



AFRICAN NATIONAL CONGRESS

SUBMISSION TO NATIONAL ENERGY REGULATOR OF SOUTH AFRICA (NERSA) ON ESKOM'S APPLICATION FOR A PRICE INCREASE FOR THE 2008/9 FINANCIAL YEAR

Introduction and Background

Eskom informed the South African government in 1994 that the surplus capacity in the electricity sector will come to an end in 2007 and that there was a need for government to invest in order to increase its generating capacity. Government decided, at that time, to put Eskom's plans to expand on hold, as they had wanted to encourage private, foreign investment in the industry. Such foreign investment in generating capacity did not take place and this has placed a burden on the energy sector, both in terms of generating sufficient electricity to meet the demands of a growing economy and maintaining the existing capacity.

South Africa has experienced frequent and wide spread incidences of scheduled and unscheduled load shedding for at least the last two to three years and since January 2008, South Africa has been going through a period of an unprecedented electricity challenge manifesting in electricity shortage. This situation has resulted in the significant reduction of the electricity supply reserve margin which in turn brought about unprecedented load shedding.

Eskom made an application to the National Energy Regulator of South Africa (NERSA) on 18 March 2008 for the revision of 14,2% price determination for 2008/9. Eskom requested for percentage increase to be revised to 60% nominal and that such increase be implemented from 1 April 2008. Eskom stated that the reason for its application is the significant changes in its business environment, namely the primary energy costs and the accelerated demand side management costs.¹

The African National Congress (ANC) announced on 19 March 2008 that it had noted the announcement that power utility Eskom has applied to the National Energy Regulator of South Africa for a 53 % (real) hike in electricity tariffs. The ANC expressed grave concern that such a move, if implemented, would have adverse effects on the daily lives of the poor people of South Africa and decided to call for an Energy Summit to find alternate methods of addressing the energy crisis.

The ANC also engaged with various academics and civil societies in order to get a wide variety of opinions and inputs on the most appropriate pricing structure for South Africa. There is widespread acknowledgement that some sort of tariff increase will be necessary

¹ National Energy Regulator of South Africa (NERSA) Draft Consultation Paper *Eskom Application for a Price Increase for 2008/9 financial year, April 2008*

and that these increases must be structured in a manner that does not affect South Africa's poor disproportionately.

It is further accepted that substantial fiscal injections will be necessary to ensure that financial ratios crucial to the retention of Eskom's credit rating and its financial health are maintained.

It is recognised that the final increases granted for this five-year period will be subject to the NERSA regulatory processes and may require some changes in the rules surrounding its multi-year price determination framework.²

African National Congress Approach

The ANC believes that whilst advancing economic development agenda, the fulfillment of basic needs remains a priority. The Reconstruction and Development Programme (RDP) was clear that democratic South Africa's energy policy must concentrate on the provision of energy services to meet the basic needs of poor households, stimulate productive capacity and urgently meet the energy needs associated with community services such as schools, clinics and water supplies.³

Currently, the burden of electricity expenditure is large for most households, especially the poor. Further increase in tariffs would lead to increased hardship for the poor. It should be acknowledged that although a significant portion of poor households are now connected (electrified), affordability is still a challenge even within the context of Free Basic Electricity. Quite often the poor households are unable to enjoy the benefits of being connected to the electricity grid since they cannot even afford the minimum amount of electricity required for their basic needs.⁴

The ANC is clear in its belief that South African citizens and consumers should not have to pay for mistakes made by government in the early 1990s, both in terms of decisions not to expand the generation capacity of Eskom and to use the low cost of an energy as an incentive to attract investment in a globally competitive world.

This submission is informed by the following principles:

- 14,2% has already been granted.
- Eskom should not be granted any increase that compensates them for under-recovery over the past financial years.
- The demand side management interventions have to be funded by the state.
- The pricing policy should be mainly based on cost plus principle. When we lost contact with Eskom processes this was about 95% of the coal stock. Spot market should be considered in the most extreme conditions.
- Coal stock reserved should not be allowed to drop far below the acceptable 20 days level. Hence the proposal that coal pricing must be negotiated with the coal mining industry.
- Funding of the capitalisation programme must be clarified taking into account what can be regarded as the globally acceptable debt/equity ratio. This will talk to the worry about the credit rating of Eskom by the international rating agencies.
- The increase over the next five or so years must be in nominal terms and not in real terms as it is impossible for consumers to predict inflation levels. This is particularly important today where inflation is mainly driven by external factors.

²NEDLAC presentation of the DRAFT Agreement of the National Electricity Summit, 16 May 2008

³ Reconstruction and Development Programme, 1994

⁴ African National Congress Research Unit (Parliament) *Briefing Document: Electricity Tariffs, May 2008*

The **ANC thus proposes a model that will smooth out the price over five years** as that, in its view, will give the various sectors in the economy time to adapt and adjust budgets and how they structure their every day consumption of electricity and do business.

The ANC endorses the view, as espoused by the Human Sciences Research Council that Eskom's proposed price increases enable an unnecessarily fast repayment of loan finance and exceed what is required to maintain credibility with its creditors. The HSRC estimates that a **real price increase of 100% rising by equal amounts of 14, 85% over 5 years** (based on compound growth) would be sufficient to cover the cost of investment , offer sufficient interest cover, provide adequate debt/ equity ratios and therefore not adversely affect Eskom's credit rating. The increase of 14, 855 in 2008/9 does include the actual primary energy costs, as reported by Eskom (rising from R13bn in 2006/7 to R23 bn in 2008/9) Thereafter, primary energy costs rise by 8%, the anticipated average rate of inflation over the next 5 years.⁵

The HSRC modeled the impact of a 100% price increase over 5 years:

Scenario 1, where funding Demand Side Management remains Eskom's responsibility

	Mar 07	Mar 08	Mar 09	Mar 10	Mar 11	Mar 12	Mar 13
Real unit price increase			14.9	14.9	14.9	14.9	14.9
Net profit after tax & interest (Rbn)	7.00	0.00	0.58	3.52	4.54	5.42	6.25
Net profit before tax to Turnover (%)	23.8	0.00	1.5	6.7	6.7	6.2	5.4
Net profit before tax to Total Assets (%)	10.6	0.00	0.4	1.9	2.0	2.1	2.1
Increased borrowings (Rbn)	-8.4	-17.3	-64.7	-52.4	-38.1	-21.6	-34.4
Interest cover	7.3	1.0	1.3	1.9	2.0	2.8	4.2
% interest bearing debt over equity	58.3	88.7	211.1	304.6	372.2	405.3	417.1
% interest debt over equity & S/holder loan	58.3	88.7	181.7	207.8	191.3	164.7	177.7

- Eskom maintains that credit rating could fall if debt/ equity rises above 200% or interest cover below 3.0
- The alternatives on last lines assume capitalization of shareholder debt-in which case no interest expense is incurred
- Borrowing costs are assumed to have the following premiums depending on debt/ equity ratios: 20% premium if D/E higher than 100%; 40% if D/E greater than 200%, but with average rate that is never higher than average rate of inflation
- DSM costs rise from R2,5bn in 2008/9, to R2,8bn in 2009/10, R3,2 bn in 2010/11 and R3,5bn from 2011/12

⁵ Altman, M *Comment on Eskom's proposal for Price increase in 2008/9* Human Sciences Research Council (HSRC), May 2008

Scenario 2, where funding for DSM removed from Eskom to fiscus

	Mar 07	Mar 08	Mar 09	Mar 10	Mar 11	Mar 12	Mar 13
Real unit price increase			14.9	14.9	14.9	14.9	14.9
Net profit after tax & interest (Rbn)	7.00	0.00	0.58	5.61	7.22	8.63	9.94
Net profit before tax to Turnover (%)	23.8	0.00	1.5	10.7	10.6	9.8	8.7
Net profit before tax to Total Assets (%)	10.6	0.00	0.4	3.1	3.2	3.3	3.4
Increased borrowings (Rbn)	-8.4	-17.3	-64.7	-50.3	-35.4	-18.4	-30.4
Interest cover	7.3	1.0	1.3	2.3	2.3	3.1	4.6
% interest bearing debt over equity	58.3	88.7	211.1	291.2	340.2	354.2	349.2
% interest debt over equity & S/holder loan	58.3	88.7	181.7	200.0	178.8	149.9	156.8

- Eskom maintains that credit rating could fall if debt/ equity rises above 200% or interest cover below 3.0
- The alternatives on last lines assume capitalization of shareholder debt-in which case no interest expense is incurred
- Borrowing costs are assumed to have the following premiums depending on debt/ equity ratios: 20% premium if D/E higher than 100%; 40% if D/E greater than 200%, but with average rate that is never higher than average rate of inflation
- The cost of DSM is excluded from 2009/10

Based on the above calculations, the HSRC concluded that a price increase of 14, 85% p.a. over the next 5 years would ensure that Eskom achieves profitably in every year and that interest cover is low for 3 years and returns to acceptable levels by 2011/12. Where DSM is excluded from the calculation from 2009/10, profits rise to almost R10bn in 2012/13 and debt/ equity ratios are mostly within acceptable ratios.

The ANC (and the HSRC) is convinced that DSM should not be part of Eskom's funding responsibilities and that the state should bear responsibility for this and thus, **Scenario 2** in the above models is the preferred one for the ANC.

The preferred proposal for price increase should also be buttressed by engaging with the coal mining industry on a pricing structure that will be supportive of the programme to resolve the current crisis that is based on the principle of special domestic prices beyond the contract allocation. The special arrangements should not be about profit maximization nor should they push coal mining companies into loss making situations.

Conclusion

The ANC remains convinced that the proposal set out in this paper provides the correct balance between social and economic interests and will best serve all sectors of the country.

However, the current debate around a suitable tariff increase for South Africa may point to a need to have a broader discussion about the country's general energy policy. There should thus be further engagement around issues such as whether electricity is a public good or not and what the answer to that question means for pricing and service delivery.

Other areas of engagement should be about the nuclear energy programme and issues of drawing the private sector into South Africa's energy industry.