Eskom Regulatory Clearing Account (RCA) year 5 of MYPD 3

Public Hearings – Gauteng – Soweto

Date: 1 February 2019

The Regulatory Clearing Account (RCA) is NERSA regulatory mechanism for risk management

RCA is a balancing mechanism between NERSA decision where Eskom's application is analysed and verified with reasons provided

and

what materialised based on Eskom's audited financial statements(Backward looking reconciliation)

NERSA and Eskom are guided by NERSA prudency guidelines which include:

- Inform licensees in advance of basis of assessment to be conducted
- Improve regulatory certainty by providing a transparent framework
- Whether a cost is prudently incurred depends on how decision was made, not only outcome of the decision
- Actions considered reasonable by a person with similar skills and knowledge under similar circumstances
- Committed costs and binding agreements would be considered
- Hindsight cannot be used for prudency assessment

The key risks that are managed through this NERSA risk management process can be grouped into variances arising due to following sources

- Increases in costs due to changing environment and assumptions or
- NERSA Decisions made for purposes of MYPD3 revenue decision which did not materialise

RCA Mechanism allows for recovery of only efficient and prudent costs
in accordance with NERSA prudency guidelines

RCA Year 5 of MYPD 3 balance application is mainly related to sales volumes variances

- RCA submission is **based on MYPD3 Methodology decision and reasons for decision for MYPD 3 RCA 2013/14**
- Is **driven substantially by revenue under-recovery due to lower sales** as assumed in the MYPD 3 decision for FY 2018..
- The determined **RCA application of R21 541 million** is **motivated with facts and evidence** to enable prudency assessments by NERSA
- Cost variances relate predominantly to **primary energy costs** including OCGT costs which **off-set the revenue variance** related to sales
- **Opex variances are not included in RCA as it is not re-measurable** in terms of the MYPD 3 methodology (has been changed in revised methodology)
- **Energy Conservation Scheme** (ECS) adjustments **~ R1 100 million** of sales variance
- Nuclear spent fuel decommissioning costs of R830 m incurred in 2013/14 approved for recovery over 10 years resulting in R83m being included in the total RCA claim for liquidation purposes of R21 624 million (i.e R21 541m + R83m)

*Cost variances relate predominantly to **primary energy costs** including OCGT costs **off-set revenue variance***

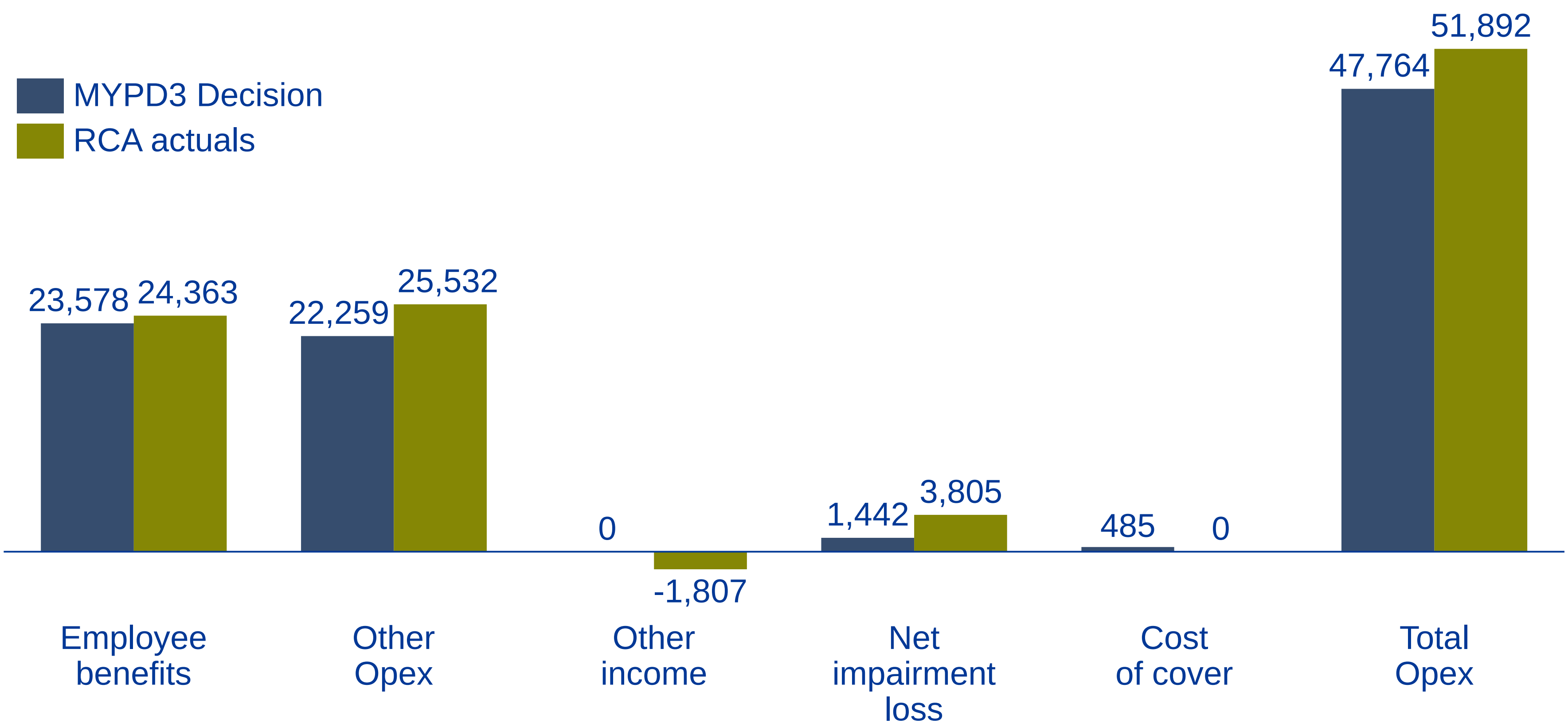
MYPD 3 Year 5 RCA application: Revenue variance is majority of balance and reduced by cost variances in favour of consumers

RCA for 2017/18 (Year 5 of MYPD3)	MYPD3 Decision	Actuals 2017/18	Variance to MYPD3	RCA adj	RCA 2017/18
Total Revenue R million	205 213	175 041	30 172	-3 277	26 895
Primary Energy , R million					
Coal	49 914	46 992	-2 922	-15	-2 937
Open Cycle Gas Turbines (OCGTs)	1 724	328	-1 396		-1 396
Other primary energy	6 766	7 576	810	-	810
Independent Power Producers	23 018	19 317	-3 701	1 983	-1 718
International Purchases	470	2 768	2 298		2 298
Environmental levy	9 746	8 061	-1 685		-1 685
Demand Market Participation (DMP)	-	160	160		160
Total primary energy , R million	91 638	85 202	-6 436	1 968	-4 468
CECA for RCA , R million	33 667	34 592	925	0	925
EEDSM for RCA , R million	1 244	142	-1 102	-17	-1 118
Operating costs for RCA , R million	47 764	51 892	4 128	-4 128	-
SQI for RCA , R million				390	390
Inflation adjustments , R million				39	39
ECS (Electricity conservation scheme) adjustment				-1 122	-1 122
FY2018 RCA application for year					21 541
Nuclear decom - RCA 2013/14 phased 10 years for liquidation					83
FY2018 Liquidation claim , R million					21 624

NERSA undertook to include CECA adjustments for years 2-4 in this application

Operating cost variances are not considered in terms of MYPD Methodology for MYPD 3 period

Eskom had ***incurred an additional R4 128 million*** *during 2018 year. Based on RCA equivalent actual operating costs of* ***R51 892 million*** *and operating costs in the decision of* ***R47 764 million.***



In terms of the MYPD Methodology **Eskom cannot submit these additional efficient operating expenses for RCA purposes** and have thus had to absorb the variance

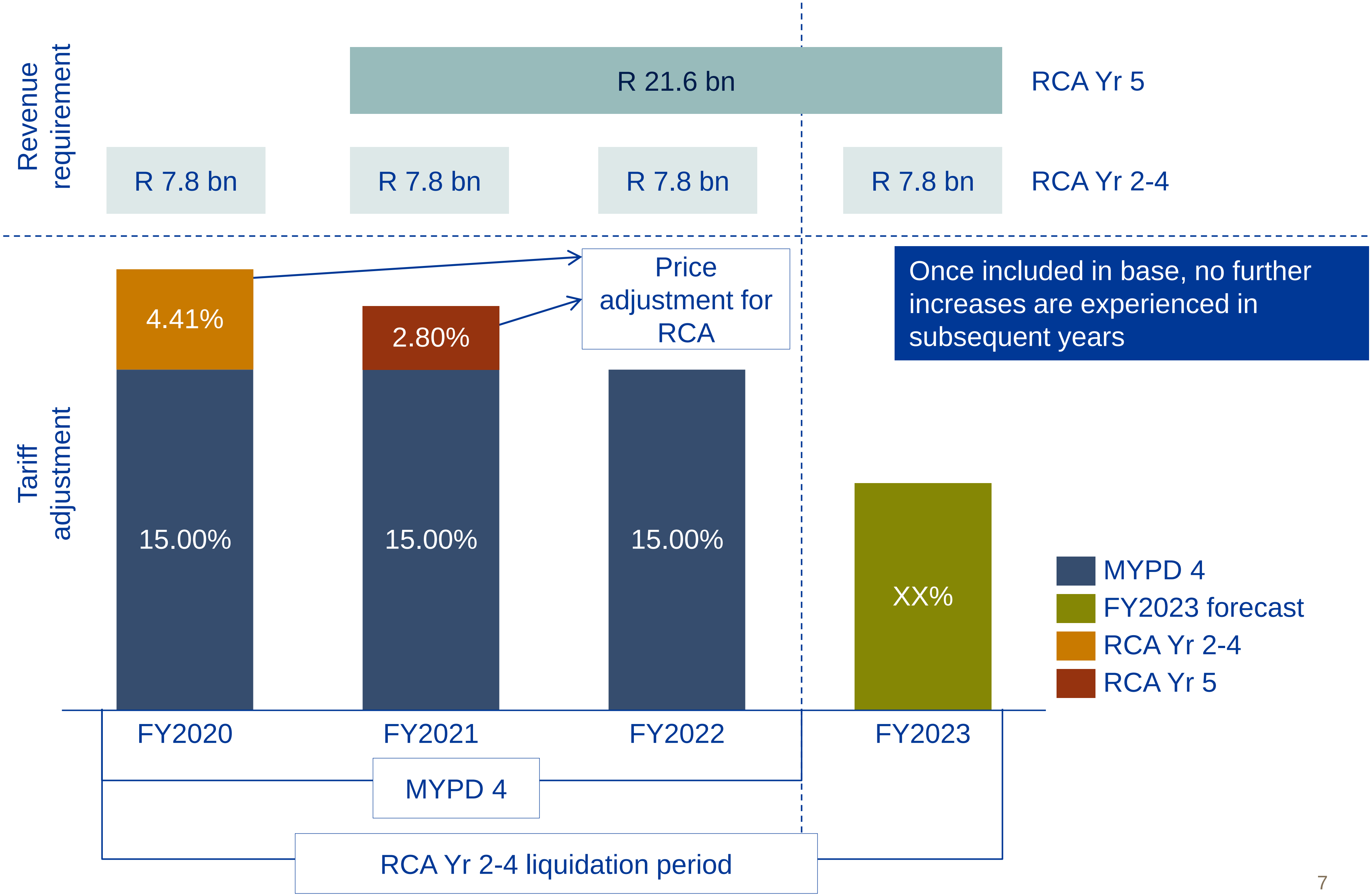
Eskom is maintaining it RCA application

RCA year 5 application was compiled in accordance with the MYPD 3 methodology as well as reasons for decision for RCA year 1 of MYPD 3

	MYPD methodology	RCA precedent
Revenue due to sales volume changes	✓	✓
Coal burn costs	✓	✓
Capital expenditure clearing account	✓	✓
Eskom IPP costs	✓	✓

Compliance with MYPD methodology, in respect of NERSA decisions and in **accordance with NERSA Regulatory Principles**

Eskom Liquidation proposal : Increase of 2.80% to recover RCA year 5 balance over same period as RCA years 2 - 4



Once included in base, no further increases are experienced in subsequent years

Conclusion on MYPD 3 2018 RCA application

- Eskom is guided by following in making its regulatory clearing account (RCA) application
  - MYPD Methodology applicable to MYPD 3 period
  - NERSA Prudency guidelines
  - NERSA 2014 RCA reasons for decision
  - NERSA Regulatory Principles
- Eskom has made proposals on liquidation of RCA balance to be undertaken in same time period as NERSA liquidation for RCA for years 2015 to 2017
- Eskom again undertakes to address, in subsequent RCAs, any outcome from various regulatory processes to address fraud and corruption
  - The Mckinsey recovery of R902m that occurred in 2019 financial year and will be accounted for in 2019 RCA


THANK
YOU!

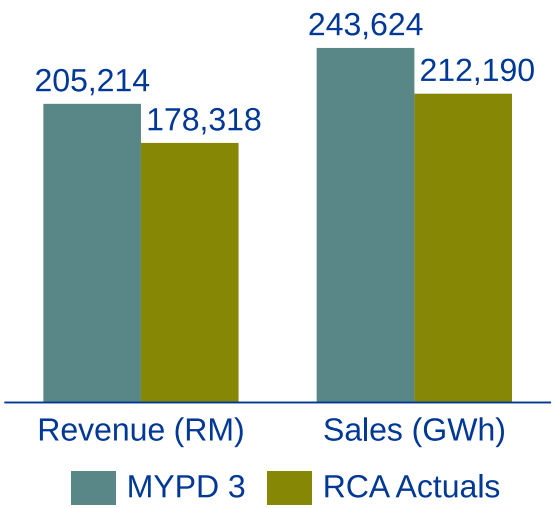
Changes in fundamental assumptions since MYPD3 application

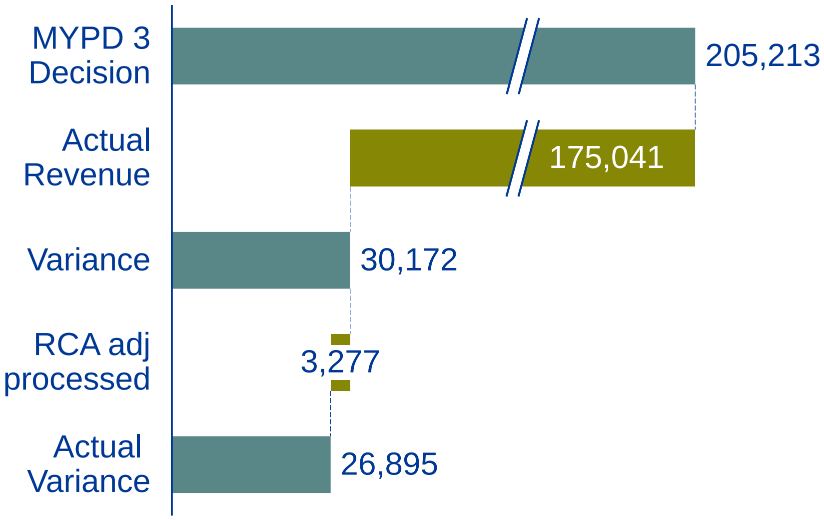
MYPD3 Application	Current Situation	Comment
Sales forecast average growth of 2% p.a. assumed with a starting value of 222TWh in March 2013 reaching 244TWh by March 2018	Actual sales reached 212TWh by March 2018.	Sales forecast did not materialise due to major changes in the assumptions plus the adverse global economic situation not recovering as anticipated
Generation plant performance (Energy availability factor – EAF) assumed at an average 82% for 2017/18	Actual average EAF was an average of 78% for the year	Actual plant performance has been improving over the year. However, has not reached the performance level assumed by NERSA in the MYPD 3 decision.
New build commission dates for 1st units Medupi – June 2013 Kusile - 2016/17 Ingula – 2013/14 Sere – 2013/14	New build commissioning revised dates as follows: Medupi Unit6 – Aug 2015 Medupi Unit5 – Apr 2017 Medupi Unit 4 – Nov 2017 Kusile Unit 1- Sept 2017 Ingula – All units commissioned by Mar 2017 Sere – 31 Mar 2015	Eskom has been meeting its revised commissioning dates.

Changes in fundamental assumptions since MYPD3 application

MYPD3 Application	Current Situation	Comment
Coal country compact < 10%price increases	Efficiency savings implemented through business productivity programme and design to cost initiatives.	Coal burn escalations dropped significantly in 2017/18 compared to historical trends. In fact coal burn variance is in favour of the consumer.
OCGTs – load factors assumed at 3% based on certain other assumptions materialising	OCGTs – actual load factors have been <1% in 2017/18	OCGTs usage reflects a turnaround with a significant variance for benefit of consumer.
IPPs – local and international	Lower costs associated with REIPP programmes	Certain REIPP programmes did not mateialise, as anticipated.
Capex – R337bn over the five year period	Capex – given the lower revenue decision, Eskom reprioritized capex to a projected portfolio of R251bn over the five year period.	In response to MYPD3 revenue decision Eskom has reprioritised capex spent

Electricity sales volumes continue to remain lower than that assumed by NERSA in the MYPD 3 decision





Eskom's electricity revenue is derived from 3 customer categories:

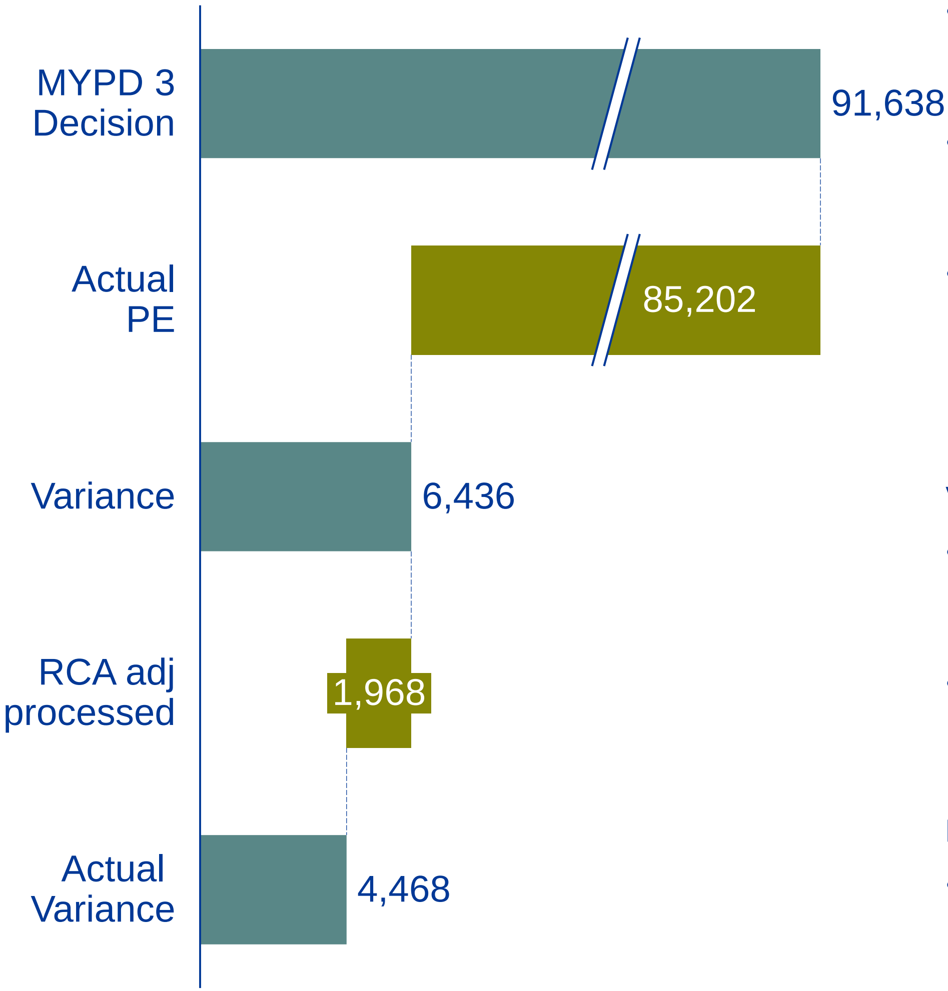
1. standard tariffs
2. local negotiated pricing agreements
3. exports (international) customers

Revenue variance of R30 172m in AFS is adjusted by R3 277m to account for revenue impairment resulting in a RCA revenue adjustment of R26 895m. Thus RCA includes all billed revenue (not collected revenue as in AFS)

The drivers for the declining sales trend include:

- **Weakening markets –** oversupply and high stock levels; low commodity prices; environment that favours cutbacks over growth.
- **Low growth and low infrastructure spend in SA –** projects (sales growth) being delayed or cancelled; inadequate infrastructure and policy/regulatory uncertainty
- **Increasing prices** – Energy efficiency improvements; closures due to competitiveness and profitability; reduced peak / high season usage; increased use of own generation.
- **Deteriorating electricity supply performance (maintenance and restoration)** – poor quality and reliability of supply causing plant stoppages.

Eskom has aligned the treatment of primary energy to the NERSA 2013/14 RCA decision



Variances in favour of consumer:

- The coal burn variance of R2 937 million is a result of lower electricity production, lower production from cost-plus and fixed price mines, delays in coal quality improvement.
- The energy availability of Eskom fleet, commissioning of new power stations and usage of IPPs have resulted in lower usage of OCGT and a variance of R1 396 million
- Eskom utilized 64 GWh more energy from IPPs when compared to the MYPD3 decision in 2017/18, but due to lower average costs the results was R1 718 million less spent on IPPs compared to the MYPD3 decision.

Variances in favour of Eskom:

- Eskom acquired electricity from neighboring countries that resulted in an international purchases variance of R2 768 million
- Variances of R160 million for Demand market participation (DMP) costs and R810 million for other primary energy costs

RCA Adjustments include :

- DoE peakers - where capacity charge for RCA is recovered in same year as expenditure is incurred whereas in AFS in accordance with IFRS, it is capitalised over term of PPA

Other categories contributing to the RCAs

CECA for RCA , R million	925
EEDSM for RCA , R million	-1 118
SQI for RCA , R million	390
Inflation adjustments , R million	39

- **Capital Expenditure Clearing Account** (CECA) - Variance is attributable to higher costs incurred for new build projects, outage capital costs and partially reduced by lower expenditures incurred for Transmission and Distribution networks; following Eskom's capital expenditure reprioritisation process.
- **EEDSM** programs produced less verified capacity savings during year, than determined by NERSA, resulting in variance in favour of the consumer
- Eskom has exceeded **service quality incentive** targets set by NERSA for Distribution and Transmission during 2017/18. This resulted in Distribution achieving an SQI of R292.8 million and Transmission of R99.7 million
- **Inflation adjustment-** On opex is due to higher inflation rate in actual mode versus that assumed by NERSA in MYPD 3 decision.