RCAs submitted for FY2014/15, FY 2015/16 and FY 2016/17

Nelspruit
NERSA Public Hearings
7 May 2018

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

RCA is a balancing mechanism between what was awarded by NERSA on the basis of a forecast (MYPD), and what actually materialised (Eskom's audited financial statements) - a backward looking reconciliation

NERSA Framework

1. Differences materialise if Eskom either does not achieve or exceeds the awarded revenue (due to pricing or demand factors), or incurs costs greater or lower than those which were taken into account when NERSA calculated the MYPD allowable revenue
2. RCA balance could either be in favour of Eskom or consumer
3. RCA is subject to approval by the Regulator
4. Liquidation of the RCA as approved by the regulator may result in an increase or decrease in future electricity prices
5. The MYPD Methodology as published by NERSA in December 2012 is applicable to the MYPD3 control period

Eskom application

1. Eskom has submitted 3 RCAs for years 2 to 4 to be adjudicated
2. Applications were made based on the 2013/14 RCA determination and principles applied by Nersa
3. RCA application **not** a revenue application based on future estimates
4. The RCA is not a response to the price increase 5.23% for FY2018/19
5. Eskom is not expecting a once off price adjustment for the 3 RCAs

The RCA is a globally accepted regulatory principle and is part of RCA best practices; MYPD2 RCA decision made in 2014 and MYPD3 RCA Year 1 (2013/14) made in 2016

Fraud, corruption and irregularities

We wish to re-iterate the message by Interim Group Chief Executive during his introduction of the Eskom presentation in Cape Town:

- In January 2018, Government appointed a new Board of Directors
- 4 senior management have left Eskom due to serious misconduct allegations
- 4 executives remain on suspension, pending disciplinary hearings
- Continue to combat corruption and pursue justice within legal framework
- Undertaking mandatory lifestyle audits of all employees' two levels below CEO
- No Eskom officials are allowed to do business with Eskom
- Investigating 239 matters reported through whistleblowing facility – more than 70 cases have been addressed
- Various investigations are underway, including
  - Department of Public Enterprises Portfolio Committee inquiry
  - Judicial inquiry under leadership of Deputy Chief Justice, Justice Zondo
  - Special Investigation Unit recently announced by President
- Eskom welcomes these inquiries and investigations and will participate to contribute towards the objectives being met

- Eskom has started process to seek repayment from Mc Kinsey and Trillian by instituting a High Court review application Court to have contract set aside

Principles from RCA 2013/14 decision made on 1 March 2016

1. Allowed revenue is computed on at Eskom Company level and based on billed revenue
2. Gas turbines variances limited to amounts allowed by NERSA and additional volumes recouped at average variable costs for coal
3. International purchases treated as cross border IPPs
4. Over expenditure of operating costs are absorbed by Eskom and is not allowed to be recovered
   - For the three years under consideration, all categories of operating expenditure in accordance with NERSA decision experienced over expenditure
5. "Variances can be linked to two key sources:
   - Increases in costs due to a changing environment and assumptions after the MYPD 3 decision;
   - Assumptions made for purposes of the MYPD3 revenue decision which did not materialise."

Summary of the RCAs for Year 2-4 of MYPD3

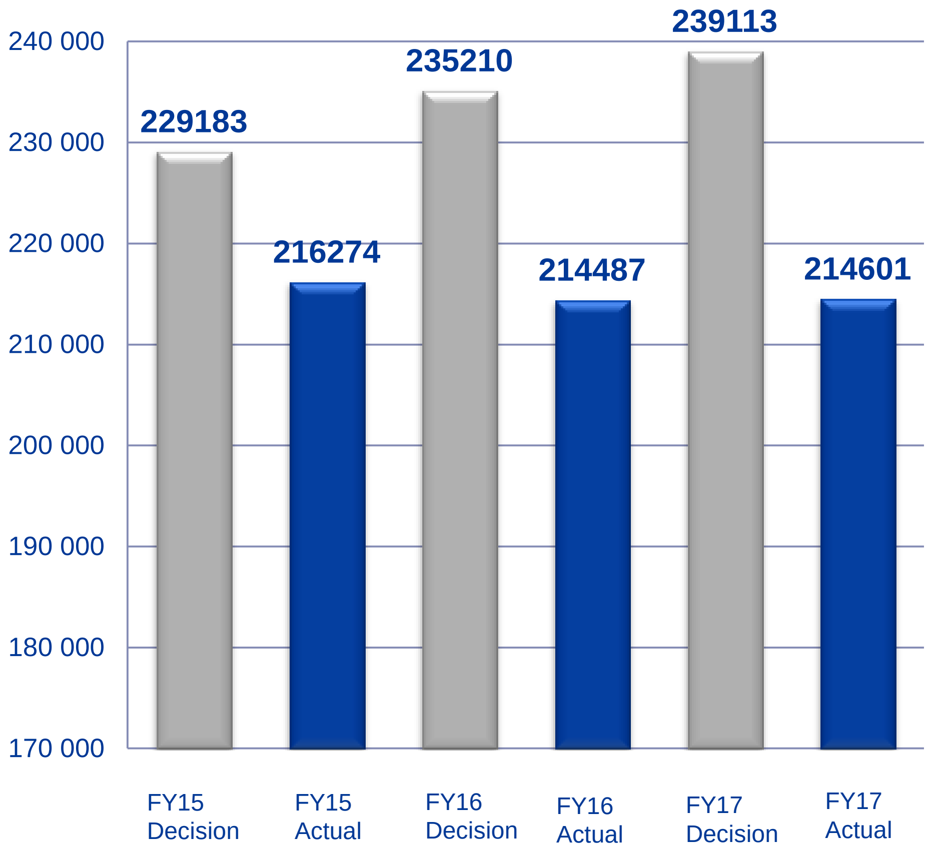
The Constitutional Court ruling of August 2017 has cleared the way for Nersa to process the 3 outstanding RCAs which total over R66 billion

RCA for 2016/17 (RM)	RCA 2014/15	RCA 2015/16	RCA 2016/17	Total RCAs Years 2-4	% contribution
Revenue	8 787	15 578	20 016	44 382	**67%**
Independent Power Producers	4 346	620	2 452	7 418	**11%**
International Purchases	3 299	3 567	2 283	9 149	**14%**
Coal	574	3 258	-359	3 473	**5%**
Open Cycle Gas Turbines (OCGTs)	1 944	689	-1 259	1 374	**2%**
Other Primary Energy	1 355	728	722	2 805	**4%**
Environmental Levy	-683	-1 180	-1 404	-3 267	**-5%**
Subtotal	**19 622**	**23 261**	**22 451**	**65 334**	
Other	-437	372	1 418	1 353	**2%**
RCA balance	**19 185**	**23 633**	**23 869**	**66 687**	**100%**

Revenue alone contributes to 67% of the RCAs over the 3 years

Revenue Variance attributable to lower sales volumes

Total sale volumes (GWh)



MYPD Methodology[1]

- Allows for **revenue adjustments** attributable to **volume and mix changes**

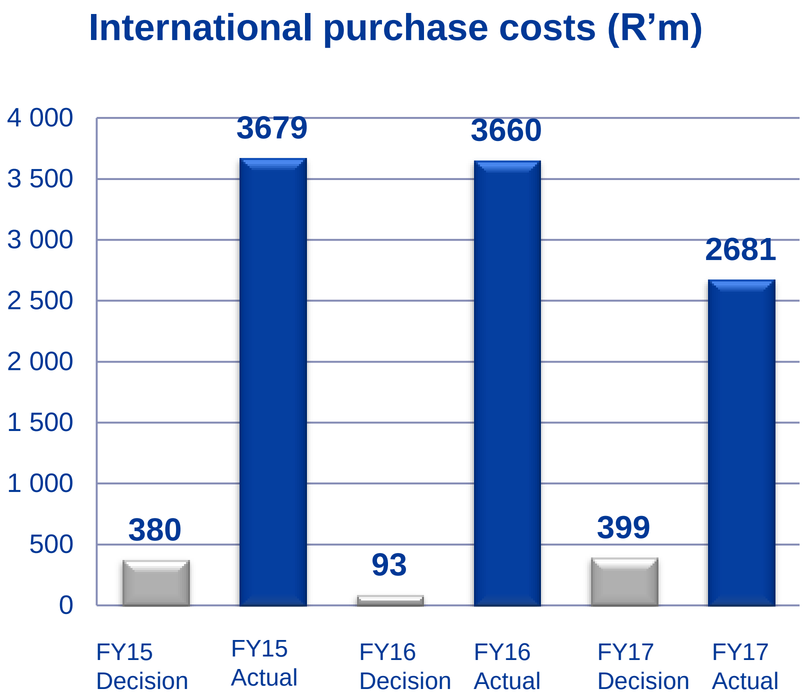
Reasons for RCA amount

- Lower sales volume from standard tariff customers –

  Drop in volumes due to various factors including
  - Downturn in economy
  - Lower investor confidence
  - Decrease in reliance on Eskom
  - Commodity price changes
  - Elements of price elasticity
- Higher sales from export sales contributed positively to the total revenue
- Load shedding impacts in FY2015 is adjusted in the revenue variance

1 Source: Clause 14.1.5 NERSA MYPD Methodology – Final- for publication 5 December 2012

International purchases represents cross border IPPs and is passed through to consumer



MYPD Methodology

- International purchases represents cross border IPPs
- International purchases are match with international revenue
- Variance is recovered as is treated as IPPs
- Revenue variance takes extra inflows into RCA

MYPD3 RCA decision for 2013/14

- Accounted for revenue on a total basis which included export revenues
- Thus the equivalent approach was applied to purchase costs and the full international purchases was allowed for RCA 2013/14

The revenue determination for 2018/19 further reinforced this principle to incorporate the full international purchases in the primary energy costs

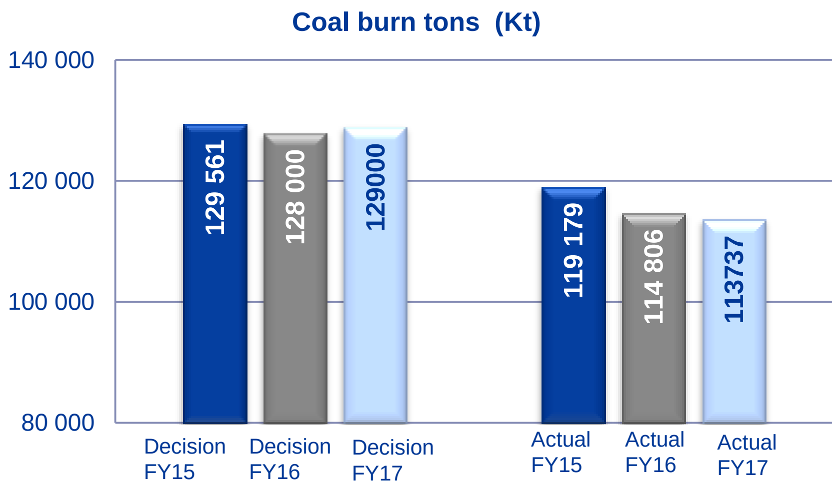
IPPs of R7.417 billion will be a pass-through cost for years 2-4 of the RCA for MYPD 3

- Variance of R7.674 billion for STPPP, R1.843 billion for Municipalities, R223 million for WEPs and R63 million for MTPPP (benefit to Eskom) in accordance with Energy Regulator decision and the Medium Term Risk Mitigation Plan of the IRP 2010
- Renewable IPP projects variance of **R423 million** (benefit to consumer)
- DOE Peaker projects were **variance of R1.205 billion** (benefit to consumer)
- Transmission ancilliary/network costs were **variance of R758 million** (benefit to consumer)
- Total IPPs reflects a net variance of R7.417 billion between years 2-4 (benefit to Eskom)

MYPD 3 Variance Decision - IPPs (Actuals)	RCA 2014/15	RCA 2015/16	RCA 2016/17	Total RCAs Years 2-4
MYPD 3 Variance	4 346	620	2 451	7 417
Renewables	2 442	-2 061	-804	-423
DOE Peakers		-605	-600	-1 205
MTPPP	-30	56	37	63
STPPP	2 132	2 682	2 860	7 674
Municipalities		858	985	1 843
WEPS	75	78	70	223
Tx Ancilliary costs/ Network costs	-273	-388	-97	-758
Cumulative variance	**4 346**	**4 966**	**7 417**	

Coal burn variance reflects a price element which is partially offset by the volume variance

Coal Burn tons and energy produced



Coal burn variance included in RCA

Coal burn variance	unit	RCA 14/15	RCA 15/16	RCA 16/17
Coal burn price variance	R'm	3 814	8 211	5 530
Coal burn volume variance	R'm	-3 240	-4 953	-5 889
Coal burn costs incl in RCA	R'm	**574**	**3 258**	**-359**

MYPD Methodology[1]

- **Performance Based Regulation (PBR) formula**
  - Compares **burn costs** between decision and actuals
  - Variance is **shared between customers** and Eskom
  - Sharing **percentage** is determined by NERSA
- The **PBR pass-through** cost consists of a **price and volume variance**

Reasons for RCA amount

- **Nersa allowed benchmark coal R/Ton was lower than Eskom's actual cost at that time**
- **Lower production** from cheaper **Cost Plus and Fixed Price mines.**
- **Procurement of additional short/medium term coal resulting in transport of coal** via road and rail instead of coal over a conveyor belt from long term contracts.
- **Favourable volume variances** passed onto consumer

1 Source: Clause 14.1.5 NERSA MYPD Methodology – Final- for publication 5 December 2012

Other primary energy for RCAs

Breakdown of other primary energy components

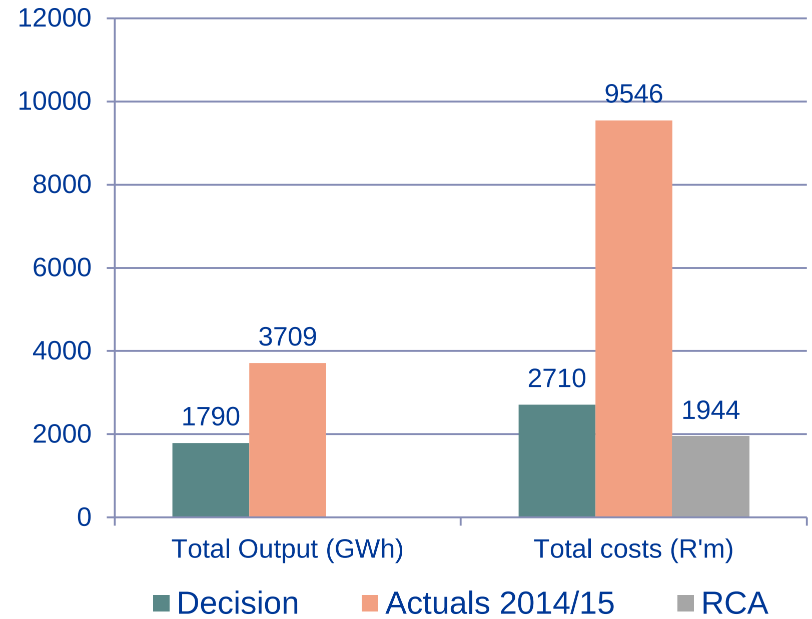
Other Primary Energy (R'm)	2014/15	2015/16	2016/17	Total
Water	-502	-428	-437	-1367
Start-up gas & oil	1 064	657	532	2 253
Coal handling	580	542	501	1 623
Water treatment	119	84	125	328
Nuclear	180	59	281	520
Fuel procurement	-86	-131	-141	-358
Sorbent usage		-55	-139	-194
Total Other Primary Energy	**1 355**	**728**	**722**	**2 805**

Drivers to other primary energy in the RCAs

- **Water** – lower costs incurred due to actual costing rates being lower
- **Start up gas -** higher number of start ups are driven by the number of outages and trips
- **Coal handling -** additional costs incurred due to more coal having been reclaimed from the strategic to the seasonal stockpiles at the stations than anticipated
- **Water treatment**– more usage of chemicals due to poor water quality
- **Nuclear fuel -** due higher rates than assumed in decision
- **Fuel Procurement** – lower due to delay in projects
- **Sorbent usage –** due to delay in FGD implementation

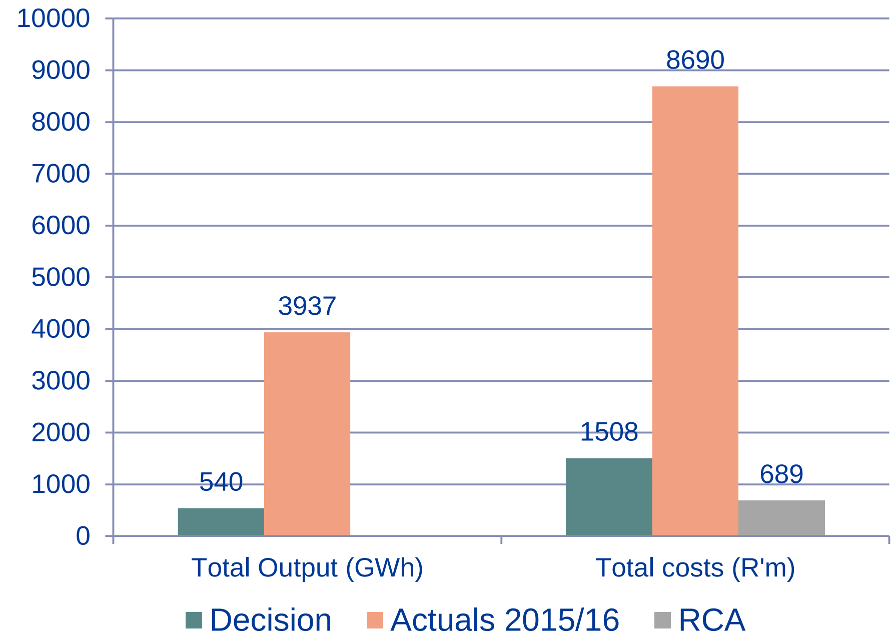
OCGT usage and costs exceeded the MYPD3 allowances in FY14/15 & FY15/16. However the RCA claim was limited based on the decision taken for 2013/14 RCA. Eskom absorbed R11.4bn to its bottom line

OCGTs analysis for 2014/15



- Actual cost over expenditure was R6836 million but the RCA claim was limited to R1944million. Thus **Eskom absorbed** the difference of **R4892 million** to its bottom-line
- Allowed OCGTs volumes was 1056 GWh plus a special allowance for the 3 months for Jan15 to Mar15 which added another 734GWh. Special allowance was to limit the impact of load shedding

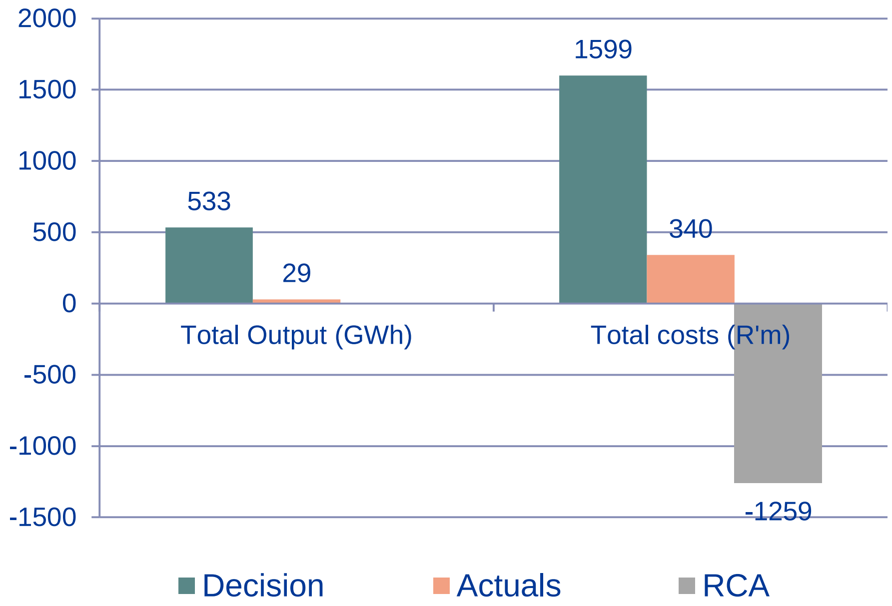
OCGTs analysis for 2015/16



- Actual cost over expenditure was R7182 million but the RCA claim was limited to R689million. Thus **Eskom absorbed** the difference of **R6493 million** to its bottom-line

OCGT usage and costs were lower in 2016/17 resulting in a claw back of R1259 million

OCGTs analysis for 2016/17



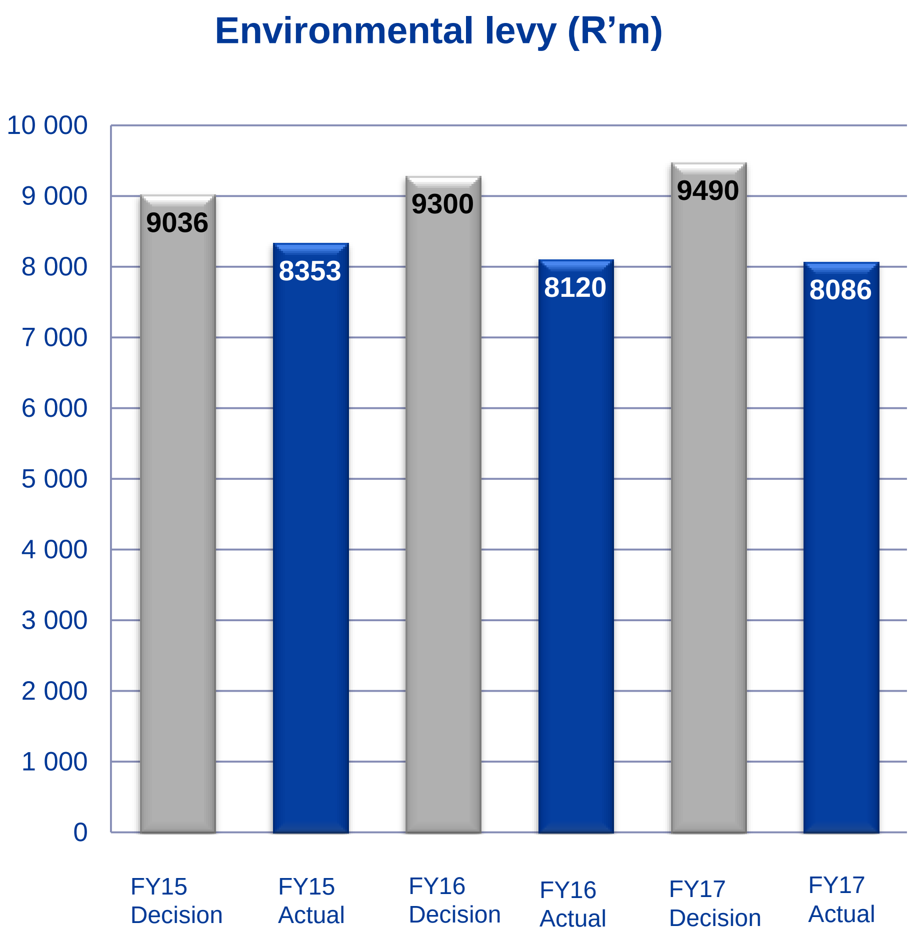
MYPD3 RCA 2013/14 decision and principle applied

- OCGT cost variances limited to amounts allowed by NERSA and additional volumes recouped at average variable costs for coal
- The above principle has been applied to the 3 RCA submissions

Reasons for RCA amount

- Due to the improvement in fleet performance and the commissioning of new capacity, lower OCGT volumes of 29GWh were required in 2016/17 compared to the allowance of 533GWh
- The under expenditure of R1259 million is then for the benefit of the consumer

Environmental levy was underspent due to lower sales and therefore lower production



MYPD Methodology[1]

- Allows for taxes and levies as a pass through

Reasons for RCA amount

- Environmental levy reflects a clawback in favour of the consumer
- Attributable to lower production levels linked to the lower sales volumes in actual mode
- Environmental levy rate is pass through to consumer

1 Source: Clause 14.1.5 NERSA MYPD Methodology – Final- for publication 5 December 2012

Other categories contributing to the RCAs

Breakdown of Other categories

Other categories (R'm)	2014/15	2015/16	2016/17	Total
Capital Expenditure (CECA)	91	332	636	1 059
EEDSM	-149	-368	-	-517
Service Quality Incentives (SQI)	236	318	343	897
Inflation	209	-152	162	219
Other income	-528	-152	-	-662
Total other categories	**-141**	**-4**	**1141**	**996**

Drivers to other categories in the RCAs

- **Capital Expenditure (CECA)** – amounts claimed as a result of variance in return on assets due to variance in capital expenditure being incurred when compared to assumption in MYPD3 decision
- **EEDSM –** lower achievement due to delays in project executions and strategy has been revised
- **SQI –** Distribution and Transmission networks have performed well over the period
- **Inflation –** Operating costs per the MYPD3 decision adjusted for change in CPI
- **Other Income** – Amount of other income adjusted based on RCA2014 decision principles

In summary Eskom's RCA applications are within the ambit of the MYPD 3 methodology and the precedent set in MYPD 3 year 1 RCA

- Eskom has submitted the RCAs for years 2,3 and 4 of MYPD3 based on:
  - MYPD3 regulatory methodology
  - Decision and principles of the RCA 2013/14 decision
- The application is based on audited financials at Eskom company level
- Eskom is requesting the revenue variance which contributes 67% (R44bn)
- IPPs contribute 11% (R7.4bn) and cross border purchases 14% (R9.1bn)
- Coal costs adds 5% (R3.5bn); OCGTs 2% (R1.4bn) and other primary 4% (R2.8bn) and Other items 2% (R1.4bn)
- Environmental levy is clawed back by 5% (R3.3bn)
- Eskom has absorbed operating costs of R33.8bn as higher expenditure is not allowed to be claimed through the RCA under the current MYPD methodology
- Eskom has also absorbed the OCGTs costs of R11.4bn above MYPD3 levels which exceed the coal cost compensation
- Eskom is aware that the RCA Balance of R66bn will not be liquidated once off and is likely to be phased.

The phasing of the liquidation of the RCAs needs to take Eskom's financial sustainability into consideration

Thank you