BUSINESS UNITY SOUTH AFRICA

NERSA'S DISCUSSION DOCUMENT: PRUDENCY ASSESSMENT CRITERIA TO ASSIST LICENSEES IN ENSURING THE PRUDENCY OF COSTS INCURRED

SUBMISSION BY BUSINESS UNITY SOUTH AFRICA (BUSA)

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BACKGROUND

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

INTRODUCTION

Business Unity South Africa (BUSA) has previously submitted a comment to the National Energy Regulator of South Africa (NERSA) on what defines "prudency"[1]. This submission was made in February 2016 at NERSA's request and was recently referenced in BUSA's submission on Eskom's One-Year Revenue Application in October 2017[2]. Both these documents are annexed to this submission for ease of reference.

In summary, BUSA's 2016 submission stated (as noted in the discussion document) that:
*The word '**prudency**' is not used in the Electricity Regulation Act 4 of 2006 ('ERA'). The tariff principles that NERSA must apply are set out in Section 15 of ERA, and include (in Section 15(1) (a)) the following directive:*
'must enable an efficient licensee to recover the full costs of its licensed activities, including a reasonable margin or return;'
In BUSA's view the requirement for a licensee to be 'efficient' if it is to be allowed to recover the full costs of its activities, any expenditure claimed must be prudently incurred. This is reflected in the Multi-Year Price Determination Methodology 1st Edition ('MYPD') as set out below:
*'14.1.2 Allowing the pass-through of **prudently** incurred primary energy costs as per Section 8 of the Methodology.'*
*'14.1.4 Adjusting for **prudently** incurred under-expenditure on controllable operating costs as may be determined by the Energy Regulator.'*
Prudently incurred therefore means expenditure that is:

- *efficiently incurred; and*
- *appropriate; and*
- *useful; and*
- *necessary; and*
- *reasonable; and*
- *which allows Eskom to provide an adequate level of service to its customers.*

BUSA believes that guidance to licensees on how they should determine prudent expenditure is an important addition to existing methodology relating to applications for tariff adjustments.

[1] Prudency in Incurring Expenditure by Eskom: Submission by Business Unity South Africa to NERSA. February 2016
[2] Eskom Revenue Application For 2018 / 2019: Submission to NERSA By Business Unity South Africa (BUSA). October 2017

NERSA's intention to formalise this requirement is therefore welcomed and BUSA appreciates the opportunity to provide comment in this regard.

The discussion document references many definitions or requirements for "prudency". Many of these are aligned and accepted internationally. These interpretations are supported by BUSA; however, any final definition and criteria must be applicable to the South African context and requirements.

Answers to the questions posed by NERSA are presented below.

QUESTIONS

Question 1: Are there other issues that the Energy Regulator should consider when dealing with prudency matters?

The existing legislation (Policies, Acts and Regulations) and regulatory methodologies place sufficient emphasis on efficiency and prudency of costs to be incurred by regulated entities.

However, judging from the current inadequate performance of the regulated State-Owned Companies (SOC's) in executing the both the capital projects and operating expenditure there may be a need to review the enabling legislation.

NERSA should consider strengthening its oversite role by requiring timely and adequate reports from the regulated entities and acting on these reports when deviations from approved determinations are observed.

Prospective versus Retrospective

Paragraph 6 of the discussion document states that: "Prudency is generally assessed post-fact…" However, the Multi-Year Price Determination (MYPD) includes the assessment of prudency, as noted in paragraph 13 of the discussion document. Therefore, it must be clear that prudency must be proved prospectively, not only retrospectively. This ensures that planning, risk assessment and decision making is prudent. As stated by Nielsen et al in Fortnightly Magazine (2009)[3]:

[3] https://www.fortnightly.com/fortnightly/2009/12/new-day-prudence

Effective management begins with planning and it continues with the systematic collection, preservation, and retrieval of project information and other data that provides support for the decision-making process and the costs incurred. Utilities, if they are to succeed in this new age of prudency, will have to document their decision-making process from the very beginning and demand that their contractors do the same. However, in today's world, the utility companies must face the fact that prudency isn't just a concept, but a requirement, and if not met, the risk of disallowed costs increases greatly. Utilities have little option but to move forward, even if it means venturing into unmarked territory.

Question 2: What other statutes and regulatory framework should the Energy Regulator consider when dealing with prudency matters?

The BUSA submission in 2016 to NERSA cited the following Canadian Case Study:

In the Ontario Energy Board v. Ontario Power Generation Inc. case, the Supreme Court reviewed the Ontario Energy Board ("OEB" or the "Board")'s decision to disallow $145 million in costs applied for by Ontario Power Generation ("OPG") in its 2011-2012 rates application.

Some of the key elements which affected the Prudence discussion in this case are noted below:

1. That there really was no difference between prudent and reasonable: In the context of utilities regulation, one cannot find any difference between the ordinary meaning of a "prudent" cost and a cost that could be said to be reasonable. It would not be imprudent to incur a reasonable cost, nor would it be prudent to incur an unreasonable cost.

2. That there is a need to differentiate between committed costs and forecast costs:

The Court in the OPG case made a distinction between forecast costs and committed costs as follows:

- *Forecast costs are costs which the utility has not yet paid, and over which the utility still retains discretion as to whether the disbursement will be made…. [C]ommitted costs are those [which] the utility has already spent … [or has] entered into a binding commitment or [is] subject to other legal obligations that leave it with no discretion as to whether to make the payment in the future.*
- *The disallowance of committed costs is particularly problematic for a regulated utility because "the utility and its shareholders will have no choice but to bear the burden of those costs themselves." In the long run, disallowance may also not be in the interests of consumers since "[d]isallowing recovery of the cost of failed investments that appeared reasonable at the time, for example, may imperil the financial health of utilities, and may chill the incentive to make such*

investments in the first place. This effect may then have negative implications for consumers, whose long-run interests will be best served by a dynamically efficient and viable electricity industry."

- *The disallowance of forecast costs is far less problematic since such a case "presents a utility with a choice: it may change its plans and avoid the disallowed costs, or it may incur the costs regardless of the disallowance with the knowledge that the costs will ultimately be borne by the utility's shareholders rather than its ratepayers."*
- *The problem of committed costs has led utilities and some legislators, regulators and courts to develop a prudent investor test, based on conditions as they stood at the time the investment was made (or costs incurred) as part of a methodology for establishing just and reasonable rates.*
- *A specific formulation of the prudent investment test framework is as follows:*
    - *Decisions made by the utility's management should generally be presumed to be prudent unless challenged on reasonable grounds.* [A caveat for this is suggested under question 7 below]
    - *To be prudent, a decision must have been reasonable under the circumstances that were known or ought to have been known to the utility at the time the decision was made.*
    - *Hindsight should not be used in determining prudence, although consideration of the outcome of the decision may legitimately be used to overcome the presumption of prudence.*
    - *Prudence must be determined in a retrospective factual inquiry, in that the evidence must be concerned with the time the decision was made and must be based on facts about the elements that could or did enter into the decision at the time.*

Question 3: Are there any other concepts that NERSA needs to consider over and above, efficiency and reasonableness?

Prudency

As noted in response to question 1 above, "prudency" should not only apply to past costs or investments.

Regulators should only allow the recovery of prudently incurred costs is supported.

The definition of imprudent costs in paragraph 27 is supported, however it should be added that any costs incurred in a corrupt manner cannot be accepted as prudent.
That the burden of proof should be on the licensee is supported. This is explored further under question 7 below.

Efficiency and Reasonableness

Paragraphs 30 through 33 are supported and align with our research into the definition of these concepts. Particularly the statement that:
Costs cannot be prudent if they were not efficiently and reasonable incurred.

Benefit/Value

In addition to these concepts, the Benefit or Value of the costs incurred should be assessed. There must be a benefit to the customer. This is under #3 of Table 3 in the discussion document. It applies in this context to Capital Expenditure, but there is an argument for the principle to be applied to any deviation from approved Operational Expenditure in addition to the other criteria listed in table 4.

Question 4: Other than providing information and reasons for a decision to NERSA, is there any other way in which the licensee should prove to the regulator that it has been prudent in incurring costs?

Beecher et al[4] (2016) in chapter 4: Economic Regulation of Utility Infrastructure, state that:
Many core standards of review are aimed at infrastructure investments, which must be found to be… "prudent" based on knowable conditions.
Utilities must operate with "reasonable economies." Rates of return must be compensatory but commensurate with risk. Both rates charged, and returns allowed must be "just and reasonable" and non-discriminatory. Importantly, profits to utilities are authorized but not guaranteed, and returns cannot place "unjust burdens" on ratepayers.
Upon a finding of imprudence, regulators will impute a reasonable cost and send the disallowed excess "below the line" (deducted from profits).
The value of the rate base, and thus the potential for profit, is a function of the scale of investment and the pace of replacement. Left to their devices, utilities will favor capital-intensive investments and accelerated depreciation. To the extent that operating expenses are

[4] Beecher, J.A. and Kihm, S.G., 2016. Risk Principles for Public Utility Regulators. MSU Press.

essentially passed along to ratepayers, they have weak incentives for cost control as well as technical innovation.
Regulators must counter these tendencies and encourage not just any investment but economically efficient and prudent investment.
Prudence reviews and audits help guard against preventable excess, waste, and cost inflation.
Further, the Supreme Court in Canada in ATCO Gas and Pipelines Ltd. v. Alberta (Utilities Commission) (2015)[5] the court rejected ATCO's argument that:
a Utility's costs are presumed to be prudent, and instead held that it is the Utility's burden to establish prudence. [25]

These sources align with paragraph's 34 through 37 of the discussion document and are supported. However, paragraph 37 and the ATCO case study cited above do not fully align with utility presumption of prudence referenced elsewhere in the discussion document.

It is recommended that, where possible and practical, the utility should obtain approval from the Regulator for any deviation. The reasons for the deviation and reasonableness of the preference should be demonstrated at this point.

Question 5: What type of information must be provided by licensees to assist the Energy Regulator in assessing the prudency of costs incurred?
Tables 3 and 4 include many details in answer to questions 3, 4, and 5 of the discussion document. Many of the details in these tables are supported and will not be repeated here.

However, the tables do not specify information requirements in MYPD and Minimum Information Requirements for Tariff Application (MIRTA) methodologies. These should be specified or clearly referenced, and the utility must comply with these information requirements in a full and transparent manner.

[5] ATCO Gas and Pipelines Ltd. v. Alberta (Utilities Commission), 2015 SCC 45

Question 6: Should a tolerance band on forecasted project costs be incorporated into the proposed assessment criteria and what should the allowed band or variance between forecasted and actual costs be?

In respect of the best practices to be considered by Regulators listed under paragraph 38. a) – the interpretation of the Nova Scotia Utility and Review Board (#5) in table 1 is preferred. It is supported that hindsight should not be used in determining prudence. The wording:

- *whether the licensee's decisions were reasonable in the context of information which was known, or should have been known at the time; and*
- *whether the licensee acted in a reasonable manner and use a reasonable standard of car in its decision-making process…*

provides certainty on the importance of prudent planning.

Accordingly, the establishment of tolerance bands is not supported. It is agreed that planning is not an exact science and there are many variables that may not be foreseen. However, the prudency review process already makes provision for such deviations, and the requirements for the prudency of these to be proven. It is agreed that where there are significant forecasting errors, there is a larger concern of whether the utility understands and can manage its business.

Question 7: The onus is on the regulated entity (licensee) to prove that it was prudent in making decisions to incur costs. How can NERSA develop its prudency assessment criteria in such a way that this is achieved, and what should the test for reasonableness that the Energy Regulator should apply be?

The list under paragraph 40 is largely supported. However, as previously mentioned, the utility presumption of prudence as per b) of the list, is not aligned with the statement prefacing the above question – that the onus is on the licensee… The prudency of costs planned or incurred must be proven by the utility.

The statement in e) is supported; prudence cannot be assessed without accurate information. As previously stated, all information required under the prudency assessment criteria as well as information required under any regulations and guidelines or methodologies. Information must be supplied to the Regulator in a full and transparent manner.

Tables 3 and 4 detail proposed prudency assessment criteria; these will be dealt with later in this report.

Question 8: Are there any other factors that NERSA should consider when considering prudency matters?

As previously stated, the interpretations given in table 1 are supported. Preference is given to #5 as this interpretation is more complete and emphasises the importance of planning. In addition, please refer to comments already supplied under question 1 and 2 above in relation to other issues and considerations for prudency.

Question 9: What other prudency principles should be considered and why?

The principles included in the discussion document are supported. As stated in the discussion document, these principles are in line with best practice regulatory principles internationally. Furthermore, the proposed principles are suited to the South African context.

The principles also emphasize the importance of prudent planning and decision-making (foresight). In keeping with these two principles, it is suggested that elements of “Rate stability and predictability” are considered.

As stated by the Public Utilities Board (Canada):
This principle requires rates to remain stable and predictable, at least to the extent practical. Therefore, the principle may justify smoothing out increases to avoid any sharp rate climbs.

A case can be made that where prudency is applied to planning and foresight, costs allowed, and consequently tariffs or rates approved will be prudent. As stated under question 6 above, failures in planning and forecasting, that would lead to unpredictable increases are indicative of more serious management concerns in the utility.

Question 10: What other criteria should be considered for capital expenditure

The proposed criteria and relevant information required in table 3 are largely supported. However, there are some challenges and gaps in relation to the criteria dealing with government policy.

Table 3, #1 required the utility to demonstrate that the infrastructure under consideration is needed… however, it may be that the facility is required as per government policy but is not needed to render the required service. Similarly, under #3, the utility is required to demonstrate benefit, but the investment decision may be government policy and not based on best interests of the licensee and customer.

Other policy considerations for capital expenditure (and operating expenditure) are government policy or legislative requirements such as “localisation” that add inefficiencies to the capital costs but are beyond the control of the utility.

The requirement for any relevant information supporting any government policy is supported, as well as economic forecasts, benchmarking studies and consideration of alternatives, especially in the event of a deviation.

It should not be assumed that if a cost is proven to be incurred in response to government policy, it should be deemed to be prudent. Prudency of the costs incurred should still be tested. For example, the build programme of Medupi and Kusile was based on government policy (IRP2010). Had these projects stayed within the original timeframes and budget, the utility and the shareholder could have argued that the costs were prudent. However, these projects are both late and over budget, because of mismanagement and inefficiencies within the utility. The delivery of these projects also could have avoided load-shedding, which incurred further unforeseen costs. The directive to “keep the lights on” and avoid load-shedding was also ostensibly government policy and came at high unforeseen costs. Load-shedding was also a result of poor planning and management at the utility and therefore cannot be deemed prudent.

As stakeholders in the development of government policy on energy and implementers thereof, both the utility and the Regulator have a responsibility to participate in the process and ensure that planning and forecasting is relevant, reasonable and realistic in line with the prudency principles outlined in the discussion document.

Question 11: How should NERSA deal with prudency matters where NERSA is not involved in the construction phase of the assets?

NERSA as the regulator and the custodian of the electricity supply industry is involved and enabled by the existing legislation to be involved in the construction phase of the asset. NERSA must exercise its mandate as stipulated in the enabling legislation.

NERSA must enforce compliance to its determinations and must diligently assess the abilities and competencies of the regulated entities to undertake the capital projects. Regulated entities undertaking capital projects must be required to provide meaningful updates during the construction phase that will enable NERSA to act accordingly when the necessary corrective action.

Question 12: What other factors should be considered for assessing prudency for operation expenditure?

The proposed criteria and relevant information required in table 4 are largely supported. However, the criteria dealing with government policy incurred costs must be included along the lines of table 3.

For example, it is understood that, as a state-owned entity (SOE), the utility must fulfil the government policy to create employment.

However, examination of the Eskom's employee count versus total energy available for distribution, shows that headcount has increased by 45% since 2007/08, and has remained between 47000 – 48000 for the last four years.

In contrast, energy available for distribution has remained flat (decreasing by 2%). The total energy available for distribution, coupled with the decline in sales, raises concerns regarding the level of overstaffing at the utility. This issue has been highlighted in the World Bank Study for Utilities in Africa[6].

These operating costs cannot therefor be deemed prudent.

[6] Eton: Eskom Financials Summary Report (2017)

In general, to test the prudency of operating expenditure retrospectively, audit reports should be included in the relevant information required.

In relation to costs incurred in carrying out government policy and the prudency thereof, the consumer should not have to bear these costs where better alternatives and/or best practice prove them imprudent.

Question 13: What test should the Energy Regulator apply to determine reasonableness of the CAPEX and OPEX in nature?

As discussed in the sections dealing with OPEX and CAPEX above.

Question 14: Please provide further comments on the proposed prudency assessment criteria to be adopted by NERSA.

The methods that have been used by the regulated entities (i.e. Renewable Energy Independent Power Producers) that realised their projects within budget and reached commercial operation ahead of time must be used as benchmarks and appropriate industry best practice on which the prudency criteria can be based.

CONCLUSION

The need for standardised, appropriate prudency assessment criteria for NERSA to apply is supported. The discussion document is a good basis for the development of prudency assessment criteria and is based on sound international best practice. However, it must be refined for the unique South African context. BUSA looks forward to presenting at the public hearings and trusts that the final publication of the criteria will be available for use in the next MYPD application.