BUSINESS UNITY SOUTH AFRICA

SUBMISSION TO NERSA BY BUSINESS UNITY SOUTH AFRICA (BUSA) ON ESKOM'S FOURTH MULTI-YEAR PRICE DETERMINATION (MYPD4) APPLICATION FOR FY 2019/20 – 2021/22

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1. ABOUT BUSA

BUSA is a confederation of business organisations including chambers of commerce and industry, professional associations, corporate associations and unisectoral organisations. It represents South African business on macro economic and high level issues that affect it at the national and international levels. BUSA's function is to ensure that business plays a constructive role in the country's economic growth, development and transformation and to create an environment in which businesses of all sizes and in all sectors can thrive, expand and be competitive.

As a principal representative of business in South Africa, BUSA represents the views of its members in several national structures and bodies, both statutory and non-statutory. BUSA also represents businesses' interests in the National Economic Development and Labour Council (NEDLAC).

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2. INTRODUCTION

CONTEXT

- In BUSA's response to Eskom's pricing applications, we have consistently emphasised the relationship between:
  - i) reliability of supply, ii) predictability of tariffs and iii) competitiveness of tariffs; and
  - the economy as a whole.
- In nominal terms, Eskom's average standard electricity prices have increased by 613% over the last 15 years[1]. Electricity is a major input for many industries in South Africa.
  - The MYPD 4 application provides for tariff hikes of 52% over a three year period (56% following the revisions), excluding the impact of i) the approved RCA applications iro 2014-2017, and ii) yet to be considered and approved RCA application iro 2017/18
  - It is likely that primary energy cost escalations would result in a further RCA application iro 2018/19
- NERSA has demonstrated in prior approvals that BUSA's submissions iro affordability have been taken into account.
- If approved, the current application would constrain investment in SA and would contribute to stagnant economic growth, significant job losses and grid defection – exacerbating the death spiral phenomenon.

The electricity price must be justifiable, both in meeting the requirements of the methodology and in being affordable.

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1 BUSA Comments on Eskom's MYPD4 Application (written submission) page 9

2. INTRODUCTION (CONT)

APPLICATION PROCESS

- We are concerned that the cumbersome MYPD application process continues to be flawed. Furthermore, it is unacceptable that consumers are given insufficient opportunity to interrogate fundamental last minute changes:
  - The process is **time consuming**, distracting Eskom management
  - If the **return on RAB is used as the balancing number**, tariff setting is **open to manipulation**
  - The intended predictability of the tariff trajectory is undermined as a result of an **ambiguous definition of prudently incurred costs** in the context of Eskom’s developmental mandate

PRUDENCY AND EFFICIENCY

- Only costs prudently and efficiently incurred are recoverable in terms of the MYPD methodology
- Eskom has a dual mandate – to supply reliable and affordable electricity and developmental mandate
  - BUSA believes that the shareholder should be liable for costs relating to Eskom’s developmental mandate, as these costs are unrelated to the efficient supply of reliable and affordable electricity
  - In prior rulings, NERSA concurred that customers should not be liable for excessive costs relating to decisions imposed on Eskom

Tariff predictability needs to improve by ensuring that there is clarity on key inputs into the tariff formula, applied consistently

2. INTRODUCTION (CONT)

ASSUMPTIONS MUST BE REALISTIC

- Eskom has consistently failed to motivate assumptions used in the price applications. Further, these assumptions have consistently failed to materialise
- It is of critical importance that assumptions are realistic. Associated RCA adjustments undermine the intended tariff predictability

GOVERNANCE AND ACCOUNTABILITY

- Eskom must be overseen and managed by an accountable and competent board and management team, responsible for:
  - **Change management**: To ensure efficiencies through an operational restructuring
  - **Growth**: To underpin economic growth in chosen market as a supplier of reliable and affordable electricity
- BUSA commends steps already implemented to:
  - Restore investor confidence
  - Address governance concerns
  - Providing clarity on Eskom’s financial circumstances

Application assumptions must withstand scrutiny, be realistic and adequately motivated. Large discrepancies between tariff applications and approvals undermine investor confidence

3. OVERVIEW OF THE MYPD 4 APPLICATION

ZAR'm	2018/19 Projected	2018/19 Approved	2019/20	2020/21	2021/22
			As per the application		
RAB related recoveries	54 742	53 020	47 964	70 154	95 963
Return on regulated capital	28 117	28 117	(16 687)	(2 765)	20 314
Depreciation	26 625	24 903	64 651	72 919	75 649
Operating expenditure	58 018	51 122	56 619	59 820	62 663
Primary Energy	64 797	48 189	73 386	75 876	79 561
IPPs	26 549	26 596	29 590	34 324	41 002
International	3 127	3 216	3 533	3 734	3 957
IDM	186	-	189	193	202
R&D	167	112	176	187	198
Levies	8 068	8 093	8 272	8 198	8 147
	215 654	190 348	219 729	252 486	291 693
CSI	292		192	193	151
Total	**215 362**		**219 537**	**252 293**	**291 542**
Revenue	**190 348**		**219 537**	**252 293**	**291 542**
Sale volumes (GWh)	212 727		215 507	216 195	218 292
Standard tariff (ZAR)	0.94		1.08	1.24	1.43
Revenue shortfall	**25 014**				

Revised plan provides for an identical total annual cost recoveries, but with a vastly different composition:

- Return on RAB (+R3.8bn)
- Primary energy, IPPs and international purchases (+R6.2bn)
- Depreciation (-R9.2bn)
- Levies and taxes (-R0.8bn)

The application for a 52% increase in tariffs over 3 years is anticipated to result in revenue increasing from R190bn in 2018/19 to R291bn in 2021/22. The revised plan provides for the same revenue, spread over a smaller user base. The increased revenue is ascribed to:

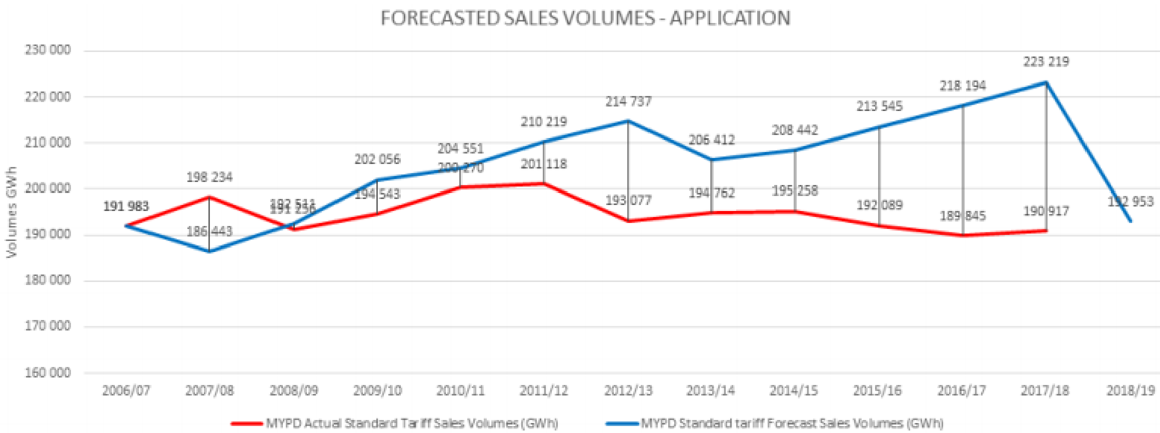
- R25bn iro costs in excess of those approved for 2018/19, primarily relating to:
  - Operating expenditure (R7bn)
  - Primary energy costs (R17bn)
- R76bn iro cost escalations from a revised base, primarily relating to:
  - RAB related recoveries: R41bn
  - Primary energy costs: R15bn
  - IPPs: R14bn
  - Operating expenditure: R4bn
- Recognising the primary energy cost overruns in 2018/19, it is probable that Eskom would submit a further RCA application

In this presentation, we focus on return on RAB, depreciation, operating expenses, primary energy costs and IPPs as key drivers of the MYPD 4 application.

4. REVENUE

OVERVIEW

- Eskom's revenue has consistently fallen short of projections as a result of sales volumes not meeting expectations. The commencement of the death spiral has contributed significantly to the steep tariff increases



BUSA assessment of the MYPD 4 assumptions

- **Sales volume** forecasts continue to be unrealistic if the tariff is approved. Standard tariff sales are reasonable (albeit somewhat optimistic) only if tariffs increase at CPI.
- We believe that the **cost structures** that underpin the **tariff** application include significant costs not prudently incurred

MUNICIPAL DEBT

- It is unacceptable that Eskom is unable to recover revenue due to it from some municipalities, currently amounting to R17bn, contributing materially to Eskom's liquidity crisis

The economy would not be able to tolerate tariff increases in excess of inflation – if the tariff application is approved, significant job losses would arise.

5. REGULATORY ASSET BASE RELATED RECOVERIES

REGULATORY ASSET BASE (“RAB”) REVALUATION

- **RAB was revalued** from c.R700bn to R1,268bn (subsequently reduced to R1,253bn) and the remaining life of the assets have been reduced – with a significant impact on return on RAB and depreciation
- We urge NERSA to perform an independent review of the revaluation. In the interim, a revaluation should be disallowed. Whilst the impact on tariffs is not immediate, it sets the base for substantial future tariff increases

Return on RAB

- It appears as if return on RAB has been used as the balancing number
  - Negative returns in the short term, increasing to only 1% in 2021/22
- It is inappropriate for Eskom to apply for negative returns. This is contrary to the methodology.
- We are in favour of appropriate returns being phased in, so as to avoid a sudden tariff increase

As indicated previously, we are in favour of a phasing in of appropriate returns

Depreciation

- The application is premised on the assumption that depreciation would increase from R25bn to R75bn over the three year period (R65bn in the first year)
- BUSA believes that the consumer should never be liable for artificially inflated depreciation pursuant to a revaluation
- Furthermore, any tariff increase pursuant to an asset life adjustment should be carefully scrutinised, as this could be indicative of costs not prudently incurred

Depreciation should be based on actual capex, prudently incurred. Asset life adjustments must be carefully motivated and scrutinised

6. COSTS

6.1 OPERATING COSTS

Human Capital (R27bn – R29bn)

- A study conducted by NERSA in 2016/17 determined that Eskom was able to produce ~240GWh with c.33k employees in 2007/08 (7.3GWh/employee). At that time (2016/17), Eskom produced ~216GWh with c.39k employees (5.3GWh/employee). Eskom currently has more than 41k employees, producing ~220GWh.
  - NERSA concluded that Eskom had c.6,000 excess staff members
  - BUSA believes that this is a conservative estimate

- It is of concern that employee costs have continued to increase – from R24bn in 2017/18 to a projected R27bn in 2018/19, contributing to operating costs being R7bn higher than the approved cost
  - Employee costs are anticipated to reduce in 2019/20. However, we continue to believe that there are significant residual inefficiencies.
  - Recognising Eskom's developmental mandate, we believe that associated costs should be funded by the shareholder, rather than the consumer

NERSA must carefully assess Eskom's human capital requirements. Any costs in excess of those required by Eskom to operate efficiently should be funded by the shareholder

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6. COSTS

6.1 OPERATING COSTS (CONT)

Operating and Maintenance costs (R28bn – R33bn)

- Operating and maintenance costs are anticipated to increase from R26bn in 2017/18 to a projected R28bn in 2018/19, primarily ascribed to maintenance, which is anticipated to increase from R14bn to R16.5bn
  - In view of the backlog, increased maintenance costs were to be expected
  - However, we believe that the consumer should not be liable for backlog maintenance costs, as such excess is a direct result of new plants not being commissioned on time

Debt impairments (R2bn – R4bn)

- Debt impairments are anticipated to peak in 2018/19 at R4bn, reducing to R2bn in 2019/20
- The consumer should not be liable for any impairment of municipal debt

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BUSA believes that the consumer should not be liable for backlog maintenance costs nor impairment of municipal debt. These costs should have been avoided

6. COSTS

6.2 PRIMARY ENERGY COSTS

Coal related (R60bn – R73bn)

- Production and coal burn are anticipated to remain stable at c.201 TWh/a and c.115t/a respectively. Coal contribution to gross production is anticipated to reduce from 84% to 81% in 2021/22. In the revised plan, Kusile and Medupi inefficiencies translate into unacceptable energy availability levels, resulting in over-utilisation of expensive OCGT capacity and IPPs
    - It is of concern that Kusile and Medupi does not appear to unlock coal volume efficiencies.
    - Unit costs have and are anticipated to increase exponentially, in line with World Bank forecasts for the industry. Costs anticipated to increase by 17% in 2018/19 (c.R480/t) – the most material contributor to the R25bn shortfall
- Cost could have been significantly lower Eskom had invested in tied mines

Other (R5bn - R6bn)

- In view of the relative immateriality of these costs, we have not performed an in-depth assessment. Certain costs contributed to the R25bn shortfall in 2018/19 and should be interrogated:
    - **Water related costs**: Increased from R2.3bn in 2017/18 to R3.3bn in 2018/19
    - **OCGT costs:** Increased from R0.3bn (2017/18) to R0.8bn (2018/19). It is of concern that consumption is not projected to reduce as Kusile and Medupi units are commissioned. In the revised plan, OCGT fuel burn is anticipated to add R6.2bn to the anticipated costs over the three year period

The consumer should not be liable for increases relating to i) the decision not to fund tied-mine capital expansion; ii) Kusile and Medupi delays; and ii) challenges arising from poor governance

6. COSTS

6.3 INDEPENDENT POWER PRODUCERS

- BUSA believes that the incorporation of additional IPPs should be encouraged, provided that:
  - Electricity is produced cost efficiently
  - Funding available to Eskom is not compromised
- IPP contribution to total output is expected to increase from c.4% to c.7.5% within the 3 year MYPD4 application, contributing 15% of the proposed tariff increase. The revised plan provides for R2bn additional IPP costs as a result of low energy availability levels
- Eskom payments for power sourced from IPPs are anticipated to peak at 245c/KWh in 2019/20, reducing to 220c/kWh in 2021/22 on a blended basis and should continue to reduce significantly thereafter. Whilst reducing, payments by Eskom remain well above the tariffs applied for
- As costs are passed on to the consumer, IPPs do not have a direct impact on Eskom's financial position. However, they do have material indirect ramifications:
  - The potential to displace lower cost Eskom production – this is not the case to date and does not appear to be the case during the MYPD4 period, recognising that OCGT production is not anticipated to decrease
  - Upward pressure on the average tariffs, thus contributing to the death spiral

BUSA believes that NERSA should consider alternative funding options to ensure that IPP costs are appropriately amortised, so as to minimise the impact on the death spiral.

7. CAPITAL STRUCTURE AND CAPITAL EXPENDITURE

- Eskom’s **capital structure** is not sustainable:
  - Debt anticipated to grow from R400bn to R600bn
  - Eskom is generating insufficient cash to cover its costs and service its debt
  - BUSA believes that debt levels need to reduce by at least R200bn
- To strengthen Eskom’s Balance Sheet, the only viable solution appears to be a capitalisation / write down of at least R200bn debt. Alternatives would not address the challenge in the near term:
  - Tariff increases in excess of inflation reduces competitiveness, thus accelerating the death spiral. The tariff methodology specifically seeks to amortise tariffs appropriately
  - If achievable, a compromise with debt providers would have a negative impact on credit ratings and on the ability to raise future funding
  - A sale of assets should be encouraged, but implementation is subject to a restructuring of the industry
- In the long run, tariffs need to be:
  - Affordable, so as to avoid the death spiral; and
  - Reflective of prudently incurred costs plus an appropriate return
- We are concerned that **capital expenditure** remains stubbornly high, notwithstanding Eskom’s financial constraints

Eskom requires Government support to strengthen its balance sheet. This needs to be subject to a broader restructuring of the industry.

8. TARIFFS IN THE REVISED PLAN

- The higher tariff in the revised plan is the result of:
  - **Lower anticipated sales volumes** – primarily from a "non-paying international customer"; but
  - **No adjustment** to anticipated recoverable **costs**
- Whilst total recoverable costs remain the same, significant revisions have been made to the composition:
  - Return on RAB (+R3.8bn)
  - Primary energy, IPPs and international purchases (+R6.2bn)
  - Depreciation (-R9.2bn)
  - Levies and taxes (-R0.8bn)
- It is of particular concern to BUSA that
  - **SA consumers are expected to pay more** as a result of the loss of an international customer
  - **Primary energy costs are anticipated to crease**, despite lower volumes. This appears to be a direct result of Medupi and Kusile inefficiencies, resulting in unacceptable energy availability and a consequential over-utilisation of expensive OCGT capacity and IPPs. At the same time, 26 units are shut down as these are "not required to meet demand"
  - **No adjustment is made to operating costs** despite the lower sales
  - Eskom is using **debt affordability as motivation for higher tariffs**, when the methodology specifically seeks to avoid this by amortising increases appropriately

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BUSA has had insufficient opportunity to interrogate revisions to the assumptions

9. OPERATING MODEL

- Eskom’s mandate is to provide reliable and affordable electricity. BUSA believes that the energy supply industry needs to be restructured to enable Eskom to fulfil this mandate
- In a restructured energy supply industry:
  - IPPs would not supply power to Eskom, but would compete with Eskom to provide electricity to the grid
  - Small Scale Embedded Generation projects word be unlocked that would enhance security of supply
- In the context of a restructured Energy Supply Industry, Eskom’s operating model would need to be holistically and comprehensively reconfigured
- In the short term, a functional separation of generation from transmission and distribution, resulting in an independent grid, is one step that can be taken soon (and without legislative amendments) as a pre-cursor to a legal separation

Eskom’s operating model is not fit for purpose – the utility must be restructured. This cannot be done in isolation of a restructuring of the whole electricity industry

10. TARIFF METHODOLOGY

- BUSA believes that the **principles of the tariff methodology are fundamentally sound**:
  - Methodology aimed at ensuring that tariffs are amortised, so as to avoid inappropriate increases to fund debt
  - Eskom should be able to recover costs prudently incurred plus an appropriate return on RAB. Failing this, financial constraints would recur in the future, irrespective of how immediate constraints are addressed
- We are, however, concerned that:
  - Consumers are given **insufficient opportunity to interrogate** fundamental last minute changes
  - Principles are **not applied consistently**: The 5-year MYPD3 application was followed by a 1-year application for the 2018/19. MYPD4 provides for only 3 years, instead of 5
  - Tariff setting is **open to manipulation** as return on RAB seemingly is the balancing number
  - The **definition of prudently incurred expenditure remains ambiguous** in view of Eskom's developmental mandate, resulting in large discrepancies between tariff applications and those approved
  - **Assumptions have proven to be inaccurate**, resulting in RCA applications that undermine predictability
  - The tariff trajectory can be changed fundamentally through a **revaluation of the regulatory base** and a **reduction of the remaining life of the assets**
- Whilst the methodology is sound, it may be appropriate to suspend it until such time as the electricity supply industry is restructured, especially as tariff setting is open to manipulation until return on RAB is fully recognised

Consideration should be given to a suspension of the MYPD methodology, approving inflation linked tariff increases until the restructuring of the ESI is complete.

THANK YOU

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