



**Preliminary response to the Eskom Revenue Application  
for the Multi Year Price Determination for the period  
2010/11 to 2012/13  
(MYPD 2)**

Issued on 14 December 2009

## Abbreviations and definitions

### *Abbreviations*

c/kWh	Cents per kilowatt hour
CCGT	Closed Cycle Gas Turbine
CPI	Consumer Price Index
DOE	Department of Energy
EEDSM	Energy Efficiency and Demand Side Management
EPP	Electricity Pricing Policy
ERA	Electricity Regulation Act No. 4 of 2006
FBE	Free Basic Electricity
GDP	Gross Domestic Product
GWh	Gigawatt hour
IPPs	Independent Power Producers
MRP	Market Risk Premium
MEA	Modern Equivalent Assets
MYPD	Multi Year Price Determination
NERSA	National Electricity Regulator of South Africa
OCGT	Open Cycle Gas Turbine
OPEX	Operating Expenditure
PCP	Power Conservation Programme
PPI	Producer price index
RAB	Regulatory Asset Base
R/MW	Rand per Megawatt
ROA	Return on assets
RTS	Return to Service
WACC	Weighted Average Cost of Capital

## Definitions

Allowable revenue	The total revenue <b>allowed to Eskom by the Regulator</b> which includes the total costs to supply plus a fair rate of return on the asset base as determined <b>by the Regulator</b> .
Beta	An arbitrary measure of the volatility of a given stock using an index of the volatility of the market as a whole: <i>A beta of 1.1 indicates a stock that is 10 percent more volatile than the market.</i>
c/kWh	Refers to price of a unit of electricity
Cost of capital	The required return necessary to make a capital project worthwhile. Cost of capital includes the cost of debt and the cost of equity.
Debt	An amount of money borrowed and owed by one party to another. In the MYPD, debt refers to all borrowings by Eskom.
Depreciated Replacement cost	This is an approach where assets are valued on the basis of the cost of replacing the existing assets (i.e.like for like)
Equity	Funds that are raised by a business in exchange for an ownership interest in a company
Funding model	Confirmed sources of long-term capital to be used by a business entity to fund its capital investments. A funding model would be backed by investors/owners' undertaking to provide some optimal combination of debt, equity, retained earnings and revenue from tariffs, in sufficient amounts to meet the planned capital expenditure
Independent Power Producers	Any undertaking by any person or entity which the government of South Africa does not hold a controlling ownership interest (whether direct or indirect), of new generation capacity at a generation facility following a determination made by the Minister of Energy in terms of section 34(1) of the Act.
Indexed historical cost	Is a replacement cost approach whereby the historical cost, which is the original cost of acquiring the asset, is adjusted upwards by inflation to obtain the current cost of that asset.
Load forecast	The forecast of the electricity consumption of all electricity users in South Africa and exports to neighbouring countries
Market risk premium	The difference between the expected return on a market portfolio and the risk-free rate.
Modern Equivalent Asset	Modern Equivalent Asset is a replacement cost approach applied where the underlying technology has changed significantly such that existing assets cannot be replaced in an identical form. In this case replacement cost is based on the cost of a modern asset with similar service potential, known as modern equivalent asset (MEA).

Primary energy	The energy resources from which electricity is produced such as fuel and water. Primary energy cost includes the associated cost of procuring and delivering the resources to the power station
R/MW	Refers to price of generation capacity
Rate of return	The gain or loss of an investment over a specified period, expressed as a percentage increase over the initial investment cost.
Regulatory Asset Base (RAB)	The total of all assets that are used in the production and supply of electricity after the deduction of the accumulated depreciation on these assets. The RAB also includes an allowance for working capital.
Regulatory methodology	A set or system of methods, principles, and rules for regulating the allowable revenue and the price at which electricity is sold
Reproduction cost	Cost of exact duplication ( creating an exact replica) of the asset with the same materials and specifications at the same location
Revenue requirement	The total revenue <b>applied for by Eskom</b> which includes the total costs to supply plus a fair rate of return on the asset base as determined <b>by the applicant</b> .
Weighted Average Cost Capital	The <b>weighted average cost of capital (WACC)</b> is the rate that a company is expected to pay on <b>average</b> to all its security holders (equity and debt) to finance its assets.

## Executive Summary

Business Unity South Africa herewith presents its submission and comment on the Revised Eskom Price application as was submitted to NERSA on 30 November 2009.

Although BUSA is cognizant of the MYPD2 rules and processes to be followed by Eskom in the application and ultimately the NERSA in terms of its ruling, this submission refers to the wider economic implication of the application and addresses itself to Government and other Stakeholders in the South African economy given the wide interest in and effect of the ruling.

The resultant size of the increase sought by Eskom is a huge shock to South Africans, and particularly to businesses. It is projected that the scale of the shock is such that many hundreds of thousands of job losses will result from the demise of many industries which will occur given that the revised application is approved.

BUSA contends that the basis on which Eskom's revised application is constructed is erroneous to the extent that the borrowing constraints are forcing it to begin to recover the capital cost of the expansion well ahead of the commissioning of generating assets. The capital raising and borrowing necessary for the funding of projects of such a size, will require shareholder contributions and an involvement by Government in excess of that already pledged. Furthermore the level of debt which the organization needs to take on is underestimated and the repayment thereof is unnecessarily accelerated.

BUSA has modeled the finances of Eskom and has good grounds to believe that if good business management practices prevail, on the part of Eskom and the Shareholder, that the price increases can be maintained at a level of increase of 25% per annum for two years and 22.5% thereafter in the third year. The detail of how BUSA believes this can be achieved is set out in full in the body of the submission hereto.

BUSA's position is that the 35% increase as proposed in the Eskom application to NERSA cannot be supported and will have negative consequences for business. The macroeconomic impact of such an increase will further curtail economic recovery prospects and is expected to increase inflation, reduce economic growth significantly and therefore increase the risk of further job losses. We remain committed to working with other stakeholders to develop long term, sustainable solutions to our current challenges.

## Introduction

### **1.1 Business Unity South Africa**

BUSA is a confederation of business organisations including chambers of commerce and industry, professional associations, corporate associations and unisectoral organisations. It represents South African business on macro-economic and high-level issues that affect it at the national and international levels. BUSA's function is to ensure that business plays a constructive role in the country's economic growth, development and transformation and to create an environment in which businesses of all sizes and in all sectors can thrive, expand and be competitive.

As the principal representative of business in South Africa, BUSA represents the views of its members in a number of national structures and bodies, both statutory and non-statutory. BUSA also represents businesses' interests in the National Economic Development and Labour Council (NEDLAC).

Internationally, BUSA is a member of the International Organisation of Employers (IOE), the Pan-African Employers' Confederation (PEC) and the Southern African Development Community (SADC) Employers' Group. BUSA is also the official representative of business at the International Labour Organisation (ILO), African Union (AU) Social Affairs Commission and World Trade Organisation (WTO).

### **1.2 Framework for the administration of electricity pricing**

#### **1.2.1 National structures for the development & administration of pricing rules**

The Energy White Paper of 1998 set out the process for establishing the National structures for the administration of Electricity prices. Subsequent to Electricity Control Board, the National Electricity Regulator (NER) was tasked to administer electricity prices from 1995. The functions of the NER were absorbed into the National Energy Regulator (NERSA) in November 2005, who has since then been empowered in terms of the Act 41 of 1987 to administer the industry. The first Multi-Year Prices Determination (MYPD1) was established in the NER prior to it becoming absorbed into NERSA.

The second MYPD process was finalized early in 2009. The rules established for MYPD2 are to be tested by the current Eskom application, and the implementation of the Electricity Pricing Policy as was Gazetted on 19 December 2008.

BUSA understands that the Eskom application is structured as per the terms of the above rules, but urges that these rules should not be applied to the letter, should the outcome be detrimental to the greater economy.

### 1.2.2 Energy security

Energy security is integral to economic development for South Africa. In this context, it is important to consider strategic issues which are important to ensuring security of supply and the sustainability of the electrical generation and distribution simultaneously with the consideration of the pricing matters. These issues include:

- a) The imminent release of the Integrated Resource Plan which is expected to provide details of South Africa's energy plan, covering the three year MYPD period and beyond will be received with great interest by BUSA. It is expected that the IRP will be released as a 'discussion document' and is not likely to be completed until the end of the first quarter of 2010.
- b) The signing of any PPA's which will indicate that the enabling environment for IPP's is now conducive to these arrangements for both renewable energy, co-generation and non-Eskom coal and gas based generation.
- c) The resolution of issues pertaining to DSM funding and the efficient management of the process is important to building in the efficient use of energy into the South African economy as are the smooth operation of other demand reducing incentives
- d) Development and expansion of the Demand Market Programme should be accelerated.
- e) A decision on the implementation of the Energy Conservation Scheme including; Power Conservation Programme (PCP), the Energy Trading Scheme and the Energy Growth Management Scheme.
- f) Augmentation of the funding for the National Solar Water Heater scheme

BUSA is concerned that limited progress has been made in addressing the above matters. Whilst we acknowledge that some work has been initiated, the pace with which implementation has been achieved has not been satisfactory in some of the areas.

We are concerned that these factors are crucial to ensuring a balanced debate on electricity tariffs, and outcome of levels of supply and demand, and it remains questionable whether the regulatory and legislative environment is optimal for the achievement of energy security objectives.

### 1.3 Background to this submission

**The National Energy Regulator (NERSA) published the details of Eskom's application in November 2009.** Eskom has applied to the National Energy Regulator of South Africa (NERSA) for a review of the electricity prices offered by Eskom. The application is for a three year control period starting from 1 April 2010 to 30 March 2013 (The Multi-year Price Determination - MYPD 2). BUSA notes that the application by Eskom was revised following consultation with the relevant stakeholders. The revision and subsequent reduction of the quantum from 45% to 35% respectively raises significant questions around Eskom's approach to tariff application.

The application of the Electricity Pricing Policy has occasioned the Eskom application to include for the first time issues around asset revaluation, and has given prominent rise to a debate as to the appropriate return on Regulatory Assets which it is to be allowed. As per the initial application Eskom sought to increase prices by 145% over three years. The revised application seeks a series of three price increases each of nominally 35% per annum, but reaching a similar end result.

BUSA welcomes an opportunity to make some comments on the Eskom application. BUSA acknowledges the contribution that energy, including electricity, makes to the economic development of South Africa. Similarly, it is our view that electricity prices can impact firm level performance, household incomes and macroeconomic indicators ultimately affecting the overall economic activity in South Africa. In this brief submission, we seek to raise our concerns around aspects of Eskom's application, in the context of the current economic environment.

BUSA herewith presents the picture of an electricity consuming Industry in crisis, and proposes lower increases in terms of a short term strategy and a longer term electricity price path during which the EPP can be implemented, and which is considered to be viable for all of the parties concerned.

## **1. Economic Impact**

### **2.1 World economic conditions**

Eskom's application to NERSA occurs in the midst of the global economic crisis. The crisis emanating from the US sub-prime housing market collapse in 2007, has spread rapidly through the global economy resulting in decline of global demand, consumer and business confidence, significant loss in global wealth led by falling asset prices and a general deterioration in the global economic prospects.

The global economy is in a severe recession inflicted by a massive financial crisis and acute loss of confidence. World output is projected to decline by 1.3 percent in 2009 as a whole and to recover only gradually in 2010, growing by 1.9 percent.

Positive signs of a global recovery have emerged. This is also confirmed by the International Monetary Fund's revision of its growth forecasts. In the first upgrade of its published forecasts in two years, the Fund now foresees a 2.5% rebound in global growth in 2010. This fact is also confirmed by J.P. Morgan Chase & Co. estimating that purchasing manager's indices globally had returned to pre-crisis levels.

However it is generally accepted by economists that the global economy recovery will be sluggish and is influenced by various policy and regulatory responses. According to the OECD, improved prospects for the U.S. and Japan have led to a better outlook for advanced economies, which are projected to expand at a 0.6% pace in 2010 instead of the previous estimate for zero growth. The group is still forecast to contract 3.8% this year, with activity not expected to pick up until the second half of 2010. Emerging economies overall are expected to remain in positive territory, growing at a 1.5% pace in 2009 and 4.7% next year. In April, the group was forecast to rise 1.6% in 2009 and 4% in 2010. A number of emerging economies remain vulnerable to external shock, with corporate borrowers facing limited access to financing of projects and for the rolling over of debt.

## **2.2 South African economic conditions**

The application is being reviewed in the middle of South Africa's first recession in 17 years. Whilst South Africa has officially exited its recession, with economic growth of 0.9% in Q3 2009, there are significant downside risks to macro economic performance as economic activity remains subdued.

South Africa's economic conditions have been influenced by negative employment dynamics, with more than 1 million people expected to have lost their jobs before the end of 2009. This impacts consumer indebtedness and disposable incomes significantly altering consumer demand which was the key driver of economic growth in the previous recent years.

Inflation has also dipped into the S.A. Reserve Bank target band, but despite this the economy remains weak and any shocks could result in a delayed recovery. Inflation is also likely to rise above the target for a few months next year driven by higher wage settlements, administered prices and the impact of Eskom tariffs on the economy. Whilst BUSA has not completed a full impact analysis on firm level impact, cases reported suggest that the proposed tariff application will seriously exacerbate challenges faced by business.

## **2.3 Economic Impact on Industry**

The proposed 35% tariff increase will have a negative impact on investment, output, and employment. Further, the tariff level will inevitably impact macro-economic indicators. Several analysis, suggest that increasing tariffs will result in increases between 0.5-1% in CPI. It is worth mentioning previous work done by the HSRC which suggested that a 51% increase in electricity tariffs (off 2008 levels) is equivalent to 10% rationing of electricity.

In broad terms, the proposed increase is likely to impact all sectors of the economy. The nature of the impact will largely depend on the nature of the operations; the energy intensity of the firm/industry concerned; the contribution of electricity to total costs for business, the structure of the market and ability of the firm to "pass-on" costs to the final consumer.

## **2.3 Vulnerable sectors of Industry**

### **2.3.1 Industries at risk**

The issue at stake is the health of Energy Intensive Industries and those who are on the brink of survival going forward, the employment in those industries (jobs), and the contribution of these industries to the national Economy.

### **2.3.2 SME**

For many energy intensive industries (and many smaller businesses some most of whom are labour intensive and find themselves in a marginal situation compounded by the economic crisis ) the challenges imposed by a series of 35% price increases will be catastrophic.

This view is not held by BUSA alone, and there is much concern for the job losses which will accompany the expected corporate survival strategy. Many of the casualties are

expected to be smaller businesses such as foundries, metal-plating, chemical manufacturers, and plastic convertors.

Estimates of the effect of the proposed 35% electrical price increase on typical auto component manufacturers illustrate the challenge as well as the possible impact:

If for comparison purposes, total costs of production including electricity are set at 100 in 2007, of which electricity is 5 for the moderate case (examples are producers of forged metal, glass, and plastic components) and 10 for the high electricity using case (typically companies with foundries producing and machining castings), with the selling price set at 110, allowing for a profit margin of 10. If Non-electricity costs and the selling price are assumed to increase at 6% per annum, with the firms having little or no ability to alter this as they do not have bargaining power in buying inputs, nor in the market for their output, since the competition is global and costs are driven down continually.

The impact of the increases of 35% per annum is to completely eliminate the profit margin by 2012 in the case of the moderate electricity users, and generate a gross loss of 14.7 in the high electricity using case. The nature of the auto industry, where South African firms have to bid against other production locations, would mean the loss of this business and closure of these plants under these circumstances. There is estimated to be around 10 000 directly employed in auto components with moderate or greater electricity usage.

### **2.3.2 Energy intensive users**

BUSA has among its members many successful businesses which are competing in global markets. The actual prices paid for electricity in the overseas businesses will be overtaken by South African electricity prices if the proposed increases are implemented. All effort should therefore be made to keep Eskom pricing on a globally competitive level

The consequences of not adopting the above approach is evident in an analysis of the impacts on gold mining, which is illustrative of the huge impact on the mining sector as a whole.

In 2008, electricity costs comprised on average 11% of the sampled gold mines' cash costs, whereas if the increases to 2014 are applied, electricity costs make up on average 28% of cash costs (as calculated in 2008 Rands).

As a result of the electricity price increases a number of mines are likely to become unprofitable to operate and thus may be forced to cut back on production or close entirely, with a concomitant decrease in employment at that specific mine. In total close to approximately 71,690 direct and indirect jobs may be at risk if the price increase proposed by Eskom is implemented in the sample of individual mines alone.

If the sample is representative of the whole mining industry, then extending these results to the entire gold mining industry would indicate that potentially around 160,000 jobs

(119,000 direct jobs and 40,000 indirect jobs) may be at risk due to the proposed tariff increase.

The mineral and forestry resources of the Republic of South Africa are among the richest in the world. The wealth of the country and the economic well-being of its citizens are in part attributable to the extractive industries which have been established based on these resources. The combination of a well developed electricity sector and a strong Coal Mining sector has given the country a competitive advantage over many other nations. A consequence of this has been the success of numerous energy intensive industries. To make electricity relatively expensive in South Africa is to remove this advantage is to jeopardize the industries.

It is acknowledged by BUSA that the prices paid for electricity must increase however BUSA counsels that the process should proceed with stealth in order for these industries to have time to adjust. To do otherwise is to court a collapse of many industries crucial to the South African economy.

## **2.4 Review of Electricity pricing drivers**

The required basis for the Eskom application is that it is built up on the key cost areas.

The drivers for the proposed price increases are stated as:

1. Increasing primary energy costs mainly due to rising coal costs, increased utilization of the more expensive power plants (e.g. OCGT plants), increased coal transportation as mines adjacent to power stations are worked out, and logistical costs.
2. Increasing operating expenses, the rate of increase of which is influenced by an expansion plan, and the cost of manning and provisioning the consequent increased electrical generating, transmission and distribution capabilities.
3. An expanded regulatory asset base which reflects the requirements of the Electricity Pricing Policy (EPP) as was gazetted, and which reflects the above mentioned increased capacity, and the basis for the valuation of these assets.
4. A scenario of apparently limited equity funding scenario availability and an apparent inadequacy of availability of loan funding from a constrained lending market, has been developed such as to force a raising of tariffs within a three year period.

Eskom is seeking to recover costs and fund a greater part of the capital programme from current tariffs, rather than to defer such costs such that they are appropriately carried by future energy users rather than have current users subsidize future users. BUSA insists that this funding model is both unnecessary and is not economically viable for South African Industry, and offers alternatives herewith in Section 3 below.

The detailed issues for which BUSA has prepared responses are raised below, in Section 5 of this submission. These are dealt with in the sequence that they are addressed by the NERSA Issues paper of 30 October 2009.

### **3. Funding Model**

#### **3.1 Funding principles**

The initial Eskom application raises the issue of how the major Eskom expansion, which was delayed by shareholder decisions, is now to be funded.

BUSA would like to call for a National Consensus between Government, Organised Industry and Labour, and Eskom as to how the Eskom business is to be funded into the future, such as to avoid front-end loading of the capital costs. The avenues for the development of such a consensus or protocol are available via the various Consultative forums, between the above parties.

BUSA acknowledges Eskom's contention that as in any business there are three main sources of funding namely: Equity provided by Shareholders, debt obtained through loans raised in the capital market and the tariff or average price from which the cost of generating, transmitting, and distributing the electricity, and providing a fair return to shareholders is covered.

Distinguishing the Eskom situation from other businesses is that Eskom is 100% owned by the state, the RSA Government and is an integral part of the rest of the economy in SA. If the pricing proposed by Eskom is too steep and precipitates the collapse of industries there will be industry and job losses, household income and expenditure is reduced, government revenue (VAT and IT) are reduced, and electricity sales ultimately also suffer. On the other hand Government still has to increase its social, crime-fighting and health expenditure

This reduced revenue will affect the financial health of Eskom and the corrective action inevitably comes back to the consumer and the state as an inflationary impact.

##### **3.1.1 Capital programme:**

Eskom is facing a significant capital investment programme, the budget of which is stated to be R385billion.

The programme has been delayed by government decision making, which has caused an escalation in the cost, which has in turn put great pressure on Eskom's short term liquidity, and which will exert pressure its long term financing facilities. The financing of the cost escalation is dealt with below in this section.

In the revised application Eskom has proposed to make greater use of alternative generating capacity which is to be available from IPP's and greater use of power available from Imports.

This is to fill the gap created by pushing out the commissioning dates of the first units of the Kusile power station. The progress of signing PPA's with IPP's is very slow, and the information available indicates that none have been signed to date. This is of concern to BUSA.

At recent workshops with NERSA the view was expressed by CIC Energy Corporation that the Madupi units might also be delayed. The slippage of project progress is always a possibility, should be of major concern to all power users.

BUSA therefore requests that NERSA interrogate the accuracy of Table 5 of the revised application.

### **3.1.2 Equity finance:**

No privately owned company would be able to embark on the proportional expansion on the scale of that being undertaken by Eskom without a rights issue or raising new capital.

The South African government, the single shareholder, has made available a R60 billion subordinated loan for the expansion of the business. This will be drawn down in three years; R10 billion in 2008/9, R30 billion in 2009/2010 and R20 billion in 2010/11.

Any private sector entity facing a similar proportional expansion would look to its shareholders for equity finance. If the shareholders are not able or willing to contribute they would have to accept inevitable equity dilution. This would not be contrary to the interests of all concerned, and represents an alternative route to solving the Eskom funding problem. This has been proposed by Eskom in the revised application, and BUSA counsels that this option should be pursued by Eskom, but that equity interests in well established generating units should rather be sold off.

BUSA views the difficulty in selling a share of Kusile to be such as to make such a deal unlikely.

Accordingly the R10b injections anticipated in 2014 and 2015 financial years of the revised application will be difficult to achieve.

BUSA is of a view that there should be an appropriate balancing of the various funding options, and a balancing of the interests of current energy users versus future energy users. BUSA has modeled the funding projections of the expansion programme and concludes that the R60bn capital injection is inadequate given the size of the current investment programme.

BUSA therefore urges that creative means of increasing the state contribution are sought and has other detailed proposals which are set out in Section 3.2.3 below.

### **3.1.3 Debt finance**

Eskom's has stated that it's ability to raise funds is limited by its +BBB credit rating. To counter this constraint Government has issued R176 billion government guarantees to facilitate access to debt and also to reduce the risk premium and the resultant average cost of debt in Eskom.

The Eskom application indicates a borrowing limit of R40b per annum, which follows the above limits. It is BUSA's view that this self-imposed constraint is unnecessarily

conservative, and this is supported by recent announcements of successful fund raising by Eskom and Government.

The financial forecasts set out in Section 3.1.5 below show that a Debt/Equity ratio in the range of 100-200 can be maintained with adequate interest cover, if additional borrowing facility can be secured. This may however require further Government guarantees in future years.

BUSA urges Eskom and the state to co-operate to raise further financing facilities to expand the debt which Eskom requires to effect the expansion programme.

#### **3.1.4 Tariff recoveries**

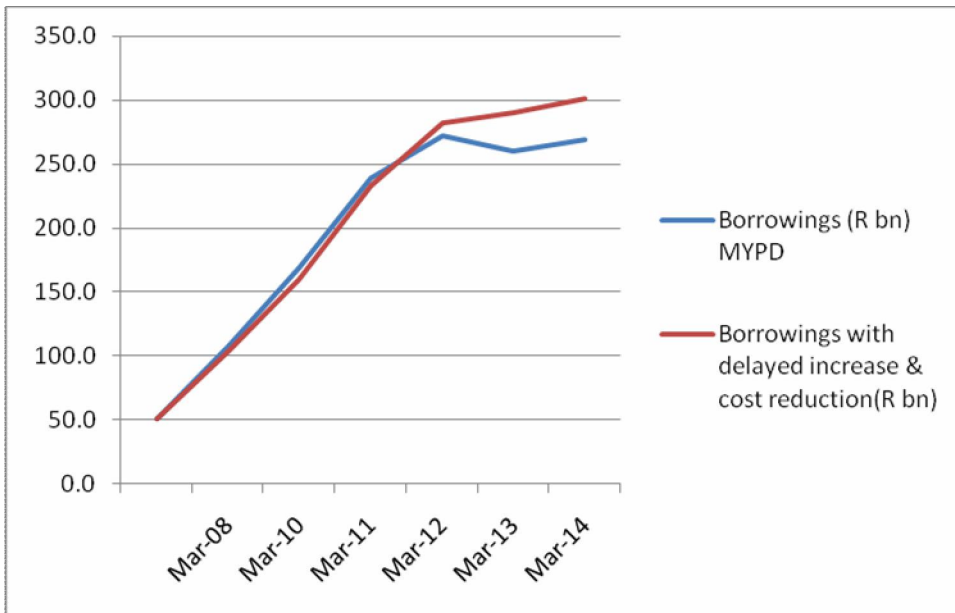
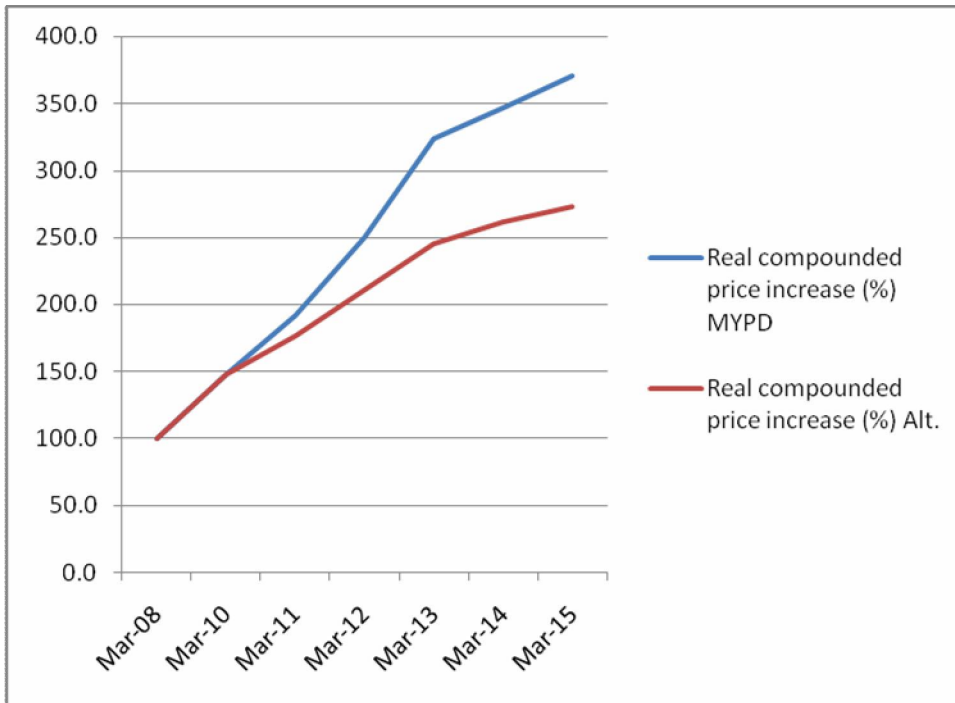
BUSA acknowledges that the long-term viability of Eskom is provided by the adequacy of the pricing setting mechanism. A predictable, certain and equitable pricing model, and the administration thereof, is fundamental to the financial health of Eskom, and essential to the long term growth of the national Economy.

The rider to this is that the extent of the increase which Eskom is seeking is liable likely to do so much damage to the economy that it is imperative that other routes to solving the problem are invoked. A long term view entails that Eskom, the Government, and industry work to ensure that structural damage is not done to energy intensive manufacturing and mining industries.

#### **3.1.5 Proposed funding mix**

BUSA has constructed a model of the Eskom projected Balance sheet and Income Statement with Cash flow statement. This model is used to explore proposed lesser price increases, and other cost reduction strategies which are shown to be viable.

These figures are presented in conjunction with the outline of an alternative price path for Eskom over the five years following the current year (2009/10), and the increased borrowing impact.



## Eskom pricing needs

### Pricing options

	Mar-10	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15
<b>Eskom revised proposals</b>						
Application - price increase (%)	31.3	35.0	35.0	35.0	13.0	13.0
Real compounded price increase (%)	148.2	191.7	250.0	323.3	345.9	370.1
MYPD						
Net profit after tax and interest (Rbn)	-1.5	5.0	25.1	56.5	62.9	77.1
Net profit before tax to Turnover %	-2.3	5.4	21.3	34.9	31.2	33.3
Net profit before tax to Total Assets	-0.7	1.7	7.0	12.9	11.5	12.2
Borrowings (R bn) MYPD	107.9	169.0	239.8	272.5	260.1	269.6
Interest covered by cash flow	1.3	1.2	2.0	2.8	3.0	3.7
Weighted Average Cost of Capital	-2.4	0.0	2.7	8.0	13.8	13.8
Debt /Equity ratio	112.6	139.9	164.3	134.6	91.2	74.4

### Reduced demand, delayed expansion, cost cutting and levy retention

Application - price increase (%)	31.3	25.0	25.0	22.5	12.5	10.0
Real compounded price increase (%)	148.2	176.8	210.3	245.0	261.0	272.7
Alt.						
Net profit after tax and interest (Rbn)	2.1	10.5	22.5	40.1	52.5	65.5
Net profit before tax to Turnover	4.9	11.6	18.9	26.1	29.0	31.5
Net profit before tax to Total Assets	1.6	3.6	5.8	8.4	9.6	10.3
Borrowings with delayed increase & cost reduction(R bn)	104.3	160.0	233.6	282.8	290.4	301.4
Interest covered by cash flow	2.0	1.7	1.8	2.2	2.6	3.2
Weighted Average Cost of Capital	-0.9	2.5	5.0	7.3	10.0	11.3
Interest bearing debt over equity - Delayed	102.9	121.3	151.3	145.4	113.0	90.6

### 3.2 Strategic issues for consideration

The revised Eskom application has some very important assumptions, including a lower Sales forecast and Prime Energy estimate.

#### 3.2.1 Revised Sales volumes

The revised application has a reduced demand forecast.

The Eskom sales volumes are still calculated from the sum of top 200 customer forecasts, but with adjustment for recent exclusions such as the Alcan/Rio Tinto smelter, and the savings resulting from a successful Solar Water Heating promotion. (To date this has been unsuccessful.)

This methodology can be criticized for failure to build in a consumer response to the large price increase, but which must be anticipated given the large proposed price increase.

If the bottom up approach of Eskom is abandoned in favour of an estimation based on GDP growth forecasts, with adjustment for expected price elasticity of demand, a lower sales forecast with a further reduction of 2.7% over five years results. This is a TWh38 reduction in energy deliveries, and a loss of revenue of R76b from the MYPD2 figures over five years.

However the practice of second guessing of the Eskom projection is to introduce a degree of risk which on a scale of the risk taken by cabinet early in this decade when they denied Eskom rights to build new capacity.

### **3.2.2 Purchase of Imports and the energy generated by IPP's**

The revised Prime Energy forecast is reduced corresponding to the lower demand forecast. It includes an increase in imports, and purchases from IPP's.

This energy availability enables the postponement of Kusile, with attendant cash flow delays.

BUSA welcomes Government's announcement that it intends to develop and implement a policy framework to deal with IPPs and looks forward to comprehensive stakeholder engagement on the framework in the first quarter of next year.

### **3.2.3 Pricing path**

A pricing path of progressive increases of 25%, 25%, 22.5%, 12.5% and 10% has the effect of nearly doubling prices over five years. The lower pricing trajectory is developed which gets the price to over R0.75 in five years, and the model shows that with cost savings the borrowings need not spiral out of control.

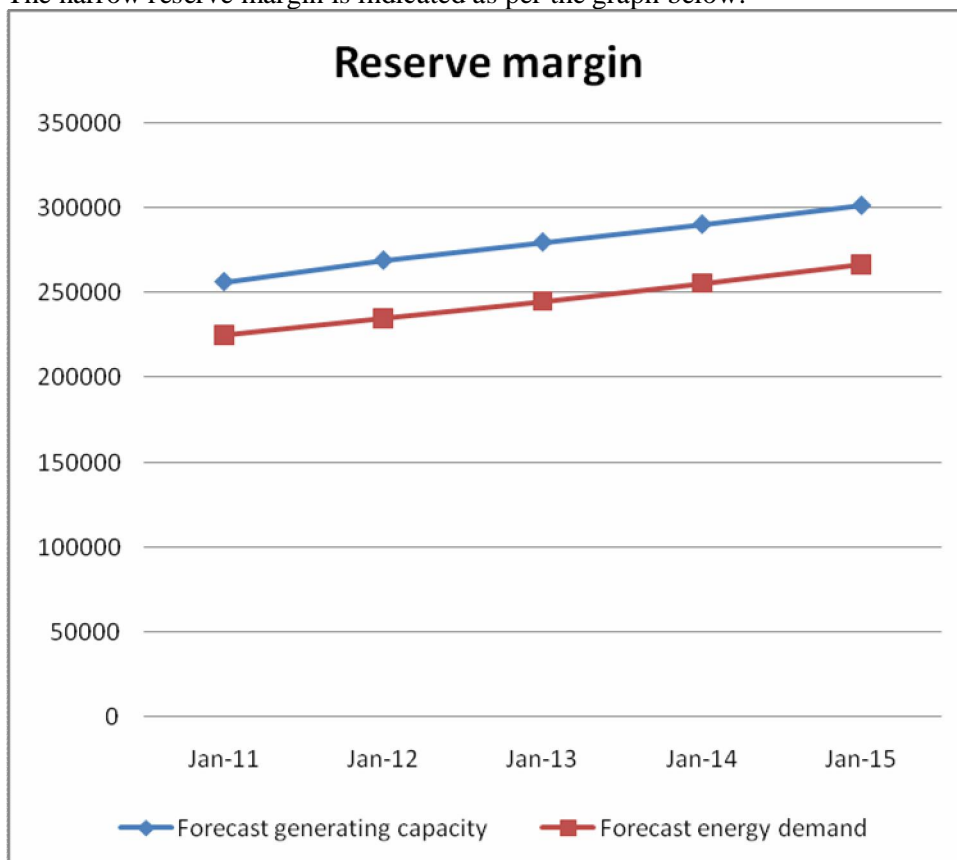
The themes which are developed which might give rise to this price path are:

1. For Eskom to delay capital costs by rescheduling project cash flows, but such that the minimum of delay is caused to the generating capacity. This will reduce borrowing requirements and consequent IDC (Interest during construction).
2. For Eskom to purchase as much power by way of Imports and to enable IPP's, and Cogeneration options.
3. For the state to agree to cover the costs of and boost the DSM programmes with the Environmental Levy, in order to curtail demand. The Levy to form part of revenues if applied to Environmental improvements.
4. For Eskom to introduce outside shareholder finance. This can be achieved by setting up subsidiaries to house suitable generating plants, and by selling a portion of the equity of these businesses against PPA's.
5. For Eskom to further reduce Opex costs by R15-25b over the next five years, e.g. Road maintenance reduction, and head count reduction.

### 3.2.4 Country risk, and security of supply

The approach adopted in the revised Eskom application has a much higher risk profile than the initial MYPD2 application, but it shows the way forward for South Africa to adopt an affordable electricity price path.

The narrow reserve margin is indicated as per the graph below:



It is recognised that should the economy recover more rapidly than expected, measures to reduce demand may be required. BUSA believes that aggressive pursuit of energy efficiency measures and demand market participation must be supported by Government, and this is particularly likely to be the case if the IPP's do not come into production on the scale forecast.

#### **4. Conclusions**

If ever there was a time for Government, NERSA and Eskom to act in concert with support of Labour and Business for the preservation of industries and jobs, the time is now.

An Industrial Development Policy for electricity is desperately needed to come to the rescue of those industries which are competing with Chinese and Indian imports, and provide a 'level playing field'. This is particularly necessary in so far as electricity costs are concerned for labour intensive industries and export oriented/import replacement industries.

Leadership is needed within Eskom to show the way forward to implement a NERSA injunction to force a curtailment of the cost plus/cost recovery mindset within the organization.

If Eskom Management and Staff are allowed to continue to rely on NERSA to 'rubber-stamp' a bureaucratic approach, which legitimizes large scale inefficiency by allowing the recovery of costs on at presentation, then Eskom is in danger of becoming a mill-stone around the neck all participating in the South African economy.

BUSA therefore appeals to NERSA to use its discretion to rule on a cost pass-through of only reasonable levels of expenditure, irrespective of the sophisticated formulae which may be presented in justification.

## 5. Specific responses

Further BUSA views are provided in the specific Stakeholder views requested by NERSA and provided below:

### 5.1 Funding

**Stakeholder Question 1:** What are your views of funding by the shareholder and debt as provided by Eskom in its application?

BUSA's view is that the Shareholder should provide further equity injections, to support its investment in Eskom through the current expansion, and increasingly into the future, as further generating and transmission capacity is required to be added.

Recent efforts by Eskom and the Government to raise funds in the International Financing markets have borne fruit, and the reported R20b facility from the African Development Bank may serve to give Eskom greater confidence of being able to fund the short term demands of the expansion, beyond the R40b per annum level.

It is BUSA's contention that with the explicit support of the state by way of a certain long term pricing path, with commitments to a sustainable tariff, that Eskom will be able to raise and sustainably afford an average debt raising in excess of the present self-imposed ceiling over the three year MYPD2 control period, and beyond.

With the pricing certainty in place and an economically sustainable tariff implemented it is expected possible that Eskom will become be a significant tax-payer, and will be restored to a status of a Public Investment with significant market value. This will imply either that regular injection of Share Capital, are well justified, or will be unnecessary, and that Eskom will be able to finance its further growth requirements without recourse to Government.

As BUSA contends that Eskom is close to a financial crisis as a result of bad past government decisions, and in making good, Government should commit to reinvesting in the business. This is in part in anticipation of taxes being received from Eskom (Income and VAT). Furthermore by allowing the retention of the Environmental Levy, which should be ploughed back into DSM and Solar Water Heater programmes, these funds, can then be applied to Environmental activities, as per the intention for the Levy.

**Stakeholder Question 2:** What are your views of funding through the tariffs as stated by Eskom?

BUSA projections show that a series of price increases such as to bring the average tariff to a level where the Long Run Marginal Cost is reached can be achieved within a five year period. At this average electricity price level Eskom will be able to raise its own capital and without regular Shareholder contribution.

**Stakeholder Question 3:** What would be the appropriate balance for the Eskom's funding options?

The BUSA projections show that within the period up to end March 2015 a steady and sustainable Debt/Equity ratio can be achieved which balances the contributions by the Shareholder, the dividend policy and the retention of profit (accumulated reserves), with the funding likely to be available from providers of loan capital.

The long term Debt/Equity ratio which is recommended by BUSA for Eskom is between 100% and 200%. At the higher end of the ration range some of the debt may need to be subordinated. This because the demands for shareholder finance are reduced and the finance costs associated with use of the assets will be borne by the energy users of that time.

Recent efforts by Eskom and the Government to raise funds in the International Financing markets have borne fruit, and the reported R20b facility from the African Development Bank may serve to give Eskom greater confidence of being able to fund the short term demands of the expansion, beyond the R40b per annum level.

## 5.2 Cost of capital

**Stakeholder Question 4:**

- 4.1 Does Eskom's proposal on the real pre-tax WACC (weighted average cost of capital) represent a fair and reasonable risk adjusted return?
- 4.2 Please provide comments regarding the components of the pre-tax WACC as proposed in the Eskom application.

The Weighted Average Cost of Capital for Eskom should be reflective of the fact that it is a state-owned monopoly, with a pricing mechanism designed to ensure its financial viability.

The rate of return allowed to Eskom will be applied to the RAB (Regulatory Asset Base) for calculation of the return to be allowed. The RAB will include a revaluation portion, which will build in the effects of inflation.

It is noted that the proposed 10.3% figure is a *real* rate of return and is lower than that which would be applicable if the revaluation of assets were not required in terms of the rules, and that if the application were to be based on a historic cost accounting a *nominal* rate with inflation included, would be appropriate.

BUSA concludes that the fair rate of return will be the real risk free rate, plus a small premium to account for the electricity pricing uncertainty, and adjusted for a gearing of 150%.

This is calculated by BUSA to be 8.0%

**Stakeholder Question 5:**

- 5.1 Please comment on the transitional rate of return to be implemented on a phased approach in line with the above calculation.
- 5.2 Comment on whether these should be considered as transitional or a representative risk adjustment rate of return?

BUSA is in agreement with the principle proposed by Eskom that its application represent a long-term (forward looking) benchmark, but which should be phased in over five years in order to soften and reduce the dislocation likely to be caused by a price shock of the magnitude contemplated.

The build-up of profitability which BUSA proposes is as follows below:

	2010/11	2011/12	2012/13	2013/14	2014/15
Real pre-tax return	2.5	3.7	5.8	8.6	10

It is proposed that in the year 2014/15 that a sustainable price is reached. This will require the necessary price increases to be implemented timeously and at a rate which is set out below.

**Stakeholder Question 6:** What are your views on the MRP and Equity benchmark figures built into the WACC?

The build-up of the components of the WACC as proposed by Eskom is to overstate the required return:

The Market Risk Premium (MRP) of 6.0% is appropriate for a quoted company, without the backing of the sovereign shareholder, and a figure of 4. % is considered suitable. The Equity beta of 1.1 is considered fair.

**Stakeholder Question 7:** Is the return on equity suggested by Eskom representing a fair real return for a regulated utility

The Eskom business is government owned and a state monopoly, and BUSA is of the view that the Rating Agencies should value Eskom along with or very close to other sovereign risks.

However when considering the track record of electricity regulation in South Africa, it must be said that the requisite degree of certainty has not been demonstrated, and that despite improved transparency of the MYPD processes, the level of political influence and lobbying has not assisted the long term investment view.

As such a premium rate of return over risk free investments must be expected and a return of

**5.3 Regulatory Asset Base**

Stakeholder Question 8:

- 8.1 What is the best way of implementing the replacement cost valuation method?
- 8.2 Should the revaluation reserve be allowed to Eskom as a return of capital (armotisation added to allowable revenue) and a return on capital (the revaluation reserve added to RAB on which a reserve is earned)?
- 8.3 Should the revaluation of assets be phased in over time, (e.g. over five years as per EPP or as proposed by Eskom), to limit the impact on prices?

BUSA notes that the Eskom MYPD2 application assumes the Regulatory Asset Base will be revalued at depreciated replacement cost. The Electricity Pricing Policy requires that the Energy Regulator, after consultation with stakeholders, must adopt an asset valuation methodology that accurately reflects the replacement value of those assets.

BUSA is of a view that the replacement cost valuation should be fully audited and disclosed in the Annual Financial Statements in accordance with International Accounting Practice. The revaluation reserve should therefore be disclosed as a Non-distributable Reserve and the assets should form part of the RAB at the assessed value.

The depreciation of the asset should be an allowable expense, with pass through, on phased basis. The phase in is suggested to be 20% in the first year, with a further 20% progressively added each year, until such time as it is fully implemented.

The amortization of the Non-distributable reserve should be to Distributable Reserves as the excess depreciation is claimed, without pass through and recovery.

BUSA is of the view that the revaluation should be performed in full at the outset, and should not be phased in over time as this would be very confusing to the readers of the Annual Financial Reports.

Stakeholder Question 9:

Should the revaluation of assets be conducted on the basis of the Modern Equivalent Assets (MEA) as prepared by Eskom or should other alternative replacement methodologies be considered?

Other replacement methodologies include Depreciated Replacement Cost (DRC) of “like for like”, Indexed Historical Cost, Reproduction Cost, and Modern Equivalent Asset Valuation MEAV adjusted for condition of asset and depreciation, please comment on the most appropriate valuation methodology to use.

BUSA is satisfied that the Historic Indexed Cost method is likely to arrive at a similar value as the MEA method if the correct and appropriate Index is used.

The MEA method will be appropriate for Eskom as it is the most accurate and the least subjective of the methods proposed, but it will be more difficult for NERSA to regulate.

**Stakeholder Question 10:** How should the principle of stable and predictable price be achieved given the requirements of the EPP to revalue assets?

BUSA is of the view that Replacement cost accounting will provide price stability of the longer term, as compared to Historic cost accounting. The latter requires indexation of the assets to achieve a fair rate of return, and this practice will become unnecessary with a revaluation.

The replacement cost accounting provides for sharply increased depreciation in the early stages of introduction of new plant and the opposite towards the end of plant life. Thus if regular appraisals of plant value are performed the depreciation provision will be fairly evenly increasing over time, in an inflationary environment.

#### **5.4 Operating Expenditure**

**Stakeholder Question 11:** What are your views on these costs as presented in Eskom's application?

BUSA notes for the record the increased disclosure and improved standard of information provided in support of the operating costs of Eskom in the application. However it is BUSA's view that the level of expenditure growth in the Existing Business is high, and the BUSA financial model shows that if expenditure growth (outside of maintenance) could be reduced by 1% per annum from present targets without affecting security of supply, this could generate savings of R5.6b in the period up to the end of March 2015.

The challenge to the Regulator is to maintain an oversight of Eskom's activities which ensures that public monies are well spent. To this end a detailed interrogation of the budgeted and actual expenditure is required.

**Stakeholder Question 12:** Stakeholders are requested to comment on the above inflation OPEX increases.

As the Existing Business operating expenditure growth is at the rate of 21.5% compounded annually over the five years to the end of 2014/15, this indicates that significant cost savings might be achieved with a cost cutting programme.

If a 3.0% per annum reduction were targeted this would yield R16.5b over the period.

**Stakeholder Question 13:** Stakeholders are requested to comment on the justification of higher maintenance costs in the light of capacity constraints, ageing plant and ensuring security of supply.

BUSA are supportive of Eskom's efforts to ensure that adequate maintenance attention is given to ageing plant. BUSA is therefore not surprised that Eskom's projections are that maintenance costs will increase above the average Producer Price Index throughout the control period.

**Stakeholder Question 14:** Are Eskom's human capital costs that are driven by the expansion program reasonable and justifiable?

BUSA believes there is potential for a 3.0% cost saving in respect of the personnel budget and for significant productivity improvements within Eskom. There needs to be a greater emphasis on performance management at an entity, business unit and individual manager/employee level

## **5.5 Primary Energy & Production Plans**

### **5.5.1 Sales Forecast**

**Stakeholder Question 15:** Stakeholders are requested to comment on the Eskom sales forecast and the balance of production and sales in the MYPD2 control period.

BUSA appreciates the difficulty in estimating the Eskom electrical demand in the circumstances of decreased (but recovering?) global economic activity and in the light of impending increases in energy costs.

The BUSA consensus forecast is that an average growth in excess of 3.5% cannot be anticipated during the five years to 2014/15.

The studies carried out by Eskom on the elasticity of demand to changes in Gross Domestic Product, and the response of customers to significantly higher prices are of great interest, but BUSA is in agreement with Eskom in that the trends observed are probably applicable in the longer term, and are less useful for short term forecasting. A figure of -0.2% to -0.3% is estimated for the demand elasticity to the price, and a figure of 1.0 for the elasticity to the income changes.

It must be anticipated that the increased electricity cost will make energy efficiency investments less viable, and that the cost increases contemplated will serve to reduce wastage.

BUSA therefore anticipates that there will be a drop off of sales and an increase in self-generation over the control period, and that among member companies the aggregate effect might be as much as a 10% decrease in demand corresponding to the revised 35% price increase.

### 5.5.2 *Production Mix Forecast*

**Stakeholder Question 16:** Stakeholders are requested to comment on the mix of generation that is used to meet the load requirements.

In the revised application the proportion of energy generated from coal sources drops from 93% on average to below 90%. This is largely attributed to the increase in Imports and power purchased from IPP's.

BUSA supports the introduction of further longer term nuclear, wind, hydro (including other African countries) and supports the development of shorter term co-generation facilities. These generating capabilities will contribute to the security of supply, and the diversification away from a total fossil-fuel prime energy base.

As stated above BUSA welcomes Government's in respect of the complete enabling environment which will provide the necessary certainty to investors in respect of Power Purchasing Agreements.

### 5.5.3 *Coal purchasing*

**Stakeholder Question 17:** Stakeholders are requested to present views on the following aspects of coal fired power station costs and colliery production:

- 17.1 The continued coal price escalation above inflation on an already high base that already provides for coal being transported by road;
- 17.2 The increase in the volume of coal transported by road until rail transport becomes available;
- 17.3 Transporting coal to power station with tied collieries when the contracted production of the tied colliery is unable to meet the burn requirements of the power station.
- 17.4 Expediting the rail and conveyor transport of supplementary coal to power stations.

BUSA understands the challenges and supports the efforts of Eskom to meet the coal requirements of its power stations. However is it not right that the consumer pays for bad planning on the part of Eskom.

A part of the BUSA membership will be providing significant investments to cater for efficient coal delivery, and meeting the longer term objectives of reducing the volumes of road deliveries.

#### **5.5.4 Coal stocks**

**Stakeholder Question 18:** Stakeholders are requested to present views on Eskom's coal stockpiling strategy:

- 18.1 The minimum coal stock that should be carried at each power station;
- 18.2 The target coal stock days of 42 days;
- 18.3 Mine contingencies being covered by mine stock to assure contractual deliveries; and
- 18.4 Minimising coal stock building from other than local tied collieries.

BUSA notes the extra attention and resources being given to coal purchasing and stock management. This corrective action is supported by BUSA. It is however surprising that it is going on for such a long time

#### **5.5.5 Roads maintenance**

**Stakeholder Question 19:** Stakeholders are requested to present views on the coal transport infrastructure and on Eskom's funding of public road maintenance and repair.

BUSA is of the view that maintaining the road infrastructure is the responsibility of the Provincial Government, and that Eskom should not be obliged to repair or maintain roads unless the damage has been occasioned by illegal overloading of vehicles using these roads, in which case it should be borne by the transport contractors.

It is Eskom's stated plan to migrate much of the road delivery of coal to conveyors over shorter distances and rail over medium and longer distances, and BUSA supports this plan.

#### **5.5.6 Cost of water supply**

**Stakeholder Question 20:** Stakeholders are requested to present views on the water cost projection and expected further increases during the MYPD2 period.

BUSA is of the view that water supplies to electrical generators should be a priority, and that fair cost of supply is to be negotiated by Eskom.

#### **5.5.7 Cost of OCGT fuel**

**Stakeholder Question 21:** Stakeholders are requested to present views on the price of OCGT fuel and the expected price escalation over the MYPD2 period.

Stakeholder Question 21: Stakeholders are requested to present views on the price of OCGT fuel and the expected price escalation over the MYPD2 period.

BUSA would expect the cost of gas-oil for the Open cycle gas turbines will fluctuate in response to the crude oil market pricing. However we are concerned that adequate steps are not being taken to minimise their use.

#### **5.5.8 Production by independent power producers**

Stakeholder Question 22: Stakeholders are requested to present views on the average price of IPP generation and whether the projected IPP volumes are realistic.

BUSA is supportive of Independent Power Producers and the average price offered for energy supplied of 79 c/kWh in 2011/12 represents a very reasonable cost for such producers to require Eskom to pay for energy delivered. The total impact on the tariff is estimated to be between R0.01 and be less than R0.036/kWh.

The price increase to 144 c/kWh in 2012/13 as an allowance for generation from the DOE initiated OCGT looks particularly attractive, in relation to the cost of gas fueled generation in the Eskom production plan. The viability of this venture has to be questioned, and particularly in view of the earlier failed initiative.

#### **5.5.9 Power Imports**

Stakeholder Question 23: Stakeholders are requested to present views on cost and volumes of power imports in the MYPD2 period.

It is noted that the revised Eskom application makes provision for a greater volume of imported electricity versus the initial application.

BUSA endorses the policy of all purchasing all available power from neighboring countries. The cost is set at R0.19 c/kWh. It appears to be a good commercial decision to purchase all available volumes, as is set out in the revised Eskom plan.

#### **5.5.10 Energy Efficiency and Demand Side Management**

Stakeholder Question 24:

- 24.1 Stakeholders are requested to comment on the recovery of full EEDSM costs;
- 24.2 Should only a portion of the EEDSM costs be allowed to be recovered through the tariff with the rest of the costs being allocated from government funds or any other means of funding EEDSM?

Demand Side Management should be responsibility of government not Eskom and this objective can be achieved by a diversion of the Environmental Levy to a fund within the DOE or a non-conflicted agency which can be used to fund DSM and Solar Water Heater installation.

BUSA's observation is that the administration of the Eskom DSM programme has been found to be bound by excessive bureaucracy, which has limited its performance in reducing demand.

BUSA supports the concept of a Non-conflicted (Independent) Agency being established to administer the Demand Side Management programme. This will be to avoid the inherent conflict of interest that Eskom has with deliberately reducing demand or sales.

Furthermore BUSA is of the view that the level of support for DSM projects should be funded from the DOE budget, as part of the Government's bid to constrain electrical energy demand in the South African economy, and in line with commitments towards a lower energy intensive/emission nation This can be achieved by diverting the Environmental Levy to fund the reduction of energy usage in the DSM programme.

### ***5.5.11 Project prioritization***

**Stakeholder Question 25:** Stakeholders are requested to comment on the following;

- 25.1 Comments on table 11 (Page 46 of Eskom's application – "Demand Side Management savings and costs")<sup>1</sup> of the application which outlines the savings realised in relation to the cost incurred (i.e. increasing in R/MW saved over the next three years);
- 25.2 How the funds should be allocated between Energy Efficiency (e.g. Compact fluorescent lamps) and Demand Side Management (load management, Demand Market Participation); and
- 25.3 Should the tariff signals be enough to incentivise customers to manage their electricity demand (e.g. load management)?

Eskom has made an application to deliver Demand Side Management savings ranging from 432 MW to 1046 MW in the next three years. The average cost of the EEDSM projects provided in the application is very low albeit increasing from R1.85m/ MW in 2009/10 to R5.05m/ MW in 2010/11, which is regarded as too expensive.

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<sup>1</sup> Proposed Revenue Application Multi Year Price Determination 2010/11 to 2012/13 (MYPD 2)

If the cost of achieving savings will be significantly less than the cost of generating the same energy, and then such measures would be supported by BUSA, as long as funding is not included in the tariff.

Stakeholder Question 26: Stakeholders are invited to comment on the following:

- 26.1 The cost structure of the PCP programme as proposed by Eskom
- 26.2 Should the cost of PCP be recovered through Eskom's tariff or other funding?
- 26.3 Should the PCP trading function be housed within Eskom or elsewhere?

BUSA is not able to support the PCP, at the present time as it considers the scheme to be an undesirable and unnecessary bureaucratic intervention, which will add significant cost to Eskom, and it is also contrary to one of the main business objectives of Eskom, namely its mandate to deliver electrical power in South Africa at a world-wide low cost.

BUSA believes that it is not appropriate to recover costs relating to PCP through the tariff. The costs of the programme should be borne through the fiscus. BUSA maintains that the PCP programme as currently envisaged could lead to unintended negative outcomes and need to be revisited especially considering the current pressures facing industry. Additionally, it is our assessment that there are a myriad of other initiatives which seek to reduce demand and funding for such initiatives cannot be expected to be recovered through tariffs.

#### **5.5.12 Research and Development Costs**

Stakeholder Question 27:

- 27.1 What criteria should be used to allow or disallow research projects?
- 27.2 Which research projects should be allowed?

BUSA considers that Research and Development is a normal business operating cost for Eskom, but should be appropriately prioritised.

Stakeholder Question 28: What would be a reasonable cap on the expenditure for research and development which Eskom undertakes?

BUSA does not consider that there should be any prescriptive limits on the Eskom Executive Management prerogative in this regard. However the returns which the business is generating should be considered.

### 5.5.13 Economic Impact

**Stakeholder Question 29:** What are your views on the statements regarding job losses and impacts on the economy?

BUSA is concerned that many jobs will be lost as South African industries become less competitive, as a consequence of the steep rate of cost increase for electricity. We do not believe the impact on the economy has been adequately evaluated. Eskom is also correct in pointing out that if the proposed tariff increase is not granted, this will have severe implications for electrical supply continuity. In the long run this will have an adverse effect on GDP growth.

**Stakeholder Question 30:** What are your views on the impact of the proposed increases on the different sectors of the economy?

As has been pointed out in the Introduction to this submission the impact of a series of 35% increases in certain energy intensive sectors will be catastrophic.

**Stakeholder Question 31:** What are your views on the inflationary consequences of the proposed tariff increases?

BUSA is not alone in pointing out that the inflationary impact of a series of 35% increases will add between 0.5 and possibly 1.0% to inflation. Administrated price inflation is already excessive in South Africa.

**Stakeholder Question 32:** What are your views on economic assumptions made by Eskom particularly, GDP growth?

BUSA estimates that the economy will grow at a slightly slower rate than that used by Eskom in its projections, but acknowledges the need for conservatism in this regard. BUSA forecasts range from 2.0% in 2010 to an average of 3.0% for the remainder of the five year period thereafter.

**Stakeholder Question 33:** What are your views of the impact of electricity prices on inflation and GDP?

BUSA estimates the negative impact on economic growth will be to reduce growth by 0.5 % per annum over the next five years. Inflation will be impacted by between 0.5 and 1.0% in each of the three years of the MYPD2 implementation, if applied at the 35% level.

### 5.5.13 Eskom Tariff Structures, Protection of the Poor and Free Basic Electricity

**Stakeholder Question 34:** Stakeholders are requested to comment on whether the existing cross subsidies should be retained, reduced or increased.

Eskom is in the business of generating and distributing electrical energy, and these are activities which cannot be compromised by burdening the company with social responsibilities.

Any activities or matters which may divert the company from this fundamental objective need to be removed from its responsibility, and it is unacceptable that Government responsibilities are moved to Eskom for implementation.

Tariffs should be cost reflective, as regulation requires, and cross subsidies should be phased out before the problem exacerbates. This may require Government intervention.

Stakeholder Question 35:

35.1 Stakeholders are requested to express their views on the need to provide cross-subsidies to the poor, cushioning high price increases;

35.2 Which group(s) of electricity customers should provide such cross-subsidies?

Regarding tariff structures and cross subsidies BUSA considers that the protection of the poor from the impact of increasing prices is not an Eskom function.

The funding of these subsidies should be via transparent transfers from the appropriate Government Department.

It would be totally inappropriate for Business customers to carry this cost as has been suggested by some.

Stakeholder Question 36: Stakeholders are requested to express an opinion on which customer groups should be considered as poor and requiring protection.

Only those below poverty datum line should be supported

See above

Stakeholder Question 37: Stakeholders are requested to comment on the proposal for an FBE levy to be collected by government from all electricity customers (Eskom and municipal).

See above

Stakeholder Question 38:

38.1 Stakeholders are requested to comment on the practicality of a single national inclining block rate tariff to be applied to all domestic/residential customers;

38.2 Stakeholders are also requested to provide views on the design principle and structure of an inclining block rate tariff.

See above.

Stakeholder Question 39: Stakeholders are requested to comment on the preferred or alternative method/ mechanism that should be used to provide protection to the poor against high electricity prices.

See above

#### **5.5.14. Any Other Comments**

**Stakeholder Question 40:** Stakeholders are requested to comment of the above statement. Has demand suppression impact been taken into account?

Eskom has stated that it has consulted key customers on their anticipated demand, and in the revised application state that adjustment is now made for DSM, the Alcan/Rio Tinto withdrawal and solar water heating.

In the longer term it is inevitable that at higher relative prices users will migrate to a lower consumption pattern, however it is submitted by BUSA that at this time economic conditions are so bad in some sectors that other savings will take priority.

**Stakeholder Question 41:** Comment on Eskom's statement of South African electricity prices compared to international electricity prices.

BUSA has evidence that electricity pricing by Eskom is uncompetitive for Industrial users versus costs of electrical supply in countries such as Taiwan, mainland China, Russia, and Pacific rim countries.

**Stakeholder Question 40:** Stakeholders are requested to make any other comments on the overall application.

For overall comments see preface to the submission

**For a forecast of the impacts of the above proposals see Annexure A below**

## Annexure A – Financial Forecasts

### Model for assessing effects of price increases on Eskom

#### Delayed expansion with cost savings & retain levy for DSM etc

Year to end:	Mar-10	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15
	R	R	R	R	R	R
	billions	billions	billions	billions	billions	billions

#### Abridged Balance Sheet

Equity	52.1	59.0	75.7	107.3	142.8	184.7
Deferred taxation	9.3	12.9	18.7	27.2	44.2	67.8
Subordinated shareholder debt	40.0	60.0	60.0	60.0	70.0	80.0
Interest bearing debt	104.3	160.0	233.6	282.8	290.4	301.4
Total financing	205.7	291.9	388.0	477.3	547.4	633.9

Property plant & equipment	224.6	313.0	412.1	504.8	576.8	665.6
Fixed assets	249.2	294.8	341.5	413.3	488.2	602.3
Works under construction	39.8	90.5	152.1	184.3	195.7	188.3
Accumulated depreciation	64.4	72.3	81.5	92.8	107.1	125.0
Working Capital	-18.9	-21.1	-24.1	-27.5	-29.4	-31.7
Inventory	4.1	5.1	6.0	7.0	7.8	8.7
Provision for environ levy repayment	0.0	0.0	0.0	0.0	0.0	0.0
Other working capital & securities	-23.0	-26.2	-30.1	-34.4	-37.2	-40.4
Net assets financed	205.7	291.9	388.0	477.3	547.4	633.9

### Abridged Income Statement

Year to end:	Mar-10	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15
Revenue	66.1	90.1	119.1	153.5	180.9	208.3
Operating expenses before interest	61.0	75.4	90.6	105.7	119.1	133.0
Depreciation - historic cost	6.2	7.9	9.2	11.3	14.3	17.9
Adjustments	1.0	-2.0	-3.0	-3.0	-3.0	-3.0
Levy retention (part of revenue)	-3.6	-5.3	-5.5	-5.7	-6.0	-6.2
New business Opex	4.9	5.3	5.8	6.4	7.6	9.9
Existing business Opex	25.4	30.5	33.5	36.8	39.8	41.7
Primary energy costs	27.1	39.1	50.5	59.9	66.5	72.8
Operating Profit	5.1	14.7	28.5	47.8	61.8	75.3
Net Interest expense	1.9	4.2	6.0	7.7	9.3	9.8
Net profit after interest	3.2	10.5	22.5	40.1	52.5	65.5
Taxation	1.1	0.0	0.0	0.0	0.0	0.0
Net profit after interest and tax	2.1	10.5	22.5	40.1	52.5	65.5
Asset revaluation/discontinued ops						
Deferred tax	1.0	-3.6	-5.8	-8.5	-17.0	-23.6
Equity increase/(decrease)	3.1	6.9	16.7	31.6	35.5	41.9

### Cash flow summary

Year to end:	Mar-10	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15
Cash in-flow						
Equity change	3.1	6.9	16.7	31.6	35.5	41.9
Levy retention if repayable	0.0	0.0	0.0	0.0	0.0	0.0
Revaluation & unwinding of provisions	4.0	3.3	4.0	4.5	3.0	3.4
Depreciation	6.2	7.9	9.2	11.3	14.3	17.9
Deferred tax & other	-1.0	3.6	5.8	8.5	17.0	23.6
Cash from operations	12.3	21.7	35.7	55.9	69.8	86.8
Shareholder loan capital	30.0	20.0	0.0	0.0	10.0	10.0
Cash generated	42.3	41.7	35.7	55.9	79.8	96.8

Cash outflow						
Capital expenditure - nominal terms inc IDC	69.6	96.3	108.3	104.0	86.3	106.7
Other items & inc. coal stocks & work. cap.	6.1	1.1	1.0	1.1	1.1	1.1
Increased borrowings	-33.4	-55.7	-73.6	-49.1	-7.6	-11.0