ANNEXURE B

MINISTER
ENERGY
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Dr. Rob Davies, MP
Minister of Trade and Industry
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0001

Dear Colleague

FRAMEWORK FOR NEGOTIATED PRICE AGREEMENTS TO MITIGATE AGAINST JOB LOSSES DUE TO THE CLOSURE OF SMELTERS

It has been brought to my attention that we run the risk that smelters in Polokwane (Limpopo) and Kriel (Mpumalanga) are due to close down due to electricity tariffs, and that over 3 000 jobs would be lost as a consequence.

At the onset I wish to indicate my support for a fast-tracked intervention to mitigate against the risk of job losses due to the closure of these key industries. Whilst Eskom has indicated that they have excess power generation capacity at the moment (which capacity is expected to widen as more Medupi and Kusile units are commissioned), it is untenable that prevailing electricity tariffs must render some smelters unviable and thus lead to closures, in contradiction of our local beneficiation strategy for job creation.

I am therefore in support of the attached framework under the EPP and have approved it for immediate application; this framework has been supported by Eskom and it will apply in respect of the smelters operated by Sublime Technologies (Silicon Carbide producer) and Silicon Smelters and it would be an interim arrangement as we embark on a wider pricing framework for the other sectors in a similar situation.

Your support would be highly appreciated.

Yours Respectfully,

Ms Tina Joemat-Pettersson, MP
MINISTER OF ENERGY
DATE: 28/3/2017

INTERIM FRAMEWORK FOR NEGOTIATED PRICE AGREEMENTS UNDER THE ELECTRICITY PRICING POLICY

Background

In the current economic environment, many industries in the country are facing challenges that impact their competitiveness and viability. In many cases, particularly for those industries exposed to global commodity markets, the electricity price plays a major role in determining competitiveness.

A number of consumers in the affected market segments have either closed completely or cut back their operations in recent years and many more are currently under threat of total or partial closure.

At the same time Eskom has indicated that they are experiencing a period of excess power generation capacity. It is evident that as we enter a phase of excess capacity (expected to increase as more of Medupi and Kusile units are commissioned), South Africa must devise a strategy to use electricity pricing to keep our energy intensive industries competitive and supportive of our local beneficiation policy.

Purpose

The purpose for Eskom offering short-term incentive pricing to the targeted consumers is to support economic growth and to retain or grow employment levels in South Africa.

The intent is to support economic growth by either:

- Retaining current electricity sales to existing operations (and thus retain jobs); or
- Reinstating lost electricity sales to operations with under-utilised assets (and thus retain or create new jobs).

Incentive electricity pricing is designed to assist customers in these industries, in the interests of the economy as a whole.

As price levels would be set above the variable cost of production, the marginal sales would make a contribution to fixed costs that would otherwise be absent. Thus, without the incentive packages, other customers would have to absorb this marginal contribution, resulting in steeper price increases.

Although commodity markets are expected to recover in the medium term, it is important to ensure that production assets and employment levels are maintained in the interim, thus ensuring that South Africa is in a position to take full advantage of the recovery when it materialises.

Furthermore, Eskom is in the early stages of the development of a new tariff option for certain categories of large industrial customer. This project is aimed at sustaining industrial sales in the longer term and attracting additional sales via increased investment in the South African economy, particularly in electricity-intensive market segments.

Type of Customer

Applicants will be large consuming customers of Eskom that contribute to the economic wellbeing of South Africa.

Applicants will currently be operating or have operations with existing infrastructure in South Africa as no one would make a new investment with only a two year deal.

If any applicant has competitors in South Africa, the application will be assessed in the context of the applicable market segment.

Framework for the development of short-term incentive pricing packages

1. Each applicant's case will be evaluated on its own merits.
2. To qualify, the following criteria will apply –
   - Electricity cost is one of the top 3 drivers of operating costs and constitutes at least 20% of operating cost at standard tariff rates;
   - "Normal" annual sales ≥ 80 GWh; and
   - Annual sales at risk ≥ 50 GWh.

   [Note: If two of the above criteria are met, some leeway may be granted in respect of the third criterion.]
3. The applicant must present a comprehensive case, covering at least –
   - Global and/or national ownership and structure
   - Location of major electricity-consuming plant/s (globally where appropriate)
   - High-level breakdown of operating costs; with more detail in respect of the top 3-4 cost categories (including electricity)
   - Product/s produced; market/s served (i.e. customers, key value chain/s & geographic spread)
   - Competitors located in SA & globally
   - Where there are local competitors, does the applicant's business model differ markedly from those of the local competitors and, if so, how?
   - Electricity prices paid outside Eskom's jurisdiction, including by competitors where available
   - Market price setting mechanism & currency; price history & 2-3 year price & volume forecast
   - Long-term prospects for market volume & price
   - Sales retention cases –
     - Financial situation; 2-3 year projections; risk of closure/cutback & timing;
     - Would potential closure be permanent; what are the prospects for reopening?
     - Economic and social impact assessment of potential closure – e.g. jobs at risk; regional impact; impact on up- and downstream industries; etc.
     - Steps taken to avoid closure (internal), e.g. cost cutting, energy/electricity efficiency; product or market initiatives
     - Steps taken to avoid closure (external); parties approached for pricing, financial and/or lobbying assistance and their responses to-date
   - Sales reinstatement cases –
     - Financial situation; 2-3 year projections; with and without requested incentive pricing;
     - What are the prospects for reopening without the requested incentive?
     - Economic and social impact assessment associated with recovered sales – e.g. jobs; regional impact; impact on up- and downstream industries; etc.
     - Steps taken to facilitate increased production (internal), e.g. cost restructuring, energy/electricity efficiency; product or market initiatives
     - Steps taken to facilitate increased production (external); parties approached for pricing, financial and/or lobbying assistance and their responses to-date
   - New/additional sales –
     - Eskom considers it extremely unlikely that customers would be in a position to justify new investments based on an incentive pricing arrangement of up to two years.

- However, should such applications be forthcoming, they will be assessed on the same basis as reinstatement sales.

4. Eskom due diligence to verify information provided –
   - Internal to Eskom / independent 3rd party sources / combination
   - Independent assessment (e.g. Eskom external auditor)
   - Access to customer records
   - Report from customer's auditor
5. Applicant's motivation –
   - What price level is requested? For how long? Escalation? Opportunity for upward price adjustments should the relevant commodity price improve?
   - Motivation for proposed price level, taking account of the benefits from all other initiatives
   - Contribution to fixed costs & EBIT at proposed pricing level?
   - What value additions are offered in return (e.g. interruptability, take-or-pay commitment, etc.)?
   - Where commodity price upside is feasible, proposed threshold price and sharing formula
6. Key elements of potential Eskom proposals –
   - Unique pricing solution based on the evidence provided, coupled with an internal assessment
   - Price level must be above the estimated variable cost of production (coal generation) in order to ensure a contribution to Eskom's fixed costs
   - Incentive to be provided as a rebate, one month in arrears
   - Package duration limited to 2 years; with built-in escalation and/or interim re-evaluation if > 1 year
   - A minimum of 2 "value-adds", such as interruptability and a take-or-pay component, must be included
   - Wherever practical, there should be an opportunity to share value with the customer when the relevant commodity price exceeds a realistic threshold (<u>only</u> upside risk)
   - If electricity constitutes < 50% of operating cost, implementation of Eskom's proposal should ideally be subject to the customer signing deals with other suppliers, thus addressing > 50% of total operating cost
   - Submissions must include assessments of both the competition risk in SA and the impact on other Eskom customers: i.e. loss of sales vs. incentive pricing
   - Where feasible, payment terms should be improved for the duration of the incentive package (e.g. advance payment)