers, which will provide the GenCos the ability to enter into more commercially bankable contracts. This flexibility allows GenCos to optimize their operations and revenue streams, leading to more realistic pricing and encouraging investment in new generation capacity.

A more competitive and flexible market can respond more effectively to changes in demand, reducing the likelihood of power shortages or surpluses. With this approach, there is a stronger incentive for both GenCos and DisCos to improve performance and efficiency, as their revenues are directly linked to their ability to meet their contractual obligations under the bilateral contracts, particularly given the shift from a “take and pay” to “take or pay” contracts.

Finally, the presence of a more competitive and transparent market can attract both domestic and international investors, driving economic growth and job creation. Increased investment in the sector can lead to improved infrastructure, enhancing the overall capacity and reliability of the electricity grid.

Nonetheless, whilst the Order provides that the DisCos should enter into bilateral contracts with terms which are aligned with the allowed recoverable generation cost from its end-user tariffs, given that such costs are not sufficiently reflective of the cost of generation, difficulties may arise as to the ability of the DisCos to enter into bankable commercial arrangements, and comply with its terms.

Scope of NERC’s Role

As the market transitions to a more competitive environment, the expectation is that market participants will be afforded the ability to transact and negotiate with minimal NERC intervention regarding PPA terms, particularly the commercial terms between the parties.

However, the Order indicates that NERC will still retain its overarching influence over the terms of bilateral contracts to be entered into by the parties. For instance, NERC is required to approve all bilateral transactions, and which restrictions have been placed upon the trading contract capacities of the GenCos and the DisCos.

Whilst these restrictions are intended to maintain market stability and for trading to be based on current market realities of what the grid infrastructure can wheel, NERC may need to gradually allow more autonomy for market participants as infrastructure investments improve the sector. Excessive regulatory interference could stifle innovation and flexibility in contract negotiations, so a phased approach to reducing oversight as the market matures could be beneficial.

Reduced Reliance on FGN Interventions

Within the current structure of the Nigerian power sector, in the absence of cost-reflective tariffs, the FGN covers the resultant gap (between the cost-reflective and allowed tariff) in the form of tariff subsidies. The subsidy is only applied to the generation cost payable by DisCos to NBET at source in the form of a DisCo’s Remittance Obligation (DRO). The DRO represents the total GenCo invoice that is billed to the DisCos by NBET based on what the allowed DisCo tariffs can cover. The outstanding portion of the GenCo invoice not covered by allowed tariffs is thus not billed to the DisCos, and is to be covered by the FGN in the form of tariff subsidies.

In this regard, the NBET invoice payable by the DisCos for 2024/Q1 was only ₦65.96 Billion, with the FGN incurring a subsidy obligation of ₦633,030,000,000.00 (Six hundred and thirty-three Billion, thirty Million Naira) (90.57% of NBET's total invoice) in 2024/Q1³¹ (average of ₦211.10 billion per month)³². This sum represents a significant burden upon the revenues of the FGN.

Therefore, to the extent that contracting with NBET has been reduced to only with respect to the NBET Firm Capacity and the Residual Capacity, the Order will reduce the financial burden on the FGN as it decreases exposure its exposure to electricity market risks by phasing out NBET's role as the primary offtaker.

Decentralisation of the Power Sector

With the passage of the Electricity Act, the Nigerian power sector is evolving towards decentralisation, with States increasingly initiating the development their electricity markets. The transition to bilateral trading aligns with the trend towards decentralization, as States can enact laws for the introduction of new market participants which can enter into their contracts with Generators. Furthermore, the opening of the market to more participants means that both DisCos and GenCos have a broad range of participants to contract with.

However, in the implementation of the Order, coordination between NERC and the State regulatory bodies will be required to avoid conflicts and ensure that decentralized initiatives complement national energy goals.

Distribution and Transmission Infrastructure

As discussed above, the implication of the Order is that more market participants are able to trade in the market and enter into contracts with the existing GenCos and DisCos. However, the current grid infrastructure may significantly hamper the extent to which these new transactions can be successfully implemented. This is especially given the following:

- **Failing Transmission/grid infrastructure** – the transmission infrastructure remains a major hurdle to efficient operation of the electricity sector due to the largely dilapidated physical infrastructure. The grid in its present state does not have adequate bandwidth to transmit the maximum generation capacity available. It is important to take cognizance of the strategic position of the transmission infrastructure as a middleman between

the generation and distribution segments.

- **Distribution infrastructure** – similar to the transmission infrastructure, significant amount of the DisCos' network poses a major hurdle to the NESI, which has led to increased and continuous accumulation of Aggregate Technical Commercial & Collections losses which have a negative effect on the commercial viability of the electricity sector.

Therefore, whilst the expectation is that projects such as the Presidential Power Initiative, and State regulation and investments shall lead to improvements in the distribution and transmission infrastructure in Nigeria, in the interim, parties should include obligations in their bilateral contracts to undertake distribution and transmission network infrastructure upgrades and rehabilitation in order to ensure grid stability.

Implication of Gas Supply Issues

One of the indices impacting the generation level applicable to the purchase of generation capacity and electrical output from the GenCos is the prevailing price, and availability, of gas. Therefore, critical to the ability of the Market GenCos to trade bilaterally and fulfil their market obligations is the availability of gas to generate electricity. Without sufficient feedstock, Market GenCos cannot generate electricity, potentially leading to performance defaults under their contracts with the DisCos.

We have identified critical gas supply issues that could impact the implementation of the Order as follows:

- **Availability of Gas:** a key requirement of the Order is that the Market GenCos must enter into effective GSAs on a "take or pay" basis, with provision for the payment of liquidated damages in the event of a gas supply default. However, there is currently a gas deficit in the market and major gas suppliers also have long term firm offtake contracts for supply of gas. Therefore, market realities may impact the ability of the GenCos to comply with this obligation.
- **Gas Infrastructure:** the current network of gas pipeline infrastructure remains inadequate to meet the domestic supply obligation. This may therefore hinder the effective transportation and delivery of gas to the Market GenCos.

31. Across 2024/Q1, this represents an increase of +₦380.56 billion (+150.56%) compared to the ₦252.76 billion (average of ₦84.25 billion per month) incurred in 2023/Q4; this increase is largely attributable to the Government's policy to harmonise exchange rates while also issuing a policy directive that end-user customer tariffs remain at the rates that came into effect in December 2022

32. See NERC's First Quarter 2024 Report: https://nerc.gov.ng/wp-content/uploads/2024/07/2024_Q1-Report_v1YA.pdf

- Domestic Gas Pricing:** the price of gas supplied as a part of gas producers' Domestic Gas Delivery Obligation (DGDO) falls well short of prices available in international markets, and as a result, domestic gas producers, upon meeting their minimum DGDO obligations prefer to export domestically produced gas at higher prices at the international market. This regime negatively impacts the amount of gas available domestically for power generation as domestic gas producers are not incentivized to make available sufficient amounts of gas within the Nigerian market.

The foregoing gas supply issues may therefore significantly impact the ability of the Market GenCos to fulfil their gas supply obligations, which has remained unresolved since 2013, when NBET entered into the first set of PPAs in the NESI.

Implementation Timeline

The chart below captures the implementation timeline of the Order³³:

Given the novelty of the market arrangements prescribed by the Order, the timelines provided above may not be sufficient to provide the market participants with the ability to fulfil their obligations under the Order, particularly the entry into complex contracts which will govern long term obligations in the NESI.

Therefore, it is important for NERC to be prepared to be flexible in providing additional time for each market participant to comply with the Order, in order to ensure that its implementation achieves the proposed objectives.

Current stage



TIMELINE																
Weeks (From Effective Date of 25 July 2024)	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Dates	25 JUL JUL 31	AUG 1 AUG 7	AUG 8 AUG 14	AUG 15 AUG 21	AUG 22 AUG 28	AUG 19 SEPT 11	SEPT 5 SEPT 11	SEPT 12 SEPT 18	SEPT 19 SEPT 25	SEPT 26 OCT 2	OCT 3 OCT 9	OCT 10 OCT 16	OCT 17 OCT 13	OCT 24 OCT 30	OCT 31 NOV 6	NOV 7 NOV 13
Market GenCos and DisCos to enter into bilateral contracts	[Green bar spanning weeks 1-9]															
Notification to NBET of the bilaterally traded capacities	[Red bar spanning weeks 1-10]															
PEL to enter into an effective GSA	[Yellow bar spanning weeks 1-6]															
Market GenCos required into effective GSAs ³³										[Yellow bar spanning weeks 10-16]						

M I L E S T O N E S

CONCLUSION

The Order represents a bold step towards liberalising Nigeria's electricity market, promoting competition, and encouraging private sector efficiency. However, its success will heavily depend on the readiness of market participants to adapt to the new framework and the ability of NERC to enforce compliance. Furthermore, whilst the shift from NBET (the FGN-backed bulk trading entity) to bilateral contracts could lead to greater efficiency, it also introduces new risks, particularly related to market liquidity and contract enforcement.

Nevertheless, with strategic oversight and collaboration among stakeholders, this transition has the potential to transform Nigeria's electricity sector, paving the way for long-term growth and stability.

33. With respect to the requirement of the Market GenCos to enter GSAs within three (3) months of commencement of bilateral trading, we note that the date may be open to different interpretations. Such commencement date may be the execution date of the bilateral trading contract, the effective date of such contracts (i.e., when the conditions precedents are fully met) or the date that the actual bilateral trading commences. In practical term, we envisage that the commencement would be when the actual bilateral trading commences under the bilateral trading contract. However, for the purposes of the chart we have included this as a date after execution of the contract.

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