ESKOM HOLDINGS SOC LIMITED:
IMPLEMENTATION PLAN OF ESKOM'S RCA BALANCES FOR THE 2018/19 FINANCIAL YEAR

CONSULTATION PAPER

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ABBREVIATIONS AND ACRONYMS

CPI	Consumer Price Index
DSCR	Debt-Service Coverage Ratio
ERA	Electricity Regulation Act, 2006 (Act No. 4 of 2006)
FY	Financial Year
GDP	Gross Domestic Product
MIRTA	Minimum Information Requirements for Tariff Applications
MYPD	Multi-Year Price Determination
NERA	National Energy Regulator Act, 2004 (Act No. 40 of 2004)
NERSA	National Energy Regulator of South Africa
NPA	Negotiated Pricing Agreement
PFMA	Public Finance Management Act, 1999 (Act No. 1 of 1999)
PPI	Producer Price Index
RCA	Regulatory Clearing Account
Rm	Rand Million
ROA	Return on Assets
SADC	Southern African Development Community
Stats SA	Statistics South Africa
FBE	Free Basic Electricity
SAM	Social Accounting Matrix
SMMEs	Small, Medium and Micro Enterprises

1. EXECUTIVE SUMMARY

1.1 Eskom is a vertically integrated monopoly responsible for generating, transmitting and distributing electricity. Although power generation has been widened to include independent power producers (IPPs), Eskom is still responsible for 94% of the production of electricity in South Africa. The National Energy Regulator of South Africa (NERSA) has the responsibility of ensuring the sustainability of the Electricity Supply Industry. This role is balanced with the need to ensure affordability of electricity. While it is Eskom's duty to raise the capital to fund its capital programme and its operations, it is NERSA's duty to enable Eskom to raise capital through a supportive regulatory environment that guarantees predictable electricity tariffs and the ability to pay its debts. This ensures a stable and dual price trajectory that enables the consumers of electricity to afford the rising costs.

1.2 As a basic and socio-economic commodity, electricity is also a major input cost to industry and manufacturing. In fact, competitively priced electricity is in essence the corner stone on which economic growth is built. The prolonged load shedding as a result of a system that has been capacity constrained during the period in question as well as up to date remains a challenge. The relief provided by the reduced demand during Covid 19 lockdown was short lived as load shedding resumed again from July 2020 as lockdown restriction started to be eased, the system therefore remains constrained and is anticipated to remain constrained in the medium term. Eskom's failure to invest in its infrastructure will continue to spur the environment of low economic growth even further.

1.3 Eskom has been experiencing deterioration in its plant availability, resulting in reduced energy sales. It has also been experiencing limited access to funding. This has resulted in it being unable to meet the electricity demand, with load-shedding being experienced from time to time since 2008. The energy shortages have negatively affected businesses, aggravating the already weak macro-economic environment.

1.4 The energy sector has been, and continues to be, a driving factor in the South African economy. The electricity prices affect a number of economic agents and macro-economic factors. To be specific, the electricity industry plays a significant role in the economy as it forms part of the production process for various key economic sectors.

1.5 NERSA is in the process of finalising the implementation plan of the 2018/19 Regulatory Clearing Account (RCA) balance before 26 November 2020. However, prior to the decision, NERSA will embark on a due process of stakeholder consultations. As part of this process, NERSA is requesting stakeholders to comment on the issues raised in this consultation paper. It is crucial to note that this decision relates to the 2018/19 Eskom RCA application.

1.6 This consultation paper is structured as follows: executive summary, background, motivation for the three proposed options and questions posed to stakeholders to facilitate the consultation process.

2. BACKGROUND

2.1 The Multi-Year Price Determination (MYPD) Methodology is used for the evaluation of Eskom's revenue and RCA applications.

a) On 15 December 2017, NERSA approved Eskom's one-year revenue requirement for the 2018/19 control period as follows:

Table 1: 2018/19 Revenue Decision of 15 December 2017

	2017/18	2018/19
Allowed revenue from tariff based sales (R'm)	198 954	176 410
Forecasted sales to tariff customers (GWh)	223 219	188 082
Standard Average Price (c/kWh)	89.13	93.79
Percentage price increase (%)		5.23%
Total expected revenue from all customers (R'm)	205 214	190 348

b) As stated in section 7.1.1 of the MYPD4 Methodology, 'the risk of excess or inadequate returns is managed in terms of the Regulatory Clearing Account (RCA). The RCA is an account in which all potential adjustments to Eskom's allowed revenue, which has been approved by the Energy Regulator, is accumulated'.

c) On 14 June 2018, the Energy Regulator made a determination on Eskom's MYPD3 RCA application for the 2014/15, 2015/16 and 2016/17 financial years.

d) On 7 March 2019, the Energy Regulator made a determination on Eskom's MYPD3 Year 5 RCA application for the 2017/18 financial year.

e) On 8 August 2019, NERSA received Eskom's RCA revenue application for the 2018/19 financial year, requesting a total RCA balance of R27 323m.

f) The NERSA team conducted a screening of Eskom's application and found that the application was not compliant with the Methodology and

Minimum Information Required for Tariff Approval (MIRTA) requirements. The sections that were identified as non-compliant were communicated to Eskom.

g) On 5 November 2019, NERSA held a meeting with Eskom to discuss the compliance of the RCA application. On 13 November 2019, Eskom submitted a corrected version of the RCA application that NERSA subjected to public consultations during the period of 3 to 24 February 2020.

h) On 14 May 2020, the Energy Regulator approved the RCA balance of R13 271m for 2018/19 and decided that it should be recoverable from the standard tariff customers, local special pricing arrangement (SPA) customers and international customers.

Table 2: 2018/19 Regulatory Clearing Account (RCA) balance

R'm	Decision FY 2019	Actuals FY 2019	Variance	RCA Adjustment	Application FY 2018/19	NERSA Adjustment	NERSA Decision
Total Revenue Rm	**190 348**	**179 892**	**10 456**	**(5 006)**	**5 451**	**(3 038)**	**2 413**
Primary Energy , Rm	**86 094**	**99 489**	**13 395**	**3 392**	**16 786**	**(5 339)**	**11 447**
Coal	39 177	49 903	10 726	1 689	12 416	(1 554)	10 861
Open Cycle Gas Turbines (OCGTs)	345	3 768	3 423		3 423	(2 937)	486
Other	782		(782)		(782)	0	(782)
Other primary energy	**7 595**	**9 320**	**1 725**		**1 725**	**(717)**	**1 008**
Water usage and procurement	2 353	2 146	(207)		(207)	0	(207)
Start-up gas and oil (coal-fired)	2 122	3 741	1 619		1 619	(717)	902
Start-up gas and oil (gas-fired)	9	0	(9)		(9)	0	(9)
Coal handling	2 010	2 000	(10)		(10)	0	(10)
Water treatment	499	474	(25)		(25)	0	(25)
Nuclear	499	768	269		269	0	269
Fuel procurement	39	144	105		105	0	105
Sorbent usage	64	47	(17)		(17)	0	(17)
Independent Power Producers	26 596	24 952	(1 644)	1 369	(275)	(130)	(406)
International Purchases	3 216	3 740	524		524	0	524
Environmental levy	8 093	7 805	(288)		(288)	0	(288)
Demand Response (DR) – Instantaneous	110		(110)	110			
Demand Response (DR) - Supplementary	162		(162)	162	44	0	44
Demand Response (DR) – Programme administration	18		(18)	62			
Other costs	**104 254**	**106 871**	**2 617**	**2 221**	**4 837**	**(5 510)**	**(672)**
Depreciation	24 903	26 427	1 524	0	1 524	0	1 524
Return on Assets (ROA)	28 117	28 107	(10)	0	(10)	(3 077)	(3 087)
Research & Development (R&D)	112	90	(22)	0	(22)	0	(22)
Demand Side Management (EEEDSM)		29	29	(2)	27	(6)	21
Operating costs	51 122	52 218	1 096	2 223	3 318	(2 426)	893
Service Quality Incentives (SQI)		186	186	0	186	(186)	0
FY 2019 RCA Balance Application					**27 259**	**(14 072)**	**13 188**
Nuclear decommissioning from RCA FY 2013/14 decision phased in over 10 years					**83**	**0**	**83**
Total RCA balance					**27 323**	**(14 072)**	**13 271**

3. LEGAL BASIS

3.1 Section 4(c) of the National Energy Regulator Act, 2004 (Act No. 40 of 2004) (‘NERA’) empowers NERSA with the responsibility to undertake the functions detailed in section 4 of the Electricity Regulation Act, 2006 (Act No. 4 of 2006) (‘ERA’).

3.2 The ERA sets out the powers and functions of NERSA. Relevant to this application is section 4(a)(ii), in terms of which NERSA is empowered to regulate prices and tariffs.

3.3 NERSA developed a Methodology, which trails the obligations mandated to NERSA by the ERA. The Methodology empowers NERSA to determine how the decision of the RCA shall be implemented. By so doing, the exercise of determining when the RCA decision shall be implemented, the Promotion of Administrative Justice Act, 2000 (Act No. 3 of 2000) (‘PAJA’) principles deciding on the administrative action compels NERSA to ensure that stakeholders that will be impacted by the decision must be consulted, so that the decision is appropriately insulated from potential challenges.

3.4 In performing its mandated functions, NERSA is required to ensure that the following objectives are achieved:

a) The efficient, effective, sustainable and orderly development and operation of electricity supply infrastructure in South Africa.
b) The interests and needs of present and future electricity customers and end-users are safeguarded and met, having regard to the governance, efficiency, effectiveness and long-term sustainability of the electricity supply industry within the broader context of economic energy regulation in the Republic.
c) Investment in the electricity supply industry is facilitated.
d) Universal access to electricity is facilitated.
e) The use of diverse energy sources and energy efficiency is promoted.
f) Competitiveness, customer, and end-user choice are promoted.
g) A fair balance between the interests of customers and end-users, licensees, investors in the electricity supply industry and the public is facilitated.

3.5 Since the implementation plan is integral to the completion of the RCA process, it is critical to emphasise the empowering provision of the law that could test the rationality and lawfulness of the decision. As highlighted earlier, the consideration of the implementation plan is not a stand-alone process, but a process aimed at finalising the RCA approval process.

3.6 NERSA is obligated by the ERA, as the custodian and enforcer of the regulatory framework within the electricity supply industry, to ensure, among others, that the interests and needs of present and future electricity customers and end-users are safeguarded and met, having regard to the governance, efficiency, effectiveness and long-term sustainability of the electricity supply industry within the broader context of economic energy regulation in the Republic and facilitate a fair balance between the interests of customers and end-users, licensees, investors in the electricity supply industry and the public.

3.7 NERSA derives its mandate to develop this implementation plan from the provisions expounded above. The implementation plan is also developed to ensure the rationality of the decision. NERSA would be remiss to its obligation in observing the rule of law and its decision would be rendered irrational if the consultation paper does not detail the information considered in arriving at the implementation decision, and show that the decision was not taken by having placed undue weight on irrelevant matters and ignoring that which the law obligates NERSA to consider.

3.8 Failure to reflect all these characteristics may expose the decision to judicial review. In recent court proceedings and with reference to the liquidation of the MYPD3 RCA for the 2014/15, 2015/16 and 2016/17 financial years, Eskom has criticised the model of spreading the implementation of RCAs over various years as tantamount to just ‘kicking the can down the road’. In other words, the postponement of the collection of revenue due will burden the customers in the long run and continue to cause harm to Eskom, because the RCA relates to costs that have already been incurred (liquidity challenges). This view is treated with extremely guarded focus arising from the obligation placed on NERSA of ensuring that the economy of the country, end users and neighbouring countries are not expose to hardship because of unaffordability and other social ills.

3.9 Rational regulatory discretion and exercising of mandated powers, which insulate the decision taken by NERSA, are distinct from an exercise of arbitrariness. It is incumbent on NERSA, when considering the implementation plan, to take note that this decision does not only affect the person or public in terms of the PAJA. When making its decision, NERSA is also required to afford affected persons the opportunity to submit their views and present relevant facts. This procedural legal guard is cognisant of the fact that circumstances may change in the exercising of administrative powers.

3.10 To establish flexibility, the PAJA details considerations that NERSA should evaluate its intent against, if it intends to deviate from observing the constitutional requirement to afford a person an opportunity to submit comments prior to the decision being taken. The requirements are:

a) the objects of the empowering provision;
b) the nature, purpose and likely effect of the administrative action concerned;
c) the urgency of taking the administrative action or the urgency of the matter; and
d) the need to promote an efficient administration and good governance.

3.11 NERSA is unable to ensure that there are objective justifications to enable it to deviate from the procedural requirement, and any attempt to be creative around the principle will be contrary to the standing of NERSA in its role as the custodian of the regulatory framework and the expectation that its performance should, at all times, satisfy the objects of the NERSA Act.

3.12 This consultation paper is the first phase of the stakeholder engagement process. It may culminate in the second phase of consultation, which will be the conducting of public hearings. The decision on the latter will have to be made after the consideration of the comments received.

4. DEVELOPING THE IMPLEMENTATION PLAN

4.1 In developing the implementation plan for the RCA balance, the following key issues and principles were considered:

a) The affordability test was considered in light of the consumers and stakeholders' potential capacity to afford the proposed increase per scenario. High inflation imposes costs to the economy and uncertainties about future inflation increase this risk, which results in a decrease in possible business investments. Therefore, a simple purchasing power comparative analysis was done relative to forecast inflation as a benchmark.

b) A sustainability test was done as part of the utility's financial analysis. Given the utility's interconnectedness within the electricity industry, its sustainability is also key with regard to public interest. How efficiently the utility employs its assets and its financial leverage were assessed. The sustainability test is driven by ratio and cash flow analysis. The following ratios were analysed:

   i. The earnings interest coverage ratio was assessed to examine the ease with which the utility can meet its interest payments, which is also an indicator of the degree of risk associated with its debt policy.

ii. The debt-service coverage ratio (DSCR), which is a measure of the cash flow available to pay current debt obligations, was also estimated.

c) The impact of the RCA balance liquidation was also viewed, taking into account the economic impact. This was viewed from a macro-economic perspective, which takes into account the Gross Domestic Product (GDP), inflation, households' income, as well as employment.

d) The impact of the COVID-19 pandemic on the South African economy was also taken into consideration. The pandemic has affected most countries around the world.

4.2 During the past nine months, the emergence and spread of COVID-19, the disease caused by SARS-COV-2, has caused an unprecedented global economic and social crisis. The COVID-19 pandemic has significantly affected all aspects of everyday life; as a result, it has translated into a global economic crisis.

4.3 The rapid spread of COVID-19 encouraged countries around the world to implement lockdown restrictions (social distancing), which led to the shutdown of financial markets, corporate head offices, businesses (large firms and small, medium and micro enterprises [SMMEs]) and important events. The lockdown restrictions imposed sent economic output crashing, caused financial market panic and curtailed travel (domestic and international), leisure and social lives more severely than many wars have.

4.4 There is a consensus among economists that the national lockdown restrictions implemented during the National State of Disaster to control the spread of COVID-19 and lessen the pressure on national public health infrastructure, exacerbated a deeper recession in South Africa. This pandemic emerged at a time when the South African economy was already in its longest downward business cycle since records started in 1945, with rising unemployment and inequality, declining real GDP per capita, and declining business confidence. Economic forecasts suggest that this could be worse due to the effects of the COVID-19 pandemic, which has disrupted global supply chains, and deferred investment decisions.

4.5 The shock 51% GDP collapse in the second quarter of 2020, following a decrease of 2.1% in the first quarter on 2020, is the biggest quarterly fall in economic activity since the first quarter of 2009 when the economy was affected by the global financial crisis. The biggest negative contributors to growth in GDP were the manufacturing (-10.8%), trade (-10.5%) and transport (-6.6%) sectors, followed by other sectors such as mining (-6%) and finance (-5.4%).

4.6 The uncertainty about the economic recovery, as lockdown restrictions are eased, suggests that the economic outlook for 2020 may even be worse than the latest National Treasury and South African Reserve bank forecasts of -7% and -8.2% in 2020 GDP, respectively. It is expected that economic activity will further decline once the widespread effects of the shocks to the economy have been quantified beyond the 2020 second-quarter performance. Some economists are predicting an even worse outcome with a double-digit GDP reduction in 2020.

4.7 The COVID-19 pandemic is also projected to increase poverty and inequality in South Africa, mainly through lower incomes and higher prices. Estimates suggest that an additional 3.5 million people have been falling into poverty since the beginning of the national lockdown restrictions in March 2020.

4.8 It should be noted that the increasing unemployment (up from 29.1% in December 2019 to 30.1% in March 2020) and inequality due to the pandemic may prevent many electricity consumers (for example, low-income households) from paying their electricity bills. According to a Statistics South Africa (StatsSA) survey report on the impact of the COVID-19 pandemic on employment and income in South Africa (StatsSA, May 2020)[1], 8.1% of respondents reported that they lost their jobs or had to close their businesses and 1.4% became unemployed. Furthermore, StatsSA reported that the percentage of respondents who reported no income increased from 5.2% before the lockdown to 15.4% by the sixth week of the national lockdown.

4.9 The delays and non-payment of electricity bills by consumers (residential, commercial and industrial) will have a detrimental effect on the entire energy supply chain in South Africa. There is an urgent call for the government to implement targeted and flexible measures to support workers and businesses, particularly SMMEs and those in the informal economy, as well as others that are vulnerable.

4.10 Overall, there is an increasing risk that the worsening macro-economic challenges, which are exacerbated by the effects of the COVID-19 pandemic and rising electricity prices, will drive more electricity consumers (industrial, commercial and residential) into default (unaffordable electricity) and ultimately affect the sustainability of Eskom. There is no doubt that the

[1] http://www.statssa.gov.za/publications/Report-00-80-03/Report-00-80-03May2020.pdf

rebound of key economic sectors such as manufacturing, trade, transport, mining and construction from negative growth will be underpinned by the costs of electricity and reliability of supply.

4.11 NERSA is considering the following three implementation options:

a) The liquidation of the RCA balance in one year.

b) The liquidation of the RCA balance over two years.

c) The liquidation of the RCA balance over three years.

4.12 Table 3 below summarises the results of the criteria used for the selection of the option to use for the implementation of Eskom's RCA balance.

Table 4: Summary of tested key issues and principles

Categories	Option 1	Option 2		Option 3		
	2021/22	2021/22	2022/23	2021/22	2022/23	2023/24
Proposed Electricity tariff increase(%)	11,23	8,12	-0,81	7,08	-0,82	-3,43
Potential Sustainability impact						
Interst cover	2,56x	2,37x	2,3x	2,3x	2,23x	1,89x
Debt cover	1,81x	1,67x	2,3x	1,62x	2,24x	1,57x
Potential Economic impact						
Impact on households(CPI)%	0,91	0,65	-0,06	0,56	-0,06	-0,25
PPI (%)	0,90	0,64	-0,06	0,56	-0,06	-0,24
Impact on GDP (R'm)	-13 778	-10 886	3 230	-9 939	3 228	1 277
Impact on investments (R'm)	-17 712	-13 994	4 152	-12 777	4 149	1 641
Impact on employment (Job opportunities)	-11 737	-9 273	2 752	-8 467	2 750	1 088

Option 1: Liquidating the Balance in One Year

4.13 Under option one, the impact of liquidating the RCA in one year reflects a 11.23% increase that will be recovered by Eskom from its customers. However, this is not affordable to consumers, as it is considerably higher than inflation forecasts. The increase will have a relatively material impact on the sustainability of Eskom's financial performance. The sustainability test outcomes are at 2.5x on interest cover ratio and 1.8x debt cover ratio, showing that Eskom will be relatively highly sustainable. However, the economy is also adversely affected by this option, as can be seen with an increase of 0.91% in both the Producer Price Index (PPI) and Consumer Price Index (CPI) (see Table 4above.

Option 2: Liquidating the Balance over Two Years

4.14 Under option two, the impact of liquidating the RCA over two years translates to an increase of 8.12%, which is above inflation in 2021/22 and will be recovered by Eskom from the customers. However, this becomes relatively affordable to consumers in the second year when the increase drops to -0.81%, which is below inflation expectation due to assumed constant revenue and sales volume. Furthermore, the household income, as compared to option one, on average, will not be adversely affected. It will have a reasonably positive impact on Eskom's sustainability; at 2.3x on interest cover and 2x on debt ratio (see Table 4). Option two has a relatively reasonable impact on affordability. It allows the power utility to be sustainable and, with regard to economic impact, its increase still has the ability to boost the productive capacity in the economy when compared to option one.

4.15 Option two also allows the RCA balance to be recovered in line with the MYPD4 control period, although it overlaps by one year. This decreases the risk of higher initial price impact for the MYPD5 period unlike option three, which will be recovered beyond the MYPD4 period by more than one year, thereby increasing the electricity prices. When comparing option two to option three, option two is more desirable as it allows revenues to be recovered within the MYPD4 control period although its affordability and economic impact are higher than those in option three.

Option 3: Liquidating the Balance over Three Years

4.16 Under option three, the impact of liquidating the RCA over three years is a 7.08% increase in 2021/22 that will be recovered by Eskom from its customers. This is affordable for consumers when compared to options one and two. Although this option provides the least impact on CPI, relative to option two there is no significant difference. However, given Eskom's liquidity challenges, this option will increase its liquidity risk exposure, which will have an unintended consequence for Eskom's financial risk. Option three has the least impact on affordability and on the economy, but the most impact on sustainability. The interest cover ratio and the debt ratio show decreases when compared to option two to a point where Eskom will not be able to cover its interest payments in 2023/24. Since this option evenly smooths out the RCA balance over a reasonable period, it eases the upward pressure on inflation and supports the consumers' level of affordability. This option spreads the RCA outside the MYPD control period, which will adversely affect the MYPD5 revenue determination and future RCAs. Under this option, the RCA balance will be distributed unevenly between the known (2021/22) and the unknown (2022/23).

5. LIST OF STAKEHOLDER QUESTIONS

Stakeholder comment 1: *Stakeholders are requested to comment on the best possible option to implement the R13 271m RCA balance, taking into account economic and financial impact.* ***Stakeholder comment 2:*** *Stakeholders are requested to comment on any other issues relevant to the matter and substantiate their answers.*

5.1 NERSA will collate all comments received from the consultation process, and these will be taken into consideration when the decision is made. The process for consultation and decision-making is outlined in the table below.

Table 5: Indicative timelines

Activity/Task	Date
Recommendation for approval of publication of the consultation paper by ELS to ER	18 September 2020
Approval of the publication of the consultation paper on Eskom's implementation plan for the 2018/19 RCA for stakeholder comments (ER)	29 September 2020
Publish consultation paper on the NERSA website	30 September 2020
Closing date for stakeholder comments on the implementation plan	30 October 2020
Public hearing on implementation (National virtual hearing)	02 November 2020
Recommendation for approval of the implementation plan by ELS to the Energy Regulator	11 November 2020
Consultation with Eskom prior ER decision	12 November 2020
Energy Regulator decision on implementation plan	26 November 2020

5.2 Stakeholders are requested to comment in writing on the consultation paper on the implementation plan. Written comments can be forwarded to mypd@nersa.org.za; hand-delivered to Kulawula House, 526 Madiba Street, Arcadia, and Pretoria; or posted to PO Box 40343, Arcadia, 0083, Pretoria, South Africa. The closing date for the submission of comments is **30 October 2020** at **16:00**.

5.3 For more information and queries on the above, please contact Mr Thilivhali Nthakheni or Ms Tabisa Nkopo at the National Energy Regulator of South Africa, Kulawula House, 526 Madiba Street, Arcadia, Pretoria.
Tel: 012 401 4600
Fax: 012 401 4700

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