BUSA presentation to NERSA on Eskom's Revenue Application for 2018 / 2019

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Midrand

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Background

- BUSA is a confederation of business organisations including chambers of commerce and industry, professional associations, corporates and unisectoral associations.
- BUSA represents the views of its members in a number of national structures and bodies, both statutory and non-statutory, including Nedlac.
- BUSA has encouraged its members to make their own specific submissions. The submission on which this presentation is based therefore constitutes an overall BUSA position.

Introduction

- Unclear why Eskom is applying for a tariff increase for a single year when MYPD3 expires in March 2018. This contradicts the rationale for the MYPD process, i.e. longer term price predictability.
- BUSA strongly supports longer term tariff determination.
- Such determination should start from a clean slate at the start of a new MYPD period and should be based on what revenue is required to support an efficient and effective operation.
- Current methodology not fit for purpose and continued use results in a rolling problem that repeats itself with every application for a tariff increase.

Introduction (2)

- BUSA has previously expressed concerns about the negative impact of unconstrained capital expenditure on the tariff.
- Higher tariffs result in fewer customers having to pay a higher unit cost for electricity.
- This places businesses under pressure, rendering them less viable and, ultimately, results in Eskom losing customers.
- Remaining customers pay an ever higher unit cost: the so-called “utility death spiral”.

Introduction (3)

- The 2017 MTBPS expressed the concern of the shareholder that failure to secure a high tariff increase will necessitate government assistance.
- Such assistance will have a significant negative impact on the fiscus and the SA economy at large
- BUSA is concerned that a reliance on above-inflation increases is neither justifiable nor sustainable.
- Eskom’s business model is no longer fit for purpose

Introduction (4)

- **Based on the information provided and associated motivation, BUSA does not believe a 19.9% increase is justified.**
- An inflation-linked increase may be justified provided that it can be motivated and that poor governance, mismanagement and corruption at Eskom is addressed, and a new board and competent and credible management is appointed.
- BUSA is deeply concerned at the threats to Eskom's solvency and liquidity unless and until appropriately capitalised.
- Eskom is arguably the greatest risk to SA's fiscal sustainability and its poor performance is increasing the risk of triggering a further ratings down grade.
- BUSA recognises that this application only deals with tariff, but the tariff cannot be considered in isolation of the economic environment.

Demand

- In BUSA's view, and as argued in previous applications, a more conservative approach to demand and therefore revenue, is required.
- Demand projections underlying this application are based on outdated information and needs to be substantially revised in the light of current and emerging circumstances
- Forecasted levels of low economic growth in the medium term will result in low levels of demand for electricity.
- **Revenue requirements used in the methodology consequently should be revised downwards accordingly.**

Sales Volumes

- Eskom provides no details for the build-up of the sales forecast.
- Eskom's proposal for a review of the sales forecast prior to NERSA's decision on this application, should be implemented.
- Eskom's under-recovery in allowed revenue for the MYPD3 must be dealt with in the context of MYPD3 in accordance with the rules of the RCA.

Energy Mix

- Global trends reflect a substantial move towards renewable energy (RE).
- Despite SA's significant renewable energy potential, it lags other countries.
- Given uncertain demand, a more dynamic approach towards new capacity should be pursued, with RE projects being far more flexible and quicker to implement than coal and nuclear.
- **Eskom is locked into an inflexible capacity expansion plan that is ill-suited to SA's current and future needs.**

Death Spiral

- The industrial and mining sectors are instructive: combined sales to these energy intensive sectors are 14% below 2011 levels.
- Higher prices likely to result in lower economic growth, less job creation and job losses.
- If Eskom's revenue application were to be granted, this would trigger further defections from the grid.
- NERSA should act now to reverse this trend and ensure Eskom's sustainability.

Prudently Incurred Costs

- MYPD requires that all expenditure be prudently incurred. However, many costs are claimed by Eskom that were not prudently incurred but were at the instruction of the shareholder.
- Interventions by the shareholder including sub optimal employment levels, air quality improvements and off take arrangement with IPPs undermine the prudence of Eskom's approach and need to be reviewed accordingly
- Costs attributable to corruption, mismanagement and poor governance cannot be claimed.
- BUSA reiterates its previous position that only prudently incurred costs should be considered in the context of this application.

Allowable Revenue

- Eskom's application uses the allowed revenue (which in fact was higher than the actual achieved) from the previous MYPD period as a baseline.
- BUSA does not believe that this methodology is correct under the circumstances.
- **A new MYPD application for 2018/19 must be supported by a demand forecast and revenue requirement for the applicable period.**
- NERSA should review this methodological approach.

Debt Arrears

- The situation of mounting arrears is unsustainable.
- Municipal debt now stands at R11 billion, of which R2 billion has accumulated over the last 5 months.
- Supply interruptions to municipalities for non-payment cannot be allowed to continue; this has devastating ramifications for businesses who have paid for their electricity.
- Eskom needs to strengthen its credit control mechanisms and should be allowed to supply electricity directly to such customers.

Additional concerns with application

- BUSA believes that the proposed increase is not justifiable on a number of grounds.
  - MYPD application fails to address Eskom's long term commercial and financial viability
  - Immediate negative impact on economy
  - Ongoing poor governance, mismanagement and corruption
  - Failure to demonstrate that all expenditure has been incurred on a prudent basis
  - Adherence to an unsustainable business-as-usual approach with no indication of how pressure on the fiscus and consumers can be mitigated.

Outstanding Information

- If NERSA decides to approve any increase, information on the following should be obtained:
  – Ability to curtail capital expenditure in light of increasing oversupply
  – Concrete actions to curb corruption, mismanagement and address governance shortcomings
  – Motivation for the sales volumes assumptions given overly optimistic GDP growth projections
  – Demonstration that the business-as-usual approach will not exacerbate the "death spiral"

Quality of Information

- Some elements of the total allowable revenue are inadequately explained or not justified.
- There are also a number of issues that require further clarification
- Include capital

Summary of Total Allowable Revenue Adjustments and Exclusions

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Allowable Revenue (R' millions)	**AR**	**Formula**	**Application 2018/19**	**Recommended for 2018/19**
Regulated Asset Base	RAB		763 589	763 589
WACC	ROA	X	2,97%	2,5%
Returns			22 690	19 090
Expenditure	E	+	62 221	55 768
Primary Energy	PE	+	59 340	56 895
Depreciation	D	+	29 140	29 140
Integrated Demand Management (IDM)	I	+	511	422
Research and Development	R&D	+	193	193
Total Allowable Revenue	**TAR**		**219 514**	**198 763**

The adjustments presented in the table above result in a revised total revenue amount for 2018/19 of R198 763 million. This translates to a standard tariff adjustment of 7.78%.

Summary of issues that require further clarification or information

Allowable revenue	Comment
Sales forecasts and demand	No details provided for the build up of sales volumes
Arrears debt	More rigorous efforts to address the current unacceptable status of debt arrears should be made and impact on tariffs explained
Regulated Asset Base	Impact of delays not taken into account
WACC	No plausible explanation of why 2.97% is required
Returns	Review return on the basis of review of the WACC
Interest payments	Forecasted interest payments not explained
IPP's	Contradiction between amounts for total IPP generation in tables 24 and 29
Research and development	List of projects not yet consulted on as required. Consultation may result in lower amounts.
Operating costs	The increase of these costs over the amounts approved for MYPD3 projections for 2017/18 not all justified

Proposed Capital Expenditure

- The proposed capital expenditure of R77 billion requires scrutiny. This represents a 32.7% increase on last year's projection.
- Insufficient details are provided for BUSA to adequately interrogate the proposed capital expenditure to establish need and prudency.
- Potential to curtail or defer expenditure not explored.
- All capital expenditure needs to be reviewed in the context of a revised appropriate IRP

Conclusions

- Any tariff increase as a result of need to be motivated and substantiated in terms of the methodology.
- BUSA continues to have major reservations about widespread corruption mismanagement and poor governance which undermines the credibility of any motivation.
- Should NERSA consider any increase justified then it should be no more than CPI (6%) and only then on the basis of appropriate motivation and substantiation.
- A number of areas, where reductions in the proposed expenditure can be achieved, have been identified.
- Where sufficient information was provided to quantify savings these resulted an amount of R20.7 billion which translates to a 7.78% tariff increase.
- In addition there are a number of areas where insufficient information was provided to allow quantitative assessment
- If these elements are also taken into account an increase of **no higher than the CPI (6%) is achievable.**

Conclusions (2)

- NERSA has a responsibility to address the risk that Eskom poses to the fiscus.
- This responsibility can be exercised through placing conditions on any increase which should include:
  - Support for short term efforts to increase demand within a legal framework
  - Waiving the 3 outstanding RCA applications
  - Increases for the next 3-5 years should be limited to CPI
  - Medium term time frame
  - Stringent enforcement of prudency
  - Demonstrate that all expenditure has been incurred on a prudent basis
  - Addressing corruption, mismanagement and poor governance.
  - Ensuring that the structure and operating model of Eskom is adequate to deliver SA's electricity needs at an affordable cost.