BUSA
BUSINESS UNITY SOUTH AFRICA

**National Office**
Unit FFN09, Block 9 Bentley Office Park
67 Wessels Street, Rivonia, Johannesburg
P.O. Box 652807, Benmore, 2010
Tel : +27 11 784 8000| Fax : +27 (0)86 609 8248
Email : busa@busa.org.za | Website : www.busa.org.za
Registration Number : 2014/042417/08

**Parliamentary Office**
9 Church Square, 1st Floor Graaffs Trust Building
Cape town CBD
P.O.Box 3867, Cape Town, 8000

# NERSA CONSULTATION PAPER

# THE ESKOM APPLICATION FOR A TWO-YEAR INCENTIVE PRICING PACKAGE FOR THE SILICON SMELTER SILICON PRODUCTION IN POLOKWANE AND eMALAHLENI

## SUBMISSION BY BUSINESS UNITY SOUTH AFRICA (BUSA)

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## Background

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).

## Introduction

BUSA welcomes the opportunity to submit comments on the above application. In doing so BUSA believes that such an application needs to be considered in the context of the current state of the economy and Eskom's financial status.

The following contextual issues are therefore considered in this submission prior to an analysis of the Consultation Paper.

- Current economic and supply/demand situation
- Eskom's financial situation
- Competitiveness of current electricity tariffs

Current economic and supply / demand situation

It is common cause that the South African economy is currently in a technical recession and that the economic growth rate that is required to address the triple challenges of unemployment, poverty and inequality is not going to be achieved in the near future. The electricity capacity constraints that contributed to low economic growth in previous years have now been reversed and Eskom has a surplus of supply. Unfortunately, low international demand for the commodity goods produced by energy intensive electricity users combined with high Eskom prices have resulted in a lower demand for electricity than forecast. At the same time, units of Kusile and Medupi are coming online, thus increasing the oversupply. The significant decline in competitiveness of these industries as a result of increased operating costs of which the ever-increasing electricity price is a constant and significant contributor has had a further negative impact on production in many of these sectors to the extent that, almost without exception, plants are not operating at full capacity. This in turn increases pressure on employment.

A review of the tariff increase applications in recent years reveals that non realisation of the forecast revenue on which the original tariff was based results in revenue shortfalls that then have to be addressed by the Regulatory Clearing Account process. The lower than estimated revenues are largely due to declining demand, which in turn means that the tariff increase required to address the revenue shortfall has to be spread over a lower consumption base, which in turn results in a further decline in demand. BUSA believes that failure to address this so-called death spiral where declining demand continues to trigger price increases, which are spread over a decreasing customer base, are increasingly unaffordable - thus leading to lower GDP growth and an increase in unemployment. The risk that the current situation will ultimately lead to irreversible financial unsustainability of Eskom needs to be recognised. In the fourteen point Inclusive Growth Action Plan recently released by the Minister of Finance, reference is made to Eskom hardship and developing a case for "soft support" for Eskom in the short term. Although BUSA welcomes the inclusion of the Eskom financial situation in the 14 point plan as a signal of Government's recognition of the unstable financial status of Eskom, there is an urgent need to initiate an investigation into the long term financial sustainability of the entity. NERSA has a key role to play in any such investigation.

The impact of the increasing unaffordability of the electricity price increases on employment has been catastrophic and unemployment currently stands at 27.7%. Although it is recognised that the cost of electricity is not the sole cause of the declining competitiveness of these industries, it certainly plays a major part in the current situation, particularly in those industries where electricity accounts for more than 30% of operating costs. The current situation is exacerbated by the fact that based on current supply/demand trends, Eskom will experience surplus capacity that will peak at 14 000 MW in the next few years. Eskom faces having to cover its fixed costs for this supply regardless of sales and, unless demand can be increased, electricity prices will have to rise significantly to cover costs on a declining sales base. This situation will increase the already untenable burden on consumers, including business, due to the above inflation increases that Eskom will continue to request to address the revenue shortfall, which is going to increase unless something is done about it.

At the same time productive capacity, which would otherwise be purchasing electricity, is lying idle and job losses continue to increase the already unacceptable level of unemployment. BUSA believes that there should be a way to use these parallel situations in a trade-off situation that would assist Eskom on the one hand and struggling companies to continue operations and retain jobs on the other. In principle, BUSA supports an approach which would contribute to addressing Eskom's financial sustainability, thus reducing its dependence on the fiscus (with the risks this holds for the sovereign debt rating) and at the same time support firms, which would otherwise close, to remain operational. In other words, if anything can be done in the short term to alleviate the financial instability of Eskom and address the need to recover revenue to cover marginal costs (as this application would) it should be favourably considered. However, it should at the same time recognise that more detailed analysis and identification of solutions remains an urgent objective.

The motivation for the application by Eskom in respect of two ferrosilicon smelters for a specific preferential price is understood. However, BUSA believes that it is imperative that any relief afforded to one company must be available to all companies in the same situation.

There is no doubt that the situation in which Ferroglobe finds itself is not unique and that many more applications are likely to be submitted. This requires a simple approach to the challenge presented by the specific class of customer which includes Ferroglobe.

Eskom's financial situation

A review of Eskom's financial performance commissioned by Business presented a range of findings that could be used in any future investigation. These findings are based on the principle that the right price for Eskom's electricity is a price consistent with an appropriate return on capital employed to expand existing capacity. In the researchers' view, the required rate of return for this purpose and consistent with the business risk incurred by a monopoly electricity generator is of the order of 2% p.a. more than the risk-free rate. Note for this purpose a 10-year RSA government bond was used as the risk-free rate. This equates to a real after-tax yield of between 3% and 4% per annum for Eskom, which is a return entirely consistent with returns realised by global utility companies. In BUSA's view it is imperative that an investigation into the sustainability of Eskom's balance sheet be launched before any longer-term tariff adjustments are considered.

In this research, historical returns were measured by calculating the cash flow return on investment (CFROI) for Eskom from the annual financial statements over time. Cash Flow Return on Investment (CFROI) corrects for accounting distortions leading to a more accurate measure of economic performance.

Since 2000 Eskom's CFROI has consistently been below the 25th percentile of global Electric Utility companies. After 2005 the picture got much worse. Inclusion of non-productive Construction-in- Progress (CIP) in the asset base depresses the return on capital. Exclusion of this element from the asset base results in an improvement of CFROI from -0.8% to 1.1%. The CFROI for Eskom has been negative for the last 4 years and for 6 out of the last 8 years. Should this profile continue it is likely to severely undermine Eskom's future financial viability.

Business believes that it is essential in the national interest to undertake a detailed study of the factors that impact on the ongoing financial performance of Eskom.

As far as BUSA is aware, Eskom may not currently earn enough to cover its debt obligations (EBITDA interest cover of 1.05 times on debt of R359bn). The ability to acquire new generation capacity is therefore at risk. Since 2008/9 electricity prices have risen 350%. These steep increases have made a significant contribution to the current decline in demand and continuing on this price trajectory will exacerbate the current declining demand trend.

It needs to be recognised that increased prices designed to increase revenue that has been determined on the basis of demand forecasts, which are not achieved, are resulting in an increasing vulnerability to the price spiral effects associated with grid defections. This is the situation in which Eskom now finds itself and which requires consideration of a different tariff dispensation for its largest customers.

In addition, the linkage between Eskom debt and the sovereign debt via guarantees presents a significant fiscal risk for the sovereign should the utility's debt migrate onto the government's balance sheet. The propensity for this was recently demonstrated with an equity injection from the fiscus. Sovereign guaranteed exposure to SOEs as at March 2017 is up 20% since last year at R308.3bn. This is significant when viewed in relation to government's own gross loan debt of R2.2 trillion or 50.7% of GDP. It is anticipated that this risk will be rigorously investigated as part of the discussions on interventions required to alleviate the risk of further downgrades and ways to mitigate the effects of the current downgrades.

Competitiveness of South Africa's electricity price

A financial benchmarking exercise on Eskom commissioned by Business has revealed that the relative attractiveness of South Africa's electricity price has declined significantly against peer countries. This will continue to impact the attractiveness of South Africa as an energy intensive production destination, which negatively impacts government's beneficiation strategy and industrial policy. The operating environment for energy intensive companies is increasingly uncompetitive and will lead to more firms like Ferroglobe either closing, reducing production levels, or going offshore. Comparison of electricity costs for ferro alloy producing countries reveals that from offering the second lowest average price (28 US c) in 2009, the average price in South Africa was 67US c in 2014 - almost a trebling of the price in five years.

Regulatory framework

The regulatory framework within which NERSA has to consider this application allows a deviation from a standard tariff for classes of electricity consumers, not individual consumers as appears to be the case here. It can be argued that there are many other companies with similar characteristics that face the same challenges as Ferroglobe but for whatever reason have not yet requested relief. BUSA accepts that NERSA has the necessary statutory power to consider this and future applications.

## Consultation paper

Eskom's application

NERSA has provided a consultation document briefly discussing the application by Eskom to provide a preferential pricing package to a specific customer, Ferroglobe, through a Negotiated Price Agreement (NPA) for a period of two years.

Regarding the economic rationale for the NPA, NERSA correctly identifies the need for the cost of supply over the period of the agreement to be provided as part of the application. Although it is assumed that this information could be easily supplied by Eskom, it appears not to have been included in the application. This means that the application may not comply with the legal and policy requirements for such applications.

Although the need to keep commercially sensitive information confidential is accepted, BUSA believes that it is important for NERSA to satisfy itself that the preferential pricing arrangement before it is above Eskom's marginal cost of supply.

Annexure A to the discussion document, entitled “Annexure providing context information for submission to NERSA” (assumed to be authored by Eskom in collaboration with Ferroglobe) sets out the advantage or the quantitative impact on Eskom’s revenues. It is noted that the application in Annexure A does not appear to cover all the requirements contemplated in Annexure B. The status of Annexure B and the way it is used by NERSA in its consideration of the application should be clearly articulated in the decision that is taken on the application. Notwithstanding the above, BUSA is of the view that the information provided in the application (except for the failure to demonstrate that the tariff to be charged does in fact cover Eskom’s cost of supply), should be sufficient for NERSA to make a decision and that for future applications, the framework should be appropriately revised to cover only the essential elements of such an application.

Increasing Eskom’s sales

Eskom has indicated that the pricing package to this single company would create (or restore) between 1 450 and 1 700 GWh of annual sales. As around 70% of smelters are not operating this winter, there is significant scope to immediately increase Eskom’s sales and revenues.

As indicated above, the current financial challenges are such that any improvement in revenue would ultimately be of benefit to all Eskom customers as it would reduce the revenue shortfall that has to be recovered through an RCA application and increases the customer base, which has to contribute to covering the revenue shortfall.

There is no doubt that the situation in which Ferroglobe finds itself is not unique, yet the consultation paper makes no reference to how other potential applications will be dealt with.

BUSA believes that any preferential pricing system must be universally applicable to clearly defined classes of customers and must be shown to benefit the whole economy. Although a thorough cost benefit analysis based on sound facts and clear policy objectives should be performed before embarking on preferential pricing, BUSA understands the urgency of the current situation. In general, a case by case assessment of random applications would not only create a situation in which Eskom or NERSA would be able to ‘pick winners’ in the competitive process of the economy, which is undesirable, but would result in an impossible administrative burden on NERSA.

BUSA would therefore prefer a more efficient approach than the one contemplated to be able to accommodate the floodgate of applications which is likely to be opened should this application be successful.

In this regard BUSA believes that NERSA should use the eligibility criteria presented in Annexure B, which could apply to firms that would otherwise reduce production which result in job losses.

The possibility that any framework, once approved, will lead to many more applications for preferential pricing must be taken into account by clarifying that customers which comply with the same criteria will be dealt with in the same way.

The current situation of declining sales will lead to further increases in tariffs for all customers and exacerbates the risk of further loss in sales, if not addressed. At the same time, given the current and projected supply surplus, BUSA believes that a preferential tariff for a specific class of large users will be of benefit to all customers and should be considered. The approach proposed above would address any concern about the impact on other customers because the outcome would result in a net benefit to the licensee and therefore all customers and the applicant.

It is recognised that when Eskom foregoes revenues, it has consequences for the future average electricity price path and the sustainability of the approved cross subsidy flows. The extent of these consequences can be limited by restricting the application of this approach to a clearly identified class of customers.

At the same time, as referred to above, a longer-term approach to Eskom’s financial situation and the uncompetitiveness of tariffs for a range of customers must be developed urgently. BUSA anticipates that the inclusion of the financial status of Eskom in the 14 point plan will provide a platform for this to occur.

**Responses to NERSA specific requests for inputs**

NERSA has requested the following inputs:

**Stakeholder inputs:**

a) Please comment on the proposed NPA its structure, fairness and impact. Please substantiate your response.

b) Please comment on the NERSA's proposed assessment principles. Please substantiate your response.

c) If it is your view that an alternative solution should be used, please provide the alternate solution and detail how this solution should be applied? Please substantiate your response with examples, if possible

Question A

It is not possible to assess the NPA structure, fairness and impact due to lack of information disclosed. However, there is no doubt that an urgent intervention is required to address not only the declining Eskom sales which will have a negative impact on all customers, but also the need to prevent significant job losses in the customer class where electricity is a significant proportion of the operating costs.

Question B

However, given the urgency of the situation in a number of companies in addition to the applicant, a framework should be urgently developed to deal with additional applications. Any consideration of a preferential pricing regime must be on the basis of a class of customers and not a single customer.

Question C

The essential objective of the application is to provide relief in terms of a reduction in the electricity tariff for Ferroglobe, which still covers the marginal cost of the licensee's operation and which allows companies to remain operational. (Note: any licensee that has customers that comply with the eligibility criteria must be allowed to apply).

BUSA supports an intervention that would achieve this objective but one that is not restricted to one customer.

It is recommended that NERSA uses the framework presented in Annexure B of the Consultation Paper as the starting point for an approach to a specific customer class.

The class of customers that requires urgent intervention and to which the approach should be restricted in the short term should comply with the following criteria:

- Electricity cost is one of the top three drivers of operating cost and constitutes at least 20% of operating cost at standard tariff rates;
- Annual electricity consumption is at least 50GWh;
- Third party audit statements confirming the above should accompany the application; and
- Any application should only be approved for a maximum of two years, after which it may be reviewed.

It is also recommended that the longer-term approach as recommended above should also be developed urgently.

## Conclusions and way forward

BUSA believes that the current financial situation of Eskom must receive urgent attention if a significant cash injection from the fiscus is to be avoided. It is anticipated that a significant tariff increase is going to be requested for 2018/19. This will not only lead to the financial unsustainability of Eskom but will also lead to further plant closures and job losses in sectors with the same characteristics as ferrosilicon. BUSA believes that a strongly co-ordinated approach involving all government stakeholders and Business should be initiated urgently to address the challenges faced by Eskom and energy intensive customers.

In the meantime, NERSA should consider the application before them favourably and at the same time initiate a process to consider additional applications on the same basis.

BUSA believes that NERSA is empowered in terms of the Electricity Regulation Act to allow deviation from a standard tariff under specific circumstances and is therefore able to set the rules and procedures for licensees to apply for such deviation.

Although BUSA would have preferred such rules and procedures to be unambiguously in place prior to any applications being considered, it is believed that the crisis of unemployment needs to be addressed urgently and that all stakeholders should be focussing on the best way to achieve the net benefit outcome that BUSA believes is possible.

BUSA would like to engage with NERSA on ways in which the approach contemplated in the application could be extended to a class of customers which meet the eligibility criteria in Annexure B of the Consultation Paper.