O'Keefe & Swartz Building,
318 Oak Avenue, Randburg
PO Box 2627, Northriding, 2162
+27 (87) 170 0639 • info@outa.co.za
www.outa.co.za

OUTA Submission to NERSA on Eskom's third multi-year determination (MYPD3) Regulatory Clearing Account (RCA) applications for year 2 (2014/15), year 3 (2015/16) and year 4 (2016/17) totalling R66.6 billion

Prepared by Ronald Chauke – Organization Undoing Tax Abuse (OUTA)

(Email: ronald.chauke@outa.co.za)

23 March 2018

1. EXECUTIVE SUMMARY

1.1 The Regulatory Clearing Account (RCA) application by Eskom is premised on its performance and revenue under-recovery during the 2014/15, 2015/16 and 2016/17 control period within the third multi-year price determination (MYPD3), amounting to R66.6bn which translates into (R19.19bn, R23.63bn and R23.87bn) respectively.

1.2 During the same period, Eskom performance in all its key indicators is characterised by poor internal controls and weak corporate governance that form the nucleus of the current Parliamentary Inquiry into State-owned Enterprises led by the Portfolio Committee on Public Enterprises. This will be further unravelled by the Commission of Inquiry into State Capture already appointed and has commenced its work under Deputy Chief Justice Chris Ngcobo.

1.3 OUTA undertaken comprehensive analysis of Eskom performance indicators and is of the opinion that Eskom does not deserve to be compensated the R66.6bn it is claiming through the RCA due to more than R250bn (attributable to the cost of corrupt practices) since 2010 to date.

1.4 OUTA recommends a zero percent **(0%)** clawback by Eskom and instead, strongly proposes that NERSA should cushion electricity customers by not granting any approval for electricity price above the 5.2% effective on 01st April for the 2018/19 control period.

1.5 Primary energy costs escalated from R18bn in 2007 to more than R82 billion in 2017, which is equivalent to a more than 500% increase. OUTA is of the opinion that this is the breeding ground for corruption as it also includes the R11.7bn coal supply contract awarded in 2015 to the Gupta-owned Tegeta Exploration and Resources currently under business rescue.

1.6 Staff cost complement is too high at 47 000 and this requires urgent attention, by either instituting gradual reduction over a pre-determined time period, e.g. over a 3 year cycle to get Eskom to be in line with World Bank utility benchmarks.

1.7 In order to improve performance, regulatory deficiencies must be eliminated and NERSA must apply prudency testing effectively and shortcomings of the MYPD Methodology addressed.

1.8 In making its decision, NERSA must take into account the fact and reality that Eskom has been experiencing major structural challenges that are embedded in the vertically integrated utility's current business model and this can't be addressed by merely raising tariffs, but requires a holistic approach driven by government, preferably led by the Presidency to eliminate jurisdiction clashes among sector departments within the electricity supply industry (ESI)".

2. INTRODUCTION

2.1 This document serves as the Organization Undoing Tax Abuse's (OUTA's) submission to the National Energy Regulator of South Africa (NERSA) on the published Eskom's Regulatory Clearing Account (RCA) applications for the last 3 years of the MYPD3.

2.2 OUTA appreciates NERSA's role in accordance to its mandate provided for in the Electricity Regulation Act, 2006 (Act No. 4 of 2006) stipulating under section 4(ii) that *"the Energy Regulator must regulate electricity prices and tariffs".*

2.3 As a civil society organization, OUTA understands and is aware of the complexities associated to the regulation of this largest electricity utility in Africa from an over and under recovery perspectives as part of its operations.

2.4 OUTA believes that Eskom's Multiple RCA Applications over three years (2014/15, 2015/16 & 2016/17) of R66,6bn should not be granted in its entirety and the basis of our reasoning is provide in the detail of this submission.

3. CONTEXT

3.1 Eskom lodged its RCA applications in in accordance with section 14.2.1 of the MYPD Methodology. Eskom is claiming that it suffered revenue under-recovery and higher primary energy costs to meet demand, whilst operating in an electricity system during the periods under review.

3.2 The alleged revenue under-recovery during the 2014/15, 2015/16 and 2016/17 control period within the third multi-year price determination (MYPD3), amounted to R66.6bn which translates into R19.19bn, R23.63bn and R23.87bn respectively.

3.3 The information contained in Eskom's RCA applications is sourced from the audited annual financial statements relating to the years of their application.

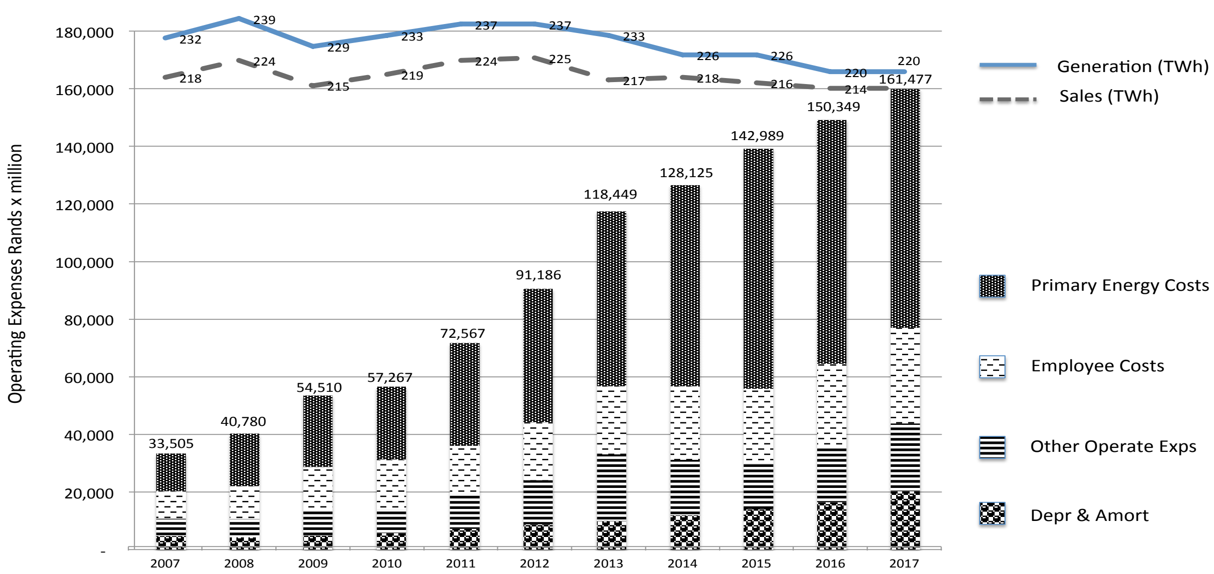
3.4 Eskom also uses NERSA's RCA reasons for decision as published from the preceding financial years as its basis for reconciliatory purposes.

3.5 Eskom's revenue comprises of electricity and non-electricity revenue. The electricity revenue is derived from 3 customer categories, namely: standard tariffs, local special pricing agreements and exports (international) customers.

3.6 In terms of the MYPD Methodology and complemented by the NERSA decision, Eskom's allowable revenue is aimed at recovering variable costs (mainly primary energy) and fixed costs (operating costs + depreciation + returns) and the process allows Eskom to continue to incur these costs, regardless of whether its sales volume increases or decreases. OUTA is of the opinion that Rule 5.4.1 the MYPD methodology relating to qualifying criteria of expenses is grossly flawed, as it doesn't curb or minimise expenses, which could be ill-conceived or related to maladministration and / or corruption. It thus allows for prior year inefficiencies and undue expenses to be perpetuated into the future.

3.7 As sales volumes increase or decrease, there would (or at least should) be a concomitant increase or decrease in operating costs. The key cost reflected in the operating costs in the table below, which reflects the variable costs related to primary energy.

ESKOM Operating Costs vs Generation Output



3.8 As per the MYPD regulatory rules, operating and maintenance costs are not included in the determination of the RCA balance and therefore not subject to RCA variance analysis. Thus, higher expenditure on operating and maintenance (O&M) costs in the current MYPD Methodology cannot be recovered through the RCA by Eskom.

3.9 Fixed costs include interest and debt repayments, which are represented by the return on assets and depreciation in the building blocks of the allowed revenue for regulatory purposes.

4. SPECIFIC COMMENTS, CONCERNS AND OBJECTIONS

4.1 OUTA believes there is insufficient transparency in the disclosure of the primary energy components and the associated costs, which does not allow or enable the stakeholders to conduct in-depth analysis and comment objectively on the true costs that should be recouped as part of the RCA.

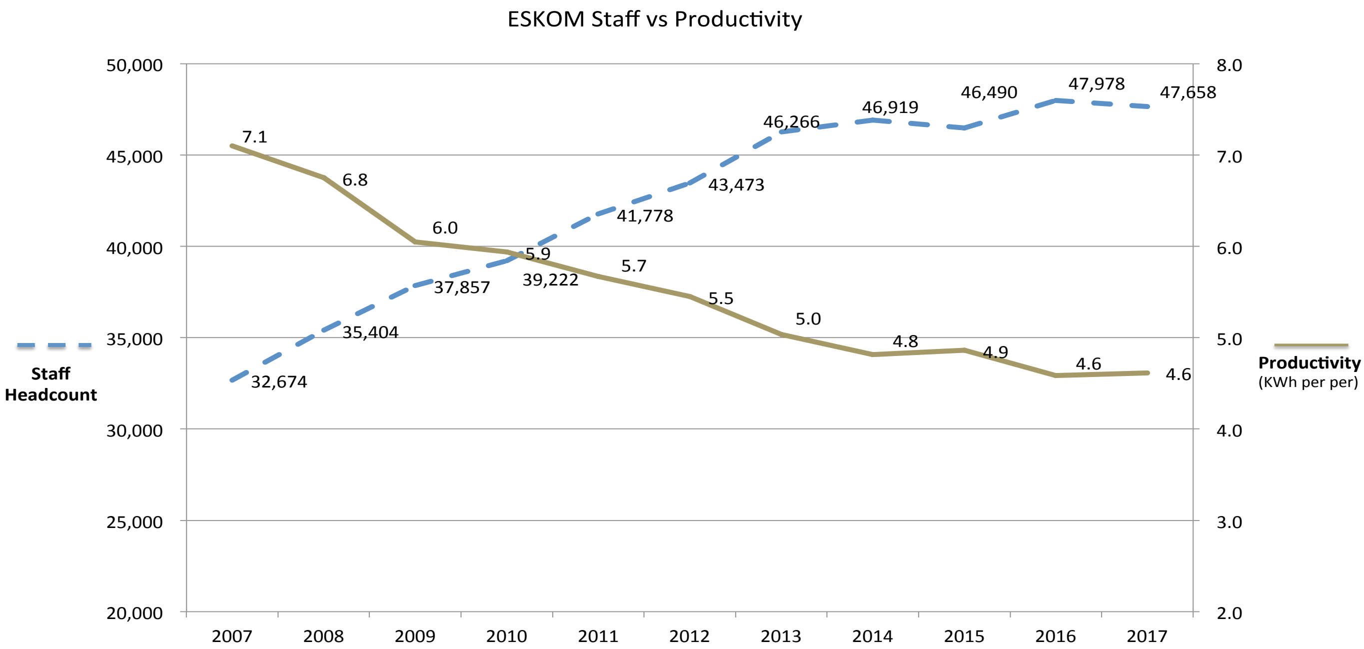
4.2 Eskom must provide its cost reduction scenarios and their impact on its business, and must be submitted to NERSA for monitoring. This appears to be absent and in the interest of the RCA prudency and accountability.

4.3 The clear outline of personnel and the associated skills for the regulated business vs the non-regulated business, are not provided. The aggregated personnel costs that are applied for in the RCA therefore fails the test of compliance to best practise.

4.4 The impact of plant removed from service due to partial load losses (technical problems, such as boiler tube leaks, silo breakdown) is not disclosed and correlated to coal consumption.

4.5 The expiry and introduction of coal contracts, more so the long-term contracts have not been disclosed, making it difficult for stakeholders to provide objective inputs and analytical comments on these RCA applications or give hope for future prospects for the procurement of cheaper coal sourced from competitive bidding process.

4.6 Eskom's personnel **productivity** has declined by 35%, from 7,1 to 4,6 KWh per person per annum from 2007 to 2017, as a result of increased staff / headcount from 32,674 to 47,658 over the same period, whilst output remained relatively flat over the same period (see table below).



4.7 The MYPD Methodology does not place a cap once the determined revenues are recouped from an RCA. Eskom therefore continues to levy the high price regardless of whether the set quantum of the revenue is achieved, leading to an *unintended' windfall*.

4.8 The transparency of coal procurement remains hidden. For instance, Eskom partially owns some of the fixed cost mines that are supplying its power stations, and this is not separately reported to give the public a clear picture of Eskom's involvement in the coal mining and its influence on pricing.

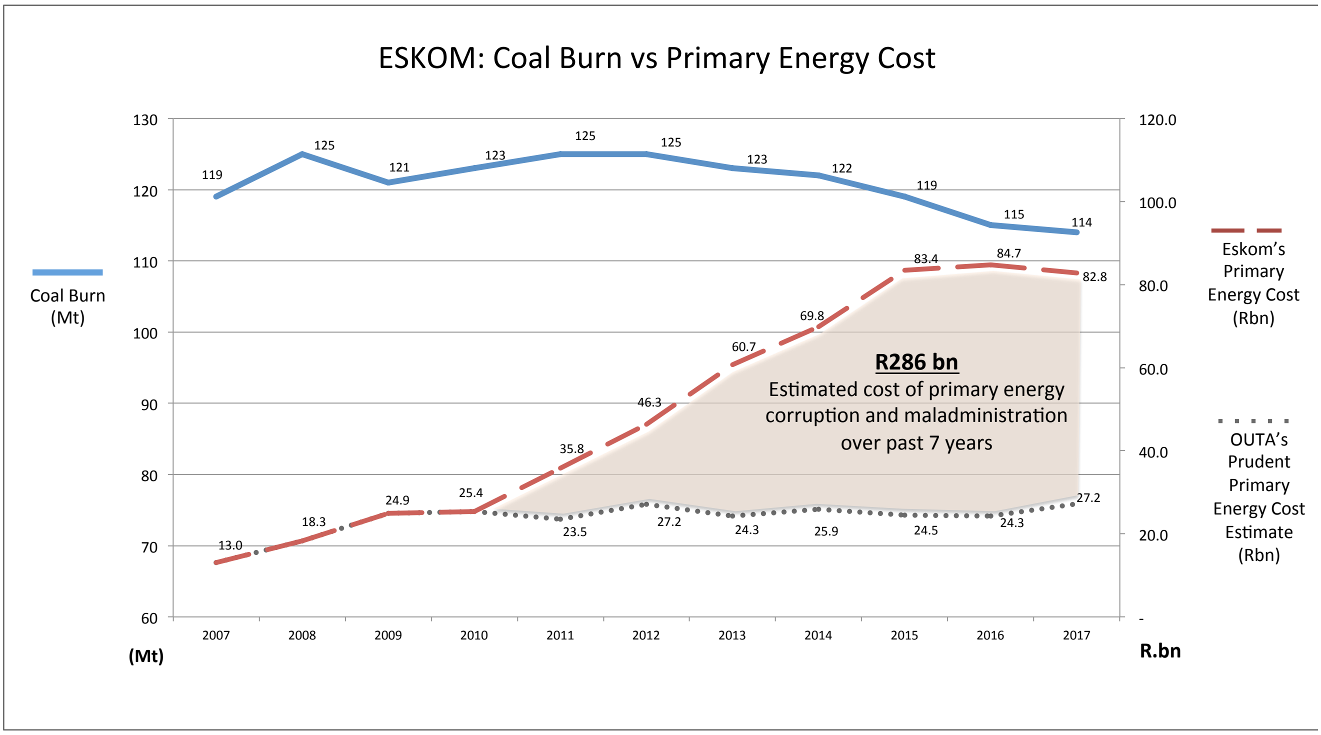
4.8.1 The following is not disclosed or accounted for:

- Value and quantity of fixed assets such as mining equipment & machinery, etc.
- % Ownership of particular mines.
- % Return on investment in those mines.
- Special agreements signed.
- Pricing arrangements and its impact on primary energy pricing.

4.9 Primary energy breakdown

4.9.1 Procured volume of coal purchased vs coal burnt. The Stakeholders need to understand what volume lies in stockpiles and what quantity might be lost. The applications are silent on this issue.

4.10 The graph below depicts coal burn versus primary energy costs, hence, the growth in primary energy costs entails a combination of a number of factors such as CPI, transport costs, etc. However, OUTA is seriously concerned about the astronomical increase from R18bn in 2008 to a large R84bn in 2017 compared to static coal burn rate remains a mystery. OUTA's analysis attributes this phenomenon to the cost of corruption, which it estimates to have grown to more than R280bn since 2007 to date.



ORGANISATION UNDOING TAX ABUSE (OUTA)
Co Reg: 2012/064213/08 NPO #: 124381NPO
DIRECTORS: Wayne L Duvenage, Leopold J J Pauwen, Benjamin Theron
NON EXECUTIVE DIRECTORS: Phumlani M Majozi, Ms Ferrial Adam (Chair)

4.11 Cost of Coal

4.11.1 Eskom disclosed in its RCA submission that approximately **28%** of coal for FY17 was sourced from long term fixed price contracts against a plan of **33%**. None of the existing contracts are impacted on directly by the price of export coal.

4.11.2 The "cost plus" mines provided approximately **33%** of the coal procured in FY17 against the plan of **35%**. The unit price (R/ton) will be the total cost of operating that mine for that period divided by the production volumes. The export price has little direct impact. OUTA is surprised why coal prices are rising at such alarming rates against the above backdrop.

4.12 Coal purchases

4.12.1 The average price Eskom pays for coal is determined by the volume of coal procured from each type of contract [cost plus, fixed price and short-term/medium-term (ST/MT) and the price of coal from each type of contract, comprising average ST/MT costs of R458/t, Cost plus costs of R388/t and fixed price costs of R262/t.

4.12.2 OUTA is concerned about this allowance as per the MYPD Methodology, because it averages (aggregates) the various input cost components in coal prices culminating in distorted pricing which can easily translate into over- or under-pricing. In case of over-pricing, this can lead to corruption like how the Gupta-linked Tegeta Exploration and Resources secured premium-priced coal contract.

4.13 Assumptions used

4.13.1 Eskom of its own admission in the RCA submissions disclosed that some of its assumptions were not accurate at the point of the MYPD3 application submission to NERSA.

4.13.2 OUTA is concerned about the reliability of the assumptions applied for the MYPD3 and RCA applications, as these tend to be out-dated, while Eskom uses the high ratios to estimate its numbers for submission to NERSA at any given point in time.

4.13.3 *Analysis of Assumptions used for 2015/16 RCA*

a) Sales forecast average growth of 2% p.a. assumed with a starting value of 222 756 GWh in March 2013 reaching 239 113 GWh by March 2016 in accordance to the MYPD3 application.
   - Actual Sales growth averaged a reduction of 0.25% from a starting value of 217 022 GWh in March 2013 to 214 601 GWh in March 2017

b) At the time of the MYPD 3 application, the extent of the IPP programs were not envisaged and additional IPP purchases were required to prevent load-shedding as a cheaper option than OCGTs.
   - Who should bear the costs of this omission?

c) Staff costs – complement of 43 000 growing to 46 000 (by 31 March 2016). Revised staff outlook decreasing staff complement to 41 020 by FY 2018
   – OUTA analysis reveal that the assumption on this item was low, compared to the actual headcount as at January 2018, standing at more than 47 000, casting doubt on the accuracy of these assumptions.
   – Eskom is experiencing liquidity challenges, but the headcount is continuing to balloon, this doesn't make business sense.

4.14 MYPD Methodology shortcomings

4.14.1 The change in RAB is determined in terms of rule 6.7.2.3 of the MYPD Methodology as shown below.

"Eskom will annually report to the Energy Regulator on its capital expenditure programme, providing information on timing and cost variances".

- OUTA: that's why build programme has exorbitant run-away cost overruns…it is not closely or regularly checked by NERSA, it should at least be quarterly monitored & reported to ensure prudency and efficient capex execution).

4.14.2 **Coal Costs**

4.14.3.1Coal will be treated as a single cost centre without differentiating between the various coal sources (for example cost plus contracts, fixed price contracts, short-term contracts and long-term contracts).

- According to OUTA, the above practice creates a problem of aggregation while different prices are paid by Eskom to different mining houses, these is a breeding ground for corruption and prices that could be detrimental to economic development and create barriers of entry into the industry (anti-competitive behaviour could result).

4.14.4 Update of Assumptions

4.14.4.1The methodology is not explicit on how outdated assumptions should be used and at what interval should updated data inputs should be used to do necessary revisions.

4.15 Cost overruns

14.5.1 Eskom Company capital expenditure of R58 924 million exceeded the NERSA decision of R46 655million by R12 269 million in 2016/17. The variance is attributable to higher costs incurred for new build projects, outage capital costs and partially reduced by lower expenditures incurred for the Transmission and Distribution networks; following Eskom's capital expenditure reprioritisation process.

14.5.2 **New Coal Build Project Costs Overruns** at Medupi, Kusile and Ingula have become untenable. Despite Eskom's RCA reference to the cost overruns of R6,1bn at Medupi and R14,7bn at Kusile and R1,6bn at Ingula these projects were originally budgeted and presented to NERSA as being R69.1bn, R80,6bn and R8,9bn respectively. The fact that the capital expenditure of these projects has escalated to around R195bn, R225bn (for Medupi and Kusile which are still incomplete), plus R36bn for Ingula at completion.

OUTA objects to these excessive and grossly exorbitant cost overruns on these projects, which have now become a heavy burden to the consumer and the tax-payer. We therefore recommend that NERSA should exercise rigorous regulatory oversight on this matter and take account of the compounded impact of these overruns (when compared to from the original budget), which is attributed to Eskom's own doing. This is a matter and cost that cannot continue to be passed on to the consumer and shouldn't be credited to Eskom's account.

4.16 Unscrupulous claims against the RCA by applicant

OUTA is of the view that Eskom is using the RCA as its own *'slush fund'*, implying that whether its internal controls are effective or not, Eskom behaves in a manner that it will claim back whatever losses it incurs an under-recovery by inflating the initial request to NERSA, knowingly that it will get something out of it if not all. NERSA has to vigilantly guard against such anomaly by rigorously analysing Eskom's RCA applications.

4.17 Employee benefits

4.17.1 In terms of the 2016/17 RCA application, actual staff costs have exceeded the MYPD3 decision due to higher salary settlement of 8.5% compared to decision assumption of 5.6%, and starting point for the staff costs base being referenced to MYPD2 decision.

4.17.2 The difference in staff costs is attributable to the starting point where NERSA used the MYPD2 revenue decision, made in 2009, as their reference for making the MYPD3 decision. Allowance was not made for the changes that occurred between the MYPD2 revenue decision and the actuals during MYPD2. Hence the starting point was too low, thus contributing to the difference included in the RCA.

- OUTA rejects this behaviour by Eskom of applying increases in excess of the inflation related salary adjustment.

ORGANISATION UNDOING TAX ABUSE (OUTA)
Co Reg: 2012/064213/08 NPO #: 124381NPO
DIRECTORS: Wayne L Duvenage, Leopold J J Pauwen, Benjamin Theron
NON EXECUTIVE DIRECTORS: Phumlani M Majozi, Ms Ferrial Adam (Chair)

5. RECOMMENDATIONS

OUTA recommends that:

5.1 NERSA must **NOT** grant approval to Eskom's RCA applications for the periods 2014/15, 2015/16 and 2016/17 control period under MYPD3 (i.e. **0% tariff adjustment**).

5.2 NERSA must seriously consider reviewing the MYPD Methodology to ensure that checks and balances are incorporated into the mechanism, in order to prohibit excessive revenue recovery under the RCA in future by the applicant (i.e. Eskom) and address shortcomings relating the use and updating of assumptions.

5.3 NERSA should review progress and monitor expenditure on a QUARTERLY basis pertaining to the build programme in contrast to the MYPD Methodology provision for Eskom to report annually on its performance relating to its infrastructure expansion programme. This will prevent the year on year inefficiencies and possible corruption to be perpetuated into the following year.

- In essence, we need NERSA and Eskom, to go back to the base year of 2007, and calculate what the costs of primary energy, staff and other pertinent costs should be today, in order to be classified as an efficient organisation.

5.4 Eskom must be required to report on its coal mining assets (capital) ownership and their market value separately.

5.5 NERSA should issue an instruction for Eskom to develop and submit a holistic coal procurement strategy and disclose associated pricing agreements as well as any special costing/pricing arrangements with particular mining houses so that the true costs of coal are reflected rather than aggregated without outlining the related input parameters.

5.6 NERSA should amend the MYPD Methodology to incorporate the separate reporting and accounting for different coal procurement and price implications on the final tariff.

5.7 NERSA must apply 'heavy-handy regulatory' approach when dealing with Eskom, especially on its RCA applications to minimise the negative implications on the economic and minimise the cost of doing business.

5.8 In exercising its regulatory oversight, NERSA must request a written commitment from the Eskom board to ensure there are set compliance parameters that must be adhered to any given control cycle/period from both regulatory and corporate governance point of view to minimise Eskom's reliance on the RCA process.

Ronald Chauke
Ronald.chauke@outa.co.za