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Impact of the proposed increase in electricity tariffs on the **agricultural sector**

NERSA public hearing | 3 February 2020

Outline

- Agri Western Cape: Background
- National and provincial economic outlook
- Economic Assessment of the sector
- Effects of externalities on the sector
- Comments and recommendations

Agri Western Cape: Background

Who is Agri Western Cape?

Agri Western Cape is the provincial representative organisation of Organised Agriculture.

Through its affiliated membership of **93 farmer unions** and more than **3,700 members**, serves as the one-stop connector between members of the farming community and all relevant interest groups.

Agri Western Cape works hand in hand with different organisations, including decision makers in government and the agricultural business sectors, to **ensure the future growth of agriculture** for the benefit of all.

*"It is our role to ensure that agriculture is promoted for the benefit of **all future growth** of our **province** and **country**."*

- Agri Western Cape

National and Provincial economic outlook

South African economic outlook

Economic growth:

The real growth GDP forecast for 2020 has recently experienced a downwards adjustment, mostly due to a combination of weaker global growth fundamentals and persistent domestic.

IMF forecast for 2020: **0.8 per cent (South Africa)**

IMF forecast for 2020: **3.6 per cent (Sub-Saharan Africa)**

Economic Constraints:

- Unemployment rate has reached a worrying level of 29.1%
- National government's debt-to-GDP trajectory is not expected to stabilise over the medium term, with the 2019 MTBPS projecting gross loan debt of R3.2 trillion **(60.8% of GDP)**.
- Meaningful containment of government expenditure and structural reforms requires immediate attention.

Increased electricity tariffs:

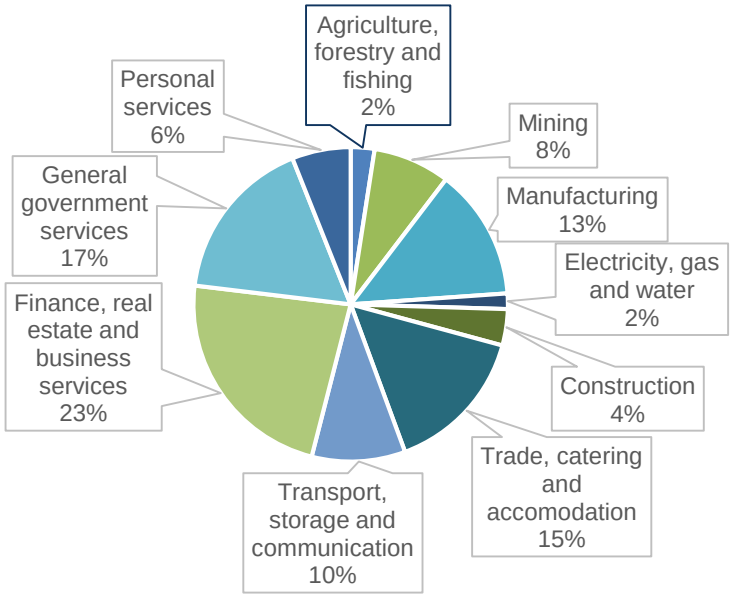
Lower demand → higher prices → less disposable income → decreased economic growth

Western Cape economic outlook

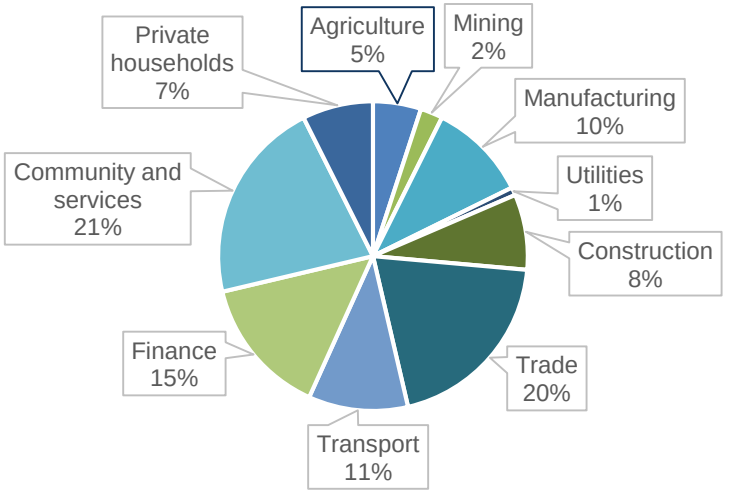
- The Western Cape economy is forecast to expand by an average annual rate of **1.6 per cent** from 2019 to 2023.
- Employment growth in the Province is forecast to average just **0.9 per cent** per year.
- In the Province, **agriculture is forecast to grow at the fastest rate** on average.
- Western Cape exports expanded by an average of **8.8 per cent** per year over the last 10 years.

South African economic outlook

GDP by sector (First three quarters of 2019)



Sectoral contribution to total employment (2019)



Source: StatsSA Quarterly Labour Force Survey

Economic Assessment
of the sector

Economic importance of the sector

The agricultural sector is a vital role player within the entire value chain. The impact of forward and backward linkages involving the agricultural sector is considerable, with the impact of irrigated agriculture being relatively large.

Agriculture's contribution to GDP is approximately 2.1%, but the combined contribution between agriculture and agro-processing results in more than 10%.

National contribution of the sector to Eskom:

- Number of Eskom customers: **1,25%** (81,303)
- Electricity sales, GWh: **2,96%** (5,796)
- Electricity revenue, R million: **4,85%** (R8,682 mil)

Effectively, the agricultural sector makes up less that 2% of Eskom's local client base, but is responsible for almost 5% of local revenue.

240 580.51 ha of irrigated fields in the Western Cape Province

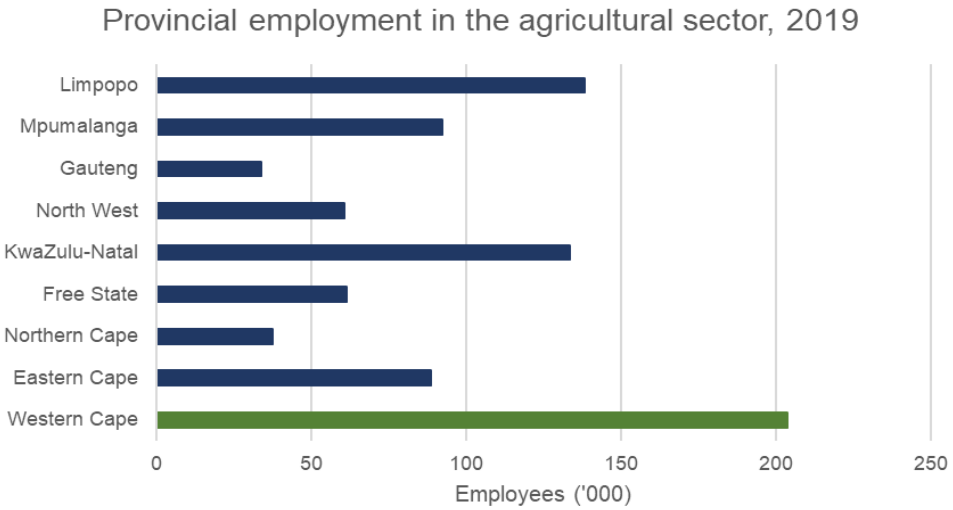
21 Western Cape cold chain facilities

394 Western Cape dairy farms

44 Western Cape fruit cool chains

Economic importance of the sector

The Western Cape agricultural sector was responsible for 215 000 jobs during Q2 of 2019, which makes up 24.4 % of the national agricultural labour force.



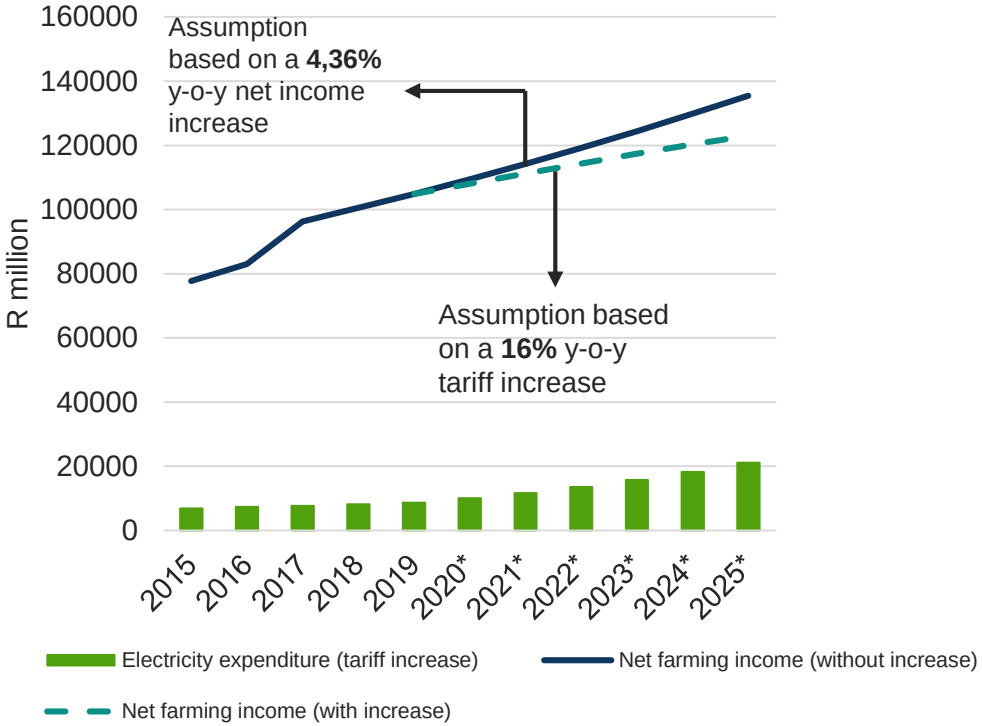
Agriculture and agro-processing are absorbing approximately **18% of the total workforce in the province**.

Agricultural industries that require a large number of employees are, for example, the fruit and wine industries that **require a significant seasonal labour force** to assist in the picking process during the annual harvest.

Source: StatsSA Quarterly Labour Force Survey

Effects of a tariff increase on the sector

The effects of a 16% tariff increase on net farming income



According to the Department of Agriculture, Forestry and Fisheries prices for horticultural products increased by approximately 3% in 2018/19. Even at a relatively modest rate of 5.3% increase in electricity prices for the year, **a depressed terms of trade** and a profit squeeze is evident.

More than **5,5% (R8.682 billion)** of total farming input costs are annually being spent on electricity. Should NERSA approve Eskom's proposal for a 16% tariff increase, this will result in net farming income decreasing, and may pose huge risks to the sector and national food security.

A practical example of the impact of a tariff increase on the deciduous fruit industry

Economic and socio-economic impact of the industry

60,968 labourers and **243,874** dependents

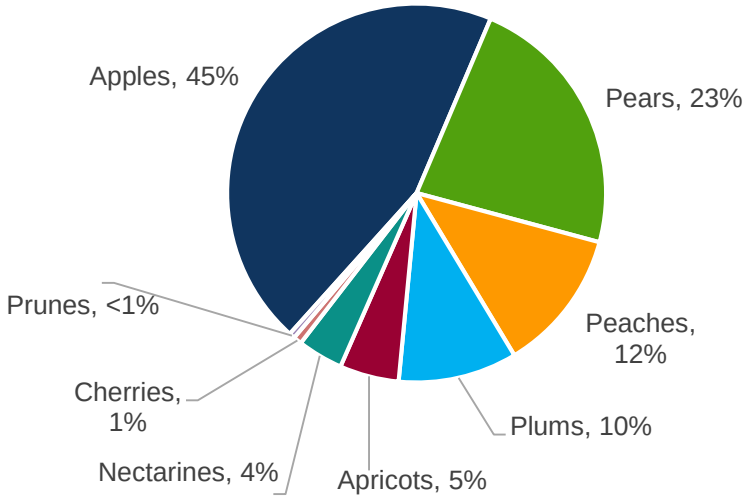
R 11,5 billion total turnover

45% of total production is exported

The industry is heavily dependent on electricity both for production and throughout the value chain.

Requires **sufficient / constant** power supply for to support existing production base and for expansion – **directly linked to job creation!**

Total area planted (45,052 ha)



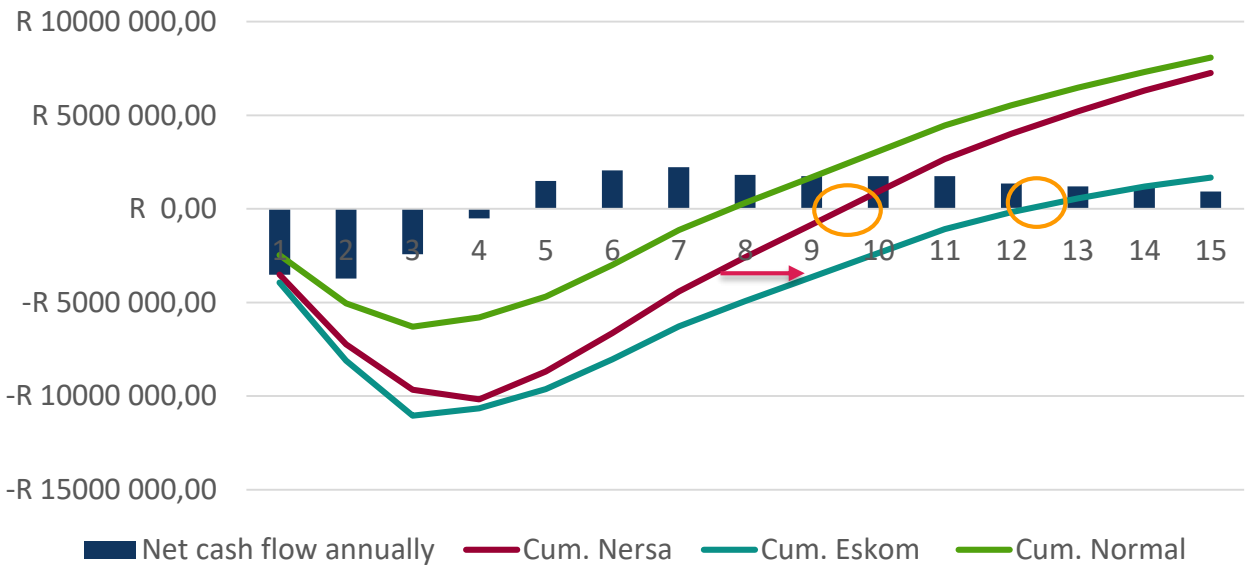
A practical example of the impact of a tariff increase on the deciduous fruit industry

It can be seen that in the long-term, these tariffs **prolong the duration** of reaching the beak-even point.

Increased production costs over time have a direct impact on profitability and hence, affordability. Fruit is a commodity that has not seen real price inflation over the last number of years and any increase in administrative costs will **impact growers negatively**.

Small growers and new entrants, not having economy of scale, will be most affected.

Long-term impact on break-even due to a cumulative tariff increase



Source: Hortgro, own calculations

Effects of externalities on the sector

Impact of load shedding on the agri sector

Regression results of load shedding on real output growth	
Economic sector	**Coefficient**
South Africa's total GDP	-0.0578
Agriculture, forestry and fishing	**-0.2684**
Mining	-0.1851
Manufacturing	-0.0934
Electricity, gas and water	-0.1776
Construction	-0.0433
Trade, catering and accommodation	**-0.0268**
Transport, storage and communication	**-0.0460**
Finance, insurance, real estate and business services	-0.0023
General government	-0,0292
Personal services	-0.0078

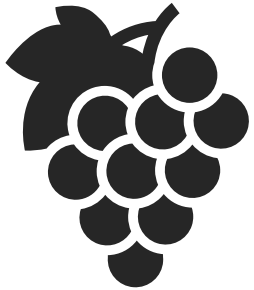
Increased intensity of load shedding has a direct impact on the growth of various sectors. A study done by SARB indicated that real GVA displayed a negative correlation to the intensity of load shedding, with **agriculture** being among the statistically significant relationships.

The effects of load shedding has clearly had a negative impact on an already pressurized agricultural sector. Increased tariffs would lead to higher input costs together with smaller profits, due to load shedding.

A practical example of load shedding on the wine industry

The impact of load shedding has a significant impact on **rising input costs** for producers, resulting in increased product prices and lower profit margins.

Assuming a producer cellar presses an average of **40,000 tons** of grapes during an annual period of **10 – 12 weeks**, the following calculations provides a practical example of additional/unforeseen expenses incurred during a period of interrupted power supply:



x 2 hired generators for 3 months @ R 80k = **R 240k**
Own generator – assume 10% interest for R 1,8 million = **R 180k per year**.

Assume **8 hours** of load shedding per week (phase 2 x 2), every second week.
Thus, 16 hours per month and a total of **48 hours** for the entire harvest period.

- Cost of fuel for own items: 48 hours x 200 litres/hour @ R16,50/liter = **R 158,400**
- Cost of fuel for hired items: 48 hours x 300 litres/hour @ R16,50/liter = **R 237,600**

Based on assumptions, the total cost of **R 816,000** is assumed. Expressed as cost per ton, it amounts to about **R 20,41 per ton**.

**Only a formal survey and investigation will contribute to an official and accurate wine industry calculation - the aforementioned is provided as a guide*

A practical example of load shedding on the wine industry

With a projected crop size of about **1,034 million tons** for the South African 2020-harvest, we can extrapolate the aforementioned calculation and indicate a potential expenditure of approximately **R 21 million per year.**

Other elements also has a direct impact on producers and, effectively, the industry as a whole.

- Varying amounts of fuel utilised as this depends on various elements such as the season, cultivar being pressed, size of the cellar and at what capacity the generator is being used.

- The impact of interrupted power supply on the quality of the product being delivered should producers not be able to use their irrigation systems when necessary.

- Thus, a top cultivar's price of about R13 / liter can easily end up in a generic product for about R6 / liter, or even lower (distillation wine) if the quality is not optimally managed.

This is the single biggest plea, from winegrowing ranks, to get Eskom on a sustainable level as soon as possible - but also not at the expense of the producer, who is already plagued by cost increases, which do not always keep pace with consumer inflation.

Outside of the norm, electricity tariff increases simply cannot be justified and / or afforded !!!

Source: Vinpro, own calculations

Comments
and recommendations

Comments

Agri Western Cape inter alia noted that:

- Eskom in its RCA submission applied for R27 240 million with primary energy variances the main contributors. Eskom has not yet recovered similar revenues as far back as 2015.
- NERSA must ensure Eskom's sustainability as a business presumably as a going concern.
- Security of electricity supply may be in conflict with pure economic dispatch given practical considerations based on the peculiar nature of plants and OCGT requirements. This does not provide justification for serious economic and financial problems encountered by Eskom.
- The RCA includes all billed revenue as opposed to collected revenue. An amount of R6 442 million is unlikely to be fully recovered. As this will obviously result in bad debts it is not clear how it can be regarded as revenue.
- NERSA and Eskom differed on whether the Arnot power station will be utilised. Given the delicate position of power supply in the country such different stances seem ridiculous to say the least.
- An average price increase is applied on all tariff rates, including network charges. Therefore, a RCA tariff increase will have a double impact on agriculture through higher tariff for electricity used and higher fee in terms of electricity line fees.

Recommendations

Although Agri Western Cape cannot claim to have the ultimate solutions at hand the following aspects are relevant in our view.

- The information on the cost structure of Eskom contained in the RCA application is unclear therefore it is impossible to tell whether the amount claimed of approximately R27 billion is based on prudency. Proper scrutiny of all Eskom's procurement contracts, as should be done by NERSA, should be non-negotiable.
- Financial ratios like interest cover for Eskom currently leaves a lot to be desired. Cost reductions seem to be inevitable.
- Clearly interaction, communication and coordination between NERSA and Eskom is lacking and should be stepped up also with a view to comprehendible communication with customers of Eskom.
- RCA settlements in arrear should be evaluated and scheduled for payment as it is currently moving to unmanageable levels.
- "Negotiated Pricing Agreements" with respect to medium term pricing arrangements also with stakeholders in the agricultural sectors should be considered as it will create a more certain cost environment.
- RCA's should be vetted by auditors with a view to detecting fraudulent activities or fruitless expenditure.

Considering all comments, we recommend that Eskom's RCA application not be approved, especially an increase on line fees, as the rising electricity tariffs is out of sync with the economic reality of a utility with a broken business model.

Questions that we direct to Eskom

In his State of the Nation Address in February 2019, President Ramaphosa said; *"To bring credibility to the turnaround and to position South Africa's power sector for the future, we shall immediately embark on a process of establishing three separate entities – Generation, Transmission and Distribution – under Eskom Holdings."*

What is the current state of affairs with this plan to subdivide Eskom into three independent components, especially in light of newly appointed Eskom CEO's warning against the hasty unbundling of Eskom?

In his State of the Nation Address in February 2019, President Ramaphosa said; *"Eskom has come up with a nine-point turnaround plan which we support and want to see implemented."*

What is the status of the implementation of this nine-point plan?

Thank you