Eskom Regulatory Clearing Account (RCA) FY 2019

NERSA Public Hearings

Date: 3 February 2020

Cape Town, Western Cape

Eskom's RCA application in accordance with the Electricity Regulation Act

Legal Basis of the MYPD methodology

The legal basis for the MYPD Methodology is provided in the Electricity Regulation Act (ERA), 2006 (Act No. 4 of 2006). The Methodology is subordinate to the requirements of ERA and the Electricity Pricing Policy. The requirements from these two documents will at all times supersede those of the Methodology.

Section 4(a)(ii) of the Act states that 'the Regulator must regulate prices and tariffs'. Further, section 15(1) and (2) of the Act prescribes the following tariff principles:

(1) A license condition determined under section 14 relating to setting or approval of prices, charges and tariffs and the regulation of revenues –

a) Must enable an efficient licensee to recover the full cost of its licensed activities, including a reasonable margin or return;
b) Must provide for or prescribe incentives for the continued improvement of the technical and economic efficiency with which the services are to be provided;
c) Must give end users proper information regarding the costs that their consumption imposes on the licensee's business;
d) Must avoid undue discrimination between customer categories; and may permit the cross subsidy of tariffs to certain classes of customers.

(2) A licensee may not charge a customer any other tariff and make use of provisions in agreements other than that determined or approved by the Regulator as part of its licensing conditions.

Eskom has made this Regulatory Clearing Account (RCA) application to recover efficient costs in accordance with the ERA and MYPD Methodology

NERSA's prudency guidelines is the basis of Eskom's RCA application

(section 3.5 of the RCA application)

Extracts from NERSA's Prudency Guideline

2.4. The Guidelines will formalise the use of a uniform approach and assist licensees in knowing (in advance) the basis on which the assessment is to be conducted. They will also inform the licensees of the specific areas or information that the Energy Regulator will focus on when assessing prudency matters.

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2.5. The existence of the Guidelines is expected to improve regulatory certainty in the long term and provide a transparent framework by ascertaining whether costs were or will be incurred prudently.

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5.2.1.4. The MYPD Methodology requires the Energy Regulator to review the efficiency of all contracts, such as those between Eskom and the Independent Power Producers (IPPs), before the conclusion of such contracts, to ensure prudency. It also requires that there be fair risk allocation between the IPP and Eskom, as the buyer. The administrative costs of the Power

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Extracts from NERSA's Prudency Guideline

6.1.1.2. Whether a cost is prudently incurred depends on how the decision to incur the cost was made, not only the outcome of the decision.

6.1.1.3. In assessing prudency, the following will be considered:

b) expenditures that meet a standard of care which a reasonable person would be expected to exercise under the same circumstances encountered by licensee at the time the decision had to be made; and

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8.3. In assessing prudency, it is also necessary to make a distinction between forecast and committed costs, as explained below:

b) Committed costs are costs that the utility has already spent or has entered into a binding commitment to pay or is subject to other legal obligations that leave it with no discretion as to whether to make the payment in the future. The disallowance of committed costs is particularly problematic for a regulated utility because the utility and its shareholders will have no choice but to bear the burden of those costs themselves.

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NERSA’s prudency guidelines is the basis of Eskom’s RCA application

(section 3.5 of the RCA application)

Extracts from NERSA’s Prudency Guideline

8.6. In using the Guidelines for Prudency Assessment, it should be emphasised that hindsight provides perfect insight, which was not available or could not reasonably have been known to those making the decisions. Therefore, it cannot be used to assess the decisions made. The assessment of decisions made must be done by first establishing what was known at the time, as well as what influences were at play at the time the decision was made.

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Eskom has applied the principles of NERSA’s prudency guideline in this RCA application

Eskom fully supports NERSA decision with addressing matters related to governance failures

- On 7 March 2019, the NERSA Media statement as confirmed by the NERSA Chairman at the media briefing was as follows with reference to previous revenue decisions:

  "The Energy Regulator also considered that Eskom conceded that certain governance failures occurred in Eskom, however, at the time of the above decisions and although some of the adjustments were effected, the extent of the governance failures or amounts associated therewith had not been fully quantified. The Energy Regulator may initiate its own investigation into the governance failures in Eskom and may effect adjustments to Eskom's revenue based on the relevant outcome of its investigation and/or those undertaken by bodies or entities, including, but not limited to, Eskom, National Treasury, the Special Investigating Unit, the South African Directorate for Priority Crime Investigation (Hawks), the Parliament of the Republic of South Africa or any Commission of Enquiry as and when they are concluded or a conclusive outcome is reached and the costs associated therewith have been quantified."

- Eskom is on record in support of this approach as clarified during previous submissions
- As an example, the recovery from Mc Kinsey has already been included in the RCA balance determination related to the FY 2018

Eskom is committed to complying with the approach decided by NERSA with regards to amounts associated with governance failures

The Regulatory Clearing Account (RCA) is the regulatory mechanism for risk management

RCA is a risk management mechanism to deal with variances between what was assumed by NERSA for purposes of its revenue determination, and what actually materialised (per Eskom's audited financial statements) - a backward looking reconciliation

Landscape for RCA application:

Focus of this consultation is FY 2019 RCA application. Various forward looking clarifications on Eskom's operations are of interest. However, ample other opportunities are available for addressing these

1. The submission is **based on the MYPD Methodology**, published by NERSA during **October 2016**
2. It is **further influenced by** the decision and reasons for **decision for MYPD 3 RCA for FY 2014** published in March 2016
3. The **reasons for decision** for MYPD 3 **RCA FY 2015, 2016 and 2017** are being **reviewed** by the Eskom Board **in a High Court application**
4. **Due to uncertainty in the environment** at that time, **NERSA approved a single year application** for FY 2019
5. The Energy Regulator **decision for FY 2019** was an average nominal **increase of 5.23%**
6. The Eskom Board initiated a process of **reviewing the NERSA revenue decision for FY 2019 through an application lodged at the High Court**. The matter has been heard and judgement is reserved.
7. Once this RCA balance for FY 2019 determination has been made by NERSA, by 24 March 2020 in terms of the requirements of the ERA, a subsequent liquidation decision will be made
8. The **liquidation decision** will **inform on the extent and timing of the price adjustment**

Key RCA related Changes in MYPD methodology

The methodology as released in October 2016 now allows operating costs to be re-measurable and the calculation for RAB related variances has changed

	MYPD 3 methodology	MYPD 4 methodology
Revenue due to sales volume changes	✓	✓
Primary energy costs	✓	✓
Regulated Asset Base and Return	**Previously was CECA**	✓
Operating costs	✗	✓

RCA application FY 2019
(Section 2.2 of RCA application)

RCA for FY 2019	Decision FY 2019	Actuals FY 2019	Variance	RCA adjustments	RCA FY 2019
Total Revenue Rm	**190 348**	**179 892**	**10 456**	**(5 006)**	**5 450**
Primary Energy , Rm	**86 094**	**99 489**	**13 395**	**3 392**	**16 786**
Coal	39 177	49 903	10 726	1 689	12 416
Open Cycle Gas Turbines (OCGTs)	345	3 768	3 423	-	3 423
Other	782	-	(782)	-	(782)
Other primary energy	7 595	9 320	1 725	-	1 725
Independent Power Producers	26 596	24 952	(1 644)	1 369	(275)
International Purchases	3 216	3 740	524	-	524
Environmental levy	8 093	7 805	(288)	-	(288)
Demand Response – Instantaneous	110	-	(110)	110	-
Demand Response – Supplementary	162	-	(162)	162	-
Demand Response – Programme administration	18	-	(18)	62	44
Other costs	**104 254**	**106 871**	**2 617**	**2 221**	**4 838**
Depreciation	24 903	26 427	1 524	-	1 524
Return on Assets (ROA)	28 117	28 107	(10)	-	(10)
Research & Development (R&D)	112	90	(22)		(22)
Demand Side Management (EEEDSM)	-	29	29	(2)	27
Operating costs	51 122	52 218	1 096	2 223	3 319
Service Quality Incentives (SQI)	**-**	**166**	**166**	**-**	**166**
FY 2019 RCA Balance Application					**27 240**
Nuclear decommissioning from RCA FY 2013/14 decision phased in over 10 years					**83**
Total RCA balance					**27 323**

Clarification of RCA adjustments

1 Revenue - (R5 006m)

Adjustments made to the revenue reflected in the AFS relate to ensuring that all billed revenue is included by adjusting for non-electricity revenue, demand response revenue as well as excluding any load shedding volume in the variances

2 Coal – R1 689m

Adjustments from AFS related to application of NERSA's MYPD methodology

3 Other – R782m

"Other" in the primary energy section illustrates a mismatch between the NERSA revenue decision and the primary energy decision

4 Demand response – R334m

Adjustment related to the application of NERSA's MYPD methodology – i.e. the variances for instantaneous and supplementary is not a pass-through since Eskom achieved more MW and GWh compared to the decision

5 IPPs – R1 369m

Adjustment related to recognition of capacity payments for the Department of Energy IPP Open Cycle Gas Turbine (OCGT) plants as well as reversal of provisions

6 Operation costs – R2 223m

Adjustments are mainly as a result of other income (adjustment related to McKinsey refund already included in a previous RCA balance decision) and arrear debt (adjustment related to a cap on arrear debt in the revenue decision)

7 EEDSM – (R2m)

Adjustment related to the application of NERSA's MYPD methodology – i.e. the variance for programme costs is not a pass-through since Eskom achieved more MW compared to the decision

Eskom's FY 2019 RCA submission is driven substantially in specific areas – Revenue Variance

Legislation

The MYPD Methodology refers to the variance between the total actual and total decision as below:

- 17.1.1.5 Adjusting for other costs (7) and revenue variances where the variance of total actual revenue differs from the total allowed revenue

Approach

- It would be unnecessary to further divide the total actual revenue variance into fixed and variable elements – since the variable elements are already addressed through the volume related aspects of the PE, etc costs. If this is done – results in double counting to the detriment of the consumer (when actual volumes are higher) or the detriment of Eskom (when actual volumes are lower)
- The total approach is in line with the MYPD methodology
- The correction of such initial over-estimation/under-estimation of sales - does not increase/decrease the overall cost to the consumers, but merely represents deferred / advance recovery of the fixed cost as per NERSA revenue decision

Variance explanation

- NERSA, in its decision assumed a higher sales volume compared to what actually materailised. Sales volume variances are due to lower international sales as well as poor economic conditions for local sales
- Sales is ~3 922 GWh lower than the decision
- Revenue from sales is R10 billion lower than the decision. After various adjustments the revenue variance in the RCA calculation is R5 450m

Eskom's FY2019 RCA submission is driven substantially in specific areas – Coal cost variance

Legislation

- The MYPD RCA formula with reference to coal costs is:
- "Performance Based Regulation PBR cost (Rand) = (Alpha x Actual Unit Cost of Coal Burn + (1 – Alpha) x Coal burn Benchmark price) X Actual Coal Burn Volume"
- The NERSA prudency criteria refers to recognition of committed costs having to be paid that leave no discretion as to whether to make the payment in the future

Approach

- NERSA's decision on primary energy was approx. R10 billion lower than the application. This would require Eskom to decrease coal costs by ~17%
- NERSA applied a theoretical index to derive the FY 2019 cost in R/t based on the FY 2014 RCA decision
- NERSA did not consider Eskom's existing contractual obligations, Eskom's procurement policies, the mining environment and the factors that impacted that environment in the intervening years
- This results in a RCA balance variance for coal costs of over R12 billion

Eskom's FY2019 RCA submission is driven substantially in specific areas – Operating Expenditure

Legislation

- The new methodology allows for operational expenditure to be re-measurable for RCA balance applications.
- It requires the most recent prudently and efficiently incurred actual costs when making a decision and adjusting for prudently incurred over or under-expenditure on operating costs as may be determined by the Energy Regulator

Approach

- Many remnants of what seems to be a previous decision were abandoned in the final decision.
- In addition, the decision is not made where the licensees and corporate applications are considered. It was assumed that the number of employees would be aligned to the sales volume in 2008.
- Recognition of other developments in the industry did not seem to have been considered.

Variance explanation

- The FY 2019 determination left Eskom with a funding shortfall. This shortfall needed management intervention and a re-prioritisation of cost between the different licensees and cost categories
- Key variances were experienced in employee benefit costs for the benefit of Eskom. Eskom implemented extreme measures, such as an embargo on external appointments to work within the financial constraints. Eskom has assumed in its application that the efficient number of employees would have reached 39 186 for FY 2019 but the actual number was 38 292
- Variances for maintenance costs were in favour of the consumer. Due to the financial constraints, Eskom was required to reprioritise, defer and revise its approach to maintenance

Eskom's FY2019 RCA submission is driven substantially in specific areas – OCGT revenue

Eskom

Legislation

- In accordance with the MYPD Methodology, the gas turbine usage should be allowed as it was incurred to ensure security or supply and was utilized as a last resort before the implementation of load shedding.

Variance explanation

- The system operator was required to dispatch more OCGTs (both Eskom's and IPPs) than in the NERSA decision or assumed in Eskom's application
- The dispatch was undertaken in accordance with NERSA's scheduling and dispatch rules
- The utilisation of OCGTs contributed towards minimising load shedding. In accordance with the MYPD Methodology, the gas turbine usage should be allowed as it was incurred to ensure security of supply and was done so as a last resort before implementing load shedding
- OCGTs were used during peak and emergency periods throughout the year. OCGT and IPP usage reduced load shedding by providing additional capacity. The use of OCGTs must be considered in combination with all other available options to manage the power system
- Reduced usage of the OCGTs would increase the incidents, duration and severity of load shedding. The knock on effect of this would be worsening plant performance and longer time periods to return to operation
- The variance between the assumptions in the decision and actuals for FY 2019 illustrate the need to use OCGTs to minimise the impact of load shedding on the SA economy
- The variance between NERSA's decision and actuals for Eskom's OCGTs was ~R3.4 billion

Conclusion on Eskom FY 2019 RCA application

- Eskom’s RCA application is based on **MYPD Methodology** and **NERSA RCA FY 2014 reasons for decision**
- Eskom’s revenue is determined by NERSA through a revenue application process and then the RCA process which this submission addresses. The RCA is meant to ensure that Eskom can recover its full **efficient costs** as the actual realities have occurred differently than assumed during the revenue decision
- Eskom’s RCA application is for **R27 240m**
- **None** of the **financial ratios** and **free cash flow outcomes** determined by NERSA has **materialised**
- **Eskom has not yet recovered revenues**, determined by NERSA to be efficient and prudent, **incurred as far back as FY 2015, by FY 2020**
- In addition, NERSA has decided that this trend would continue for revenues previously determined to be efficient and prudently incurred during the FY 2017 to only be recovered in the FY 2023. **The methodology does not allow for the time value of money to be included**
- In light of NERSA’s mandate to balance the impact on sustainability of Eskom with the impact of consumers, Eskom proposes that this **RCA balance for FY 2019 be recovered as soon as possible**


THANK
YOU!