SOUTH AFRICAN LOCAL GOVERNMENT ASSOCIATION

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SALGA Response to Eskom MYPD4 Application & Regulatory Clearing Account for year 5 of MYPD3

FREE STATE HEARING
23 JANUARY 2019

SUMMARY PRESENTATION

SUMMARY OF THE INPUT BY SALGA

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- ## GENERAL COMMENTS

  – SALGA appreciates the strategic role that Eskom plays in our country's development needs
  – Inasmuch as Debt of Eskom is tightly linked to sovereign debt risk; social instability arising from consumer rebellion is tightly linked to sovereign stability and security. The regulator has to be cognisant of both
  – SALGA is mandated by its members to sensitise the REGULAR about the impact of the MACRO ECONOMIC situation to municipal and community affordability context. That it should be noted that the last 6 cycles of rate of increases have been double the levels of inflation while conditions of unemployment and macro economic growth remain way below 2%
  – REGULATOR to consider the devastating social impact of the applied parallel and cumulative increases in both RCA and MYPD4
  – Municipalities do not enjoy the negative impact that escalating Eskom Debt has placed them upon
  – Recognises the IGR initiatives aimed at providing a lasting solution to the electricity industry sharing and debt issue
  – There application raises a few questions that must be cleared to the regular in respect of
    - Sales Volume Forecast; Depreciation effect of 30% in the revenue application, Primary Energy information lack detail on impact of IPPs during round 1-3 on planned volumes and sales + Coal Contract Management inefficiencies eg 25% y1 and Cost Containment practices – how has the entity provided for improved cost containment in its operational model

SUMMARY OF THE INPUT BY SALGA

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- **THE YEAR 5 RCA**
  - The REGULATOR is requested to review the continued relevance of the RCA mechanisms in a free market context …. Impact of variables induced by internal inefficiencies and poor planning resulting into conditions for recouping of lost or unrealised revenue through tariffs (RCA and other)
  - Forecasted sales volumes are inconsistent with the current trajectory of the country's own development demand. This may lead to planned unrealised revenue and thus pre-empting a condition for RCA decision for recouping the difference yet it is in our view built incorrectly in the planning assumption for the period ahead (see slide 16)
  - The concept of the RCA framework is understood and appreciated but in this RCA customers are purely just asked to pay higher tariffs just because Eskom didn't sell enough electricity. Not fair
  - **Municipalities are all experiencing negative growth and this number is at least 2%, and yet they represent just over 40% of Eskom's sales volumes and should leave a big enough motivation to project negative growth of sales by Eskom.**

SUMMARY OF THE INPUT BY SALGA

- **THE MYPD4 APPLICATION**
  - SALGA is mandated by municipalities to caution the regulator on the unaffordability of the current MYDP4 Application. The asking rate of 15% is not in line with Macro Economic Performance variables and may if agreed result into unbearable and unfair social taxation to already burdens electricity users
  - SALGA is mandated to convey the wishes of our municipal members that this current application rate is not supported. Municipalities are asking the regulator to rather consider an increase that is commensurate with the Macro Economic Performance indicators (eg. 5% inflation level)
  - Depreciation of 30% seems to be out of norm with International Generally accepted Accounting Standards. Further, it differs from previous applications substantially. Is this necessary to be recovered from the revenue application?

DETAIL PRESENTATION

SUMMARY OF CONCLUSIONS

- SALGA and municipalities submits that in the current economic climate, the Eskom's proposed tariff is way above inflation and cost of living adjustments.
- It is highly unlikely that customers will be able to afford three years of increases of a minimum of 15% per annum, plus RCA's parallel to this
- SALGA and Municipalities, acknowledge the municipal tariff rationalisation that is being implemented by Eskom
- Acknowledges the adjustment of municipal tariffs over the period being in the order of 17,60% in 2019; 14,20% in 2020 and 15,20% in 2021.
- It is accepted that the revenue application is a separate process from the RCA process which will greatly impact on these proposed increases.
- There is a need for NERSA to consider "performance-based regulation" for Eskom. This will require NERSA to set performance targets in several aspects of Eskom operations, like targets for cost reductions, capital expenditure on major projects including preventing slippages in project completion etc.

SUMMARY OF CONCLUSIONS

- Appreciates and sympathize with Eskom's financial challenges but everyone is going through this, there are no holy cows.
- Advise the regulator that the current rate of increase at 15% is unaffordable and may have negative effect to development objectives of the already over-burdened municipal revenues
- Advise the regular to reconsider the RCA mechanism in so far as it depends on planned volumes as basis permission to recoup unrealised revenue through tariff. This model in its current form has the unintended effect of disincentivising sound planning and internal entity operational efficiency commitments
- Entrust NERSA to make the right decision as outlined in the ERA, which amongst others are:
  - Affordability; Universal Access; and
  - Promotion of efficiencies and sound planning when allowing **efficient** utility to recover its costs with reasonable margins through these applications etc

Introduction

- SALGA Energy Summit in 2018 – all agreed that the EDI structure as it is, no longer makes sense and continues to be unsustainable,
- It is currently experiencing rapid structural changes and the electricity price increases are a major contributor to grid defection, and the technological disruption which is happening in any case
- Energy security threats and rising electricity prices, associated with decreasing technology costs and increasing product quality, have spurred a growing interest in energy efficiency and renewable energy technologies,
- <u>In particular an interest to self-generate electricity for own use from technologies such as solar photovoltaic (PV) systems from mostly the paying customers to Eskom and Municipalities</u>
- SALGA would like to re-iterate the appreciation of Eskom's predicament on its financial sustainability but, this does not take away the realities that the country is currently undergoing.
- The economy is not growing at a rate which allows for soft landing on all commodities and services, income levels are trailing behind.

Introduction

- The ESI is experiencing a delinking between economic growth and electricity demand growth.
- Electricity sales show a sustained downward trend over the last years and have dropped significantly.
- Today the sale of electricity is at record low levels for all municipalities, Eskom, the debts to municipalities and theft rising at an exponential rate.
- Peak consumption levels are however not following the same trend, driven by high households' electricity consumption, particularly in the evening peak.
- These intertwined dynamics have major implications for municipalities that are compelled to re-define their role in the electricity value chain and adapt
- <u>The model of bulk purchases from Eskom and selling kilowatt hours to customers is no longer a profitable and sustainable model for local government, especially within the current economic landscape</u>.
- It is for this reason that SALGA supports municipalities like City of Cape Town, Ekurhuleni, eThekwini etc. who are exploring other sources of energy from other players including for their own use

The Eskom Application/s

- Eskom's third Multi-Year Price Determination (MYPD3) Regulatory Clearing Account (RCA) Year 5 (2017/18) application totalling about **R27bn**

- Fourth Multi-Year Price Determination (MYPD4) application totalling R219bn, R252bn and R291bn for the 2019/20, 2020/21 and 2021/22 financial years respectively

Recent Decisions

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- On 14 June 2018, the Energy Regulator approved a total RCA balance of R32.69 billion for the three years as follows:
  - an RCA balance of R12.577 billion for the 2014/15 financial year;
  - an RCA balance of R12.058 billion for the 2015/16 financial year; and
  - an RCA balance of R8.055 billion for the 2016/17 financial year.

- On 2 October 2018, NERSA issued a statement on the liquidation of the above RCA balances.
  - Eskom will recover R7 776m from Standard tariff customers from the 2019/20 financial year until the 2022/23 financial year. Everything else remain the same.

Response to the Regulatory Clearing Account Application

Summary of the RCA Application

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RCA for 2017/18 (Year 5 of MYPD3)	MYPD3 Decision	Actuals 2017/18	Variance to MYPD3	RCA adjustments	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 decommissioning from RCA 2013/14 decision phased in over 10 years for liquidation					**83**
FY2018 Liquidation claim , R million					**21 624**

SALGA Response to RCA

- The application is dominated by the shortfall in sales (over R26bn)
- SALGA and Municipalities' position is that the sales part or the whole RCA must just be scrapped by NERSA.
- Too much burden hanging over SA customers with the recent RCAs that will be liquidated parallel to MYPD4
- The concept of the RCA framework is understood and appreciated but in this RCA customers are purely just asked to pay higher tariffs just because Eskom didn't sell enough electricity. **Not fair**
- We cannot keep punishing customers for lower demand and less purchases that are inevitable and not their fault
- Municipalities are also selling less, most if not all are having negative growth, high electricity theft and non payment levels
- NERSA and Eskom must discuss this RCA and make a decision that is not to the detriment of the customer.
- **This RCA is not supported**.

Response to MYPD4 Application

Consultation

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- SALGA Received Eskom letter which is dated 27 July 2018 with its MYPD4 application
- In terms of section 42 of the MFMA, SALGA and its members are requested to provide written comments on the proposed application within a period of 40 days
- SALGA went through its own internal consultation process with its members to comment and make a decision on the local government position
- SALGA hosted Eskom and municipalities on 05 September 2018 for a workshop discussing in details the Eskom application and for Eskom to respond to any matters of concern from SALGA and municipalities
- The purpose consultation is not for parties to agree but to clarify any matters arising and agree to disagree in some cases
- Further to this workshop SALGA sent out a document with further questions and issues of clarity. No response to those issues as yet.

The SALGA Response

Customer- Centricity and Sales Volume

- The Revenue Application document states Customer-centricity
- **The rate of 15% increase is not consistent with the economic reality that underpins incomes of users and thus their ultimate affordability levels. During the same period our Economy will be performing at just over 1% and inflation at between 4,5- 5,5%. This rate is surely unaffordable and not rational**
- These levels of tariff hikes are making it more affordable for more affluent customers to go off-grid.
- The most vulnerable, the working class and the unemployed poor people of South Africa, don't have much options
- **The ripple effect of this rate will have a compounding effect of the already burdensome debt levels or arrears situation of our municipalities.**
- If NERSA allows the increase at this rate, it will have a devastating and negative effect to municipalities and their constituent customers
- This will further negatively affect Municipalities and Eskom's sales volumes.

Customer- Centricity and Sales Volume(2)

- Eskom refers to major structural shifts in the country which would affect their sales volumes, but don't appear to make provision for this its financial models.
- The document explicitly mentions initiatives to grow sales volumes from customers.
  - These customers include industries and mines, many of whom are in distress, including municipalities, which are also financial sustainability challenges, due to rising unemployment and limited economic growth.
- However, in the table of Operating Costs (page 91) a decline in debt impairment for the period under application is shown.

Sales Volumes/Growth projections

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- In a previous 2018/19 revenue application Eskom clearly showed how the sales volume rebasing was required.
- This is when actual volumes were on a decline since 2012 and projections were still indicating a positive growth.
- **Municipalities are all experiencing negative growth and this number is at least 2%, it represents just over 40% of Eskom's sales volumes and should leave a big enough motivation to project negative growth of sales by Eskom.**
- If the prices are to be approved by NERSA with the RCA on top of that, elasticity must also be taken into account, otherwise it has to be argued that Eskom has lost the plot.

Sales Volumes/growth projections (2): Questions NERSA must ask Eskom

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- Given that the actual sales volume for 2017/ 18 declined is Eskom not overenthusiastic to project growth of almost 1% in local sales for year 1 as well as for year 3 of the application?
- What would be the basis for Eskom to forecast 8.4% growth in international sales in year 1 especially on the back of a forecasted decline of 2.4% in current financial year?
- What would be the basis for Eskom to forecast 3.8% growth in international sales in year 3?
- What would be the basis for forecasted increase of 17.67% in the selling price to local SPAs in year 2?
- What would be the basis for forecasted increase in average selling price of Export if the increase over the past five years has generally been in line with MPYD increase if not higher?
- Eskom is requested to further align its forecast sales volume to the trends in 2018/19 YTD actuals.

Depreciation as a cost in the Revenue Application

- The depreciation costs makes up almost 30% of the revenue application in each year.

- Any depreciation should be in accordance with International Financial Reporting Standards and Generally Accepted Accounting Procedures.

- This would appear to be an unnecessary allocation to the Revenue Application based almost solely on the different methodology applied in 2016 which takes into consideration the overnight costs for various generation technologies.

- Further, it is stipulated that this depreciation in the Revenue Application does not align with the depreciation recorded in the latest Annual Financial Statements. The difference should be clearly recorded and accounted for.

Depreciation as a cost in the Revenue Application (2)

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- It is further proposed that consideration be made for a separate submission for any new assets to be procured or built by Eskom – clearly outlining the costs, timeframes and impact on future tariffs.
  - This will give government and the people of South Africa more control to influence the energy generation typology.

- Further, the slippage and cost escalations experienced in the past will be minimised as the greater community will hold project managers accountable for achieving milestones and keeping the costs within the budgeted amounts.

Primary Energy

- Why is the IPPs R21 561bn p61 of 152 different from AFS p89 R19 317m,

- How does Eskom envisage own generation cost not to increase between year 2 and 3 of application whereas it is expected to increase by 18% in current financial year?

- Under Coal costs and price escalations (14.6.3), suggests that Eskom has not made any arrangements with suppliers, in order to reasonably realize the projected reduction in coal usage unit price in real terms by the end of the application period?

- Has Eskom managed to get contracted commitment from suppliers as assurance for the envisaged reduction in coal usage cost in real terms by the end of the application period?

Primary Energy(2)

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- As per p58 of 93 (Revenue Application 18/19) Eskom applied for an increase of only 5.28% increase in the coal usage cost, yet as per the current MYPD application Eskom projects the coal usage cost to increase by 18.33% in the current year which is significantly more than what it had planned only a year ago.

- Does this amount to overestimation in cost escalation or is this not indicative of significant scope for improvement in coal contract management?

- What measures has Eskom put in place to ensure that coal price escalation will reasonably be in line with Eskom management objectives?

Primary Energy (3): Depleting Coal Reserves

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- Eskom together with Department of Energy need to urgently invest in acquiring new coal mines and supplies in South Africa if the long term sustainability of the coal fired generation assets is to be maintained.

- Eskom then needs to be held accountable to strict payment terms for the coal supplied.

- Further, government intervention should be sought to introduce some taxation on the export of coal.

- At the moment coal mines are getting better prices on the export market and so are sending their coal overseas.

Imports:
Questions NERSA must Ask Eskom

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- **Why does Eskom expect the price of Imports to increase by 25% in Y1 of application and but only by 6% in each of the subsequent years?**
- What was the actual average increase in import price over past five years?
- Why is output from Imports dropping by 20% in Y1 of application?
- Why can Eskom not increase imports to levels of 11TWh achieved in FY1415?

IPPs:
Questions NERSA must Ask Eskom

- Eskom must
  - provide progress on signing of all contract with respect to Rounds 3.5, 4 and 4.5?
  - provide progress on financial closure with respect to all contract with Rounds 3.5, 4 and 4.5?
  - provide detail on envisaged roll-out (COD) of each Window 3.5, 4, & 4,5
  - provide detail with respect to envisaged roll-out of Window 3.5, 4, & 4,5 both in terms of kWh & MW per project?
  - clarify why production volumes from Round 1-3 are still increasing as these IPP should by now be operating at full capacity.
  - clarify why the average price for Round 3 is increasing by 15% in Year 1 of application after a 10% increase in the current year?
  - clarify why the average price for Round 3.5 is increasing by 14% in Year 1 of application and decreases in subsequent years?

O&M
Questions NERSA must ask Eskom

- According to para 15.1 on p91 of 152 O&M projected to increase by 1.5% only over the application period, however the projected O&M for 2017/18 is R30.9b (Table 23) yet as per AFS17/ 18 it is only R25.6b or at least 21% more than the actual:
  - Why does Eskom not adjust its application to give correct reflection of available information?
  - Does this not change the narrative that O&M are expected to decrease in real terms over the application period?
  - Does Eskom maintain that significant efficiencies will be achieved over the application period?
  - How does Eskom justify expected increase of O&M of at least 20% at the beginning of application period and almost no increase at all during the application period?
  - Eskom should look at this O&M application in the interest of more realistic cost projections and associated updated narrative?

Environmental Levy
Questions NERSA must Ask Eskom

- Why is the system average auxiliary increasing over the years? (p89 of 152)

- By consideration of operational efficiency system auxiliary why can it not be limited to maximum 5% or even less, Eskom is allocating average max of 8%

Cost Containment

- The concept of Eskom being in a financial death spiral is acknowledged
- The assertion that South Africa still has very affordable electricity compared to the rest of the world is an old argument that has not been well received.
- It would be far more beneficial for Eskom to substantiate the real costs of efficient and effective service delivery against the proposed price increases.
- Eskom has brought little to the table to show the cost containment measures it has implemented in order to minimise costs.

Cost Containment

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- The World Bank review of the staff complement benchmarked against world standards is welcomed and creates the expectation that the reduction in costs will be clearly articulated against the adjustments to staffing levels over time.

- Consideration should be given to new conditions of service that remove some of the old benefits that escalate costs without any value add

- In general, a strong stance should be taken to introduce major austerity measures throughout Eskom that will significantly contribute to reducing overheads over the longer term in order to maintain the viability and financial sustainability of Eskom.

Conclusion

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- SALGA and municipalities submits that in the current economic climate, the Eskom's proposed tariff is way above inflation and cost of living adjustments.
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Conclusion

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- Advise the regulator that the current rate of increase at 15% is unaffordable and may have negative effect to development objectives of the already over-burdened municipal revenues
- Advise the regular to reconsider the RCA mechanism in so far as it depends on planned volumes as basis permission to recoup unrealised revenue through tariff. This model in its current form has the unintended effect of disincentivising sound planning and internal entity operational efficiency commitments
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Thank you

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