MYPD 3 RCA Year 5

Multi-Year Price Determination 4 Revenue application

NERSA Public Hearings
Midrand Day 2
Closing

5 February 2019

2017/18 RCA MYPD 3

Closing Comments

Eskom maintains its MYPD 3 Year 5 RCA with an adjustment for the McKinsey recovery

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 yrs for liq					83
FY2018 Liquidation claim , R million					**21 624**
McKinsey recoupment					-1 001
FY2018 Liquidation claim , R million					**20 623**

NERSA decision on addressing fraud and corruption

In NERSA RCA balance approvals for 2014/15 to 2016/17 years, NERSA approved following:

– **Coal contracts under investigation *(para 8.3 MYPD 3 RCA 2015/16 RfD)***

*Recently the government instituted investigations into allegations of mal-administration with regard to coal procurement at Eskom. Eskom indicated to the Energy Regulator that coal costs in the RCA could have been impacted by fraud and corruption, which **is still being investigated by government entities.**The Energy Regulator will factor into **future Eskom revenue decisions** relevant conclusions of the investigations regarding coal contracts after the investigations undertaken by various bodies **have been concluded** and the expenses have been quantified.*

– **Legal and Regulatory issues *(para 7.10 MYPD 3 RCA 2015/16 RfD)***

*The Energy Regulator **is not in a position to pronounce on these matters** and notes that others bodies or entities such as National Treasury, Special Investigating Unit, South African Directorate for Priority Crime Investigation (Hawks), the Parliament of the Republic of South Africa and the Commission of Enquiry into State Capture are undertaking their investigations into governance failures in Eskom. **The Energy Regulator may also initiate its own investigation** into the activities of Eskom (including governance failures) in terms of section 4(b)(ii) of the ERA and effect adjustments to Eskom's revenue based on the relevant outcome of its investigation and/or those undertaken by other bodies or entities, including, but not limited to, Eskom, National Treasury, Special Investigating Unit, South African Directorate for Priority Crime Investigation (Hawks), the Parliament of the Republic of South Africa or any Commission of Enquiry as and **when they are concluded** and the costs associated therewith are quantified.*

*In line with section 15 of the ERA as submitted earlier, **the Energy Regulator must satisfy itself that Eskom has incurred the costs that it is claiming in this application efficiently**. Expense that resulted from corporate governance failures would have to be frowned upon or condemned as not being efficient and disallowed by the Energy Regulator. **Once the investigations are finalised**, the Energy Regulator intends to reconsider these matters.*

Conclusion on RCA

- It does not make sense for Eskom to deliberately under recover in the revenue application and delay recovery through the RCA application which does not take into consideration the time value of money
- Revenue is required to cover fixed and variable costs
- Eskom is guided by the IRP and government policy
- The application is made in accordance with the environment and prevailing circumstances when decisions were made need to be considered. The circumstances during the cycle will so need to be considered.
- Various contractual commitments include: coal contract, build contracts, employee contracts

Multi-Year Price Determination 4 Revenue application

Closing Comments

NERSA confirms Eskom's compliance

"NERSA received Eskom's MYPD3 RCA Year 5 (2017/18) application totalling R21 624m on 12 September 2018, and Eskom's MYPD4 application totalling R219bn, R252bn and R291bn for 2019/20, 2020/21 and 2021/22 financial years respectively, on 14 September 2018.

Upon receipt of the applications, NERSA conducted an analysis for compliance with both the Minimum Information Requirements for Tariff Applications (MIRTA), as well as the Multi-Year Price Determination (MYPD) Methodology. Full compliance with both MIRTA and MYPD was confirmed on 2 October 2018 after all documents were submitted."

Extract from NESA media statement on 5 October 2018

Eskom's applications are compliant. Changes made are in response to regulator panel's requests for information related to latest prevailing circumstances and environment

Both NERSA and Eskom make decisions within policy and legislative framework including:

- **ERA**
  - Eskom has provided details on prudent and efficient costs in its detailed application. NERSA will review these costs with comparison to relevant recognised benchmarks and provide comprehensive reasons
- **NERSA MULTI-YEAR PRICE DETERMINATION METHODOLOGY**
  - Eskom has provided details of its dire financial situation and extent to which it has been subsidising the electricity consumer for many years. The credit card phenomenon has been completely maxed out. NERSA would need to consider a viable price increase that balances the sustainability of Eskom with the impact on consumers.
- **NERSA PRUDENCY GUIDELINES**
  - Reasonable operator and prudently incurred cost in current circumstances depend on how decision made
    - Norm is not perfection the norm is reasonable utility operator. The environment and prevailing circumstances where decisions are made need to be considered. As an example, the manner in which Eskom is managing the average 37 year old generating system be considered. New plant needs to be given an opportunity to continue addressing latent defects within contractual agreements.
  - Committed contracts must be considered
    - For existing coal contracts, new build contracts, employment contracts, etc
  - Hindsight should not be used for prudency assessment
    - Prudency of decisions should be based on the information that was available when the decision was taken and not at the time of the review.

Generation performance conclusion

- Prudency criteria – efficiency based on context
- Our context is – root cause is over 10 years of running in the red due to late decision to allow Eskom to build new capacity
- There are issues with the new build plant but this is to be expected – bathtub curve
  - We are addressing the issues and too soon to consider derating
- Nevertheless, Eskom not happy with current performance
  - thus 9 Point Recovery Programme to improve
  - as already stated, the detail of this has been shared with Nersa
- Generation O&M costs ARE in line with international benchmarks – EPRI, IEA and African

With changes, Eskom is not requesting additional revenue

Allowable Revenue (R'millions)	ƒx	MYPD 4 application			Changes			Impact of changes		
		2019/20	2020/21	2021/22	2019/20	2020/21	2021/22	2019/20	2020/21	2021/22
Regulated Asset Base		1 268 310	1 336 120	1 401 506	- 15 310	- 12 984	- 10 764	1 253 000	1 323 136	1 390 742
WACC %	x	-1.32%	-0.21%	1.45%	-0.05%	0.11%	0.21%	-1.36%	-0.10%	1.66%
Returns	+	-16 687	-2 765	20 314	-394	1471	2741	-17 081	-1 294	23 055
Expenditure	+	56 619	59 820	62 663				56 619	59 820	62 663
Primary energy	+	73 386	75 876	79 561	1 758	1 175	267	75 144	77 051	79 828
IPPs (local)	+	29 590	34 324	41 002	1 245	578	132	30 836	34 902	41 134
International purchases	+	3 533	3 734	3 957	336	351	372	3 869	4 084	4 329
Depreciation	+	64 651	72 919	75 649	- 2 710	- 3 322	- 3 222	61 942	69 597	72 427
IDM	+	189	193	202				189	193	202
Research & Development	+	176	187	198				176	187	198
Levies & Taxes	+	8 272	8 198	8 147	- 236	- 253	- 290	8 036	7 945	7 857
RCA	+									
Subtotal		**219 730**	**252 485**	**291 692**	**0**	**0**	**0**	**219 730**	**252 485**	**291 692**
Corporate Social Investment (CSI)	-	- 192	- 193	- 151	0	0	0	- 192	- 193	- 151
Total Allowable Revenue		**219 537**	**252 292**	**291 542**	**0**	**0**	**0**	**219 537**	**252 292**	**291 542**

Average standard tariff price increase	**15.0%**	**15.0%**	**15.0%**	**2.1%**	**0.4%**	**0.5%**	**17.1%**	**15.4%**	**15.5%**

Change in % increase due mainly to recovery of efficient costs over realistic sales volume

Significant losses continue even with MYPD 4 application

Eskom Holding - MYPD4 Application (R'milliions)	Projections FY2019	Application FY2020	Application FY2021	Application FY2022
Revenue	190 862	220 359	253 095	292 401
Primary Energy	-75 991	-87 050	-89 080	-92 014
IPP costs	-26 549	-30 836	-34 902	-41 134
Other income	1 127	1 206	1 244	1 301
Employee benefit expense	-27 140	-26 762	-27 684	-28 935
Arrear Debt	-4 436	-4 442	-3 647	-3 903
Other expenses	-28 213	-29 231	-31 234	-32 514
Profit before depreciation	**29 658**	**43 244**	**67 791**	**95 203**
Depreciation	-22 095	-27 926	-26 906	-29 950
Profit after depreciation	**7 563**	**15 318**	**40 886**	**65 252**
Net FV gains/(loss) on embedded derivatives and financial instruments	-222	-1 649	-1 926	-3 086
Net Finance costs	-27 467	-33 392	-42 594	-48 112
Net (loss)/profit	**(20 125)**	**(19 723)**	**(3 635)**	**14 054**

Analysis: Inability to meet debt commitments would have severe consequences

In case Eskom does not receive necessary and timely support from the regulator and the authorities, Eskom's default may prove inevitable. Such scenario would bring disastrous consequences for both Eskom and South Africa as a whole, in particular consumers and businesses

Eskom

- ❑ Cross default / acceleration of other liabilities
- ❑ Rating downgrades to default (until lengthy negotiations with creditors are finalised) => difficulties in conducting business with suppliers
- ❑ Freeze of access to any new funding necessary to finance capex
- ❑ Increased risks of power outages

Government

- ❑ Immediate crystallisation of Eskom's liabilities
- ❑ Worsening of government's debt metrics (new debt to be raised to cover payments under these liabilities)
- ❑ Increased cost of financing
- ❑ Crystallisation of Eskom's liabilities under IPP agreements

Consequently, consumers and businesses would be strongly impacted by (i) decreased availability of electricity (due to disrupted operations of Eskom) and (ii) electricity price increases (due to the increase of privately led electricity generation). Overall, South Africa tax payers would be requested to support the recovery effort.

MFMA and NERSA requirements for subsequent decision do not allow for a one year MYPD 4 decision at this stage

Indicative

- Apr-19 to Jul-19 – Eskom consults on GSFA
- Jul-19 to Feb-20 – Eskom start Preparation for application
- Feb-20 to May-20 – Eskom consults SALGA /NT in terms of MFMA
- May-20 to Nov-20 – NERSA Analysis and public hearings
- Nov-20 to May-21 – Decision on tariffs, MFMA submission on Municipal tariffs

Additionally

Time allowed for restructuring → Then Eskom makes an application given the timeline → The earliest possible implementation is from 1 April 2022 which is after the MYPD 4 period

In conclusion, Eskom's financial situation is unsustainable

- Restoring financial sustainability will require:
  - Eskom to continue maintaining cost escalations within inflation range
  - Price increases of about 2% p.a. are required to cover IPPs costs growth
  - Year 1 reaches 6,4% (4.4% from RCA liquidation decision + IPPs 2%)
  - Balance sheet support from the shareholder
- Government support will be required to address the arrear debt recovery from Municipalities
- Customers require reliable supply of electricity
- Efficiency and prudency evaluation must be cognisant of the operational context and circumstances
- Restoring operational performance comes at a cost which must be funded and recovered through revenue requirements
- *"Eskom will use the proceeds from the liquidation of the MYPD 3 RCA decisions to contribute to mitigating the debt service shortfalls"* – *R50 billion shortfall*
- Debt providers, rating agencies, auditors and other stakeholders will await this crucial decision
- Ultimately a part of the solution will impact either the electricity consumer or the taxpayer

THANK YOU