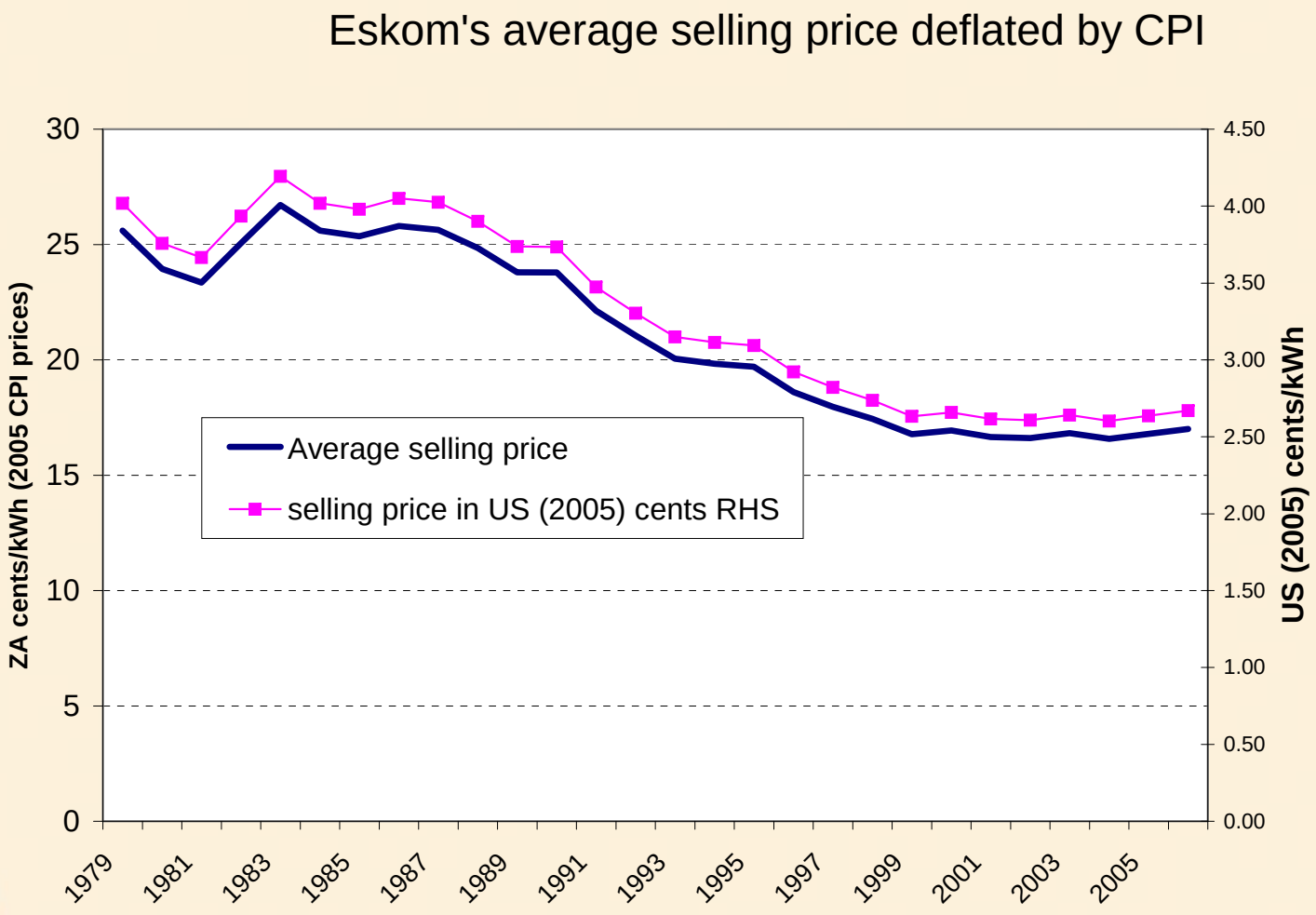
South Africa: Electricity Pricing Considerations

Presentation at the National Electricity Summit

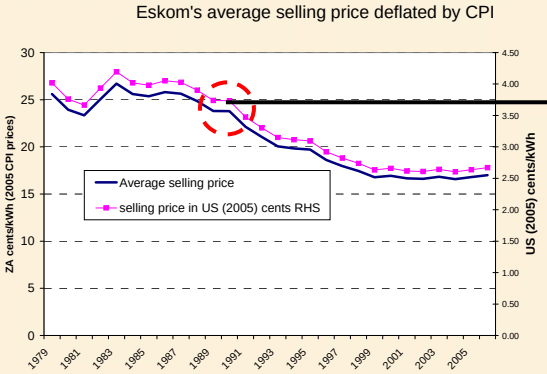
16 May 2008

Eskom Application for a Review of the 2008/9 Price Increase in Context

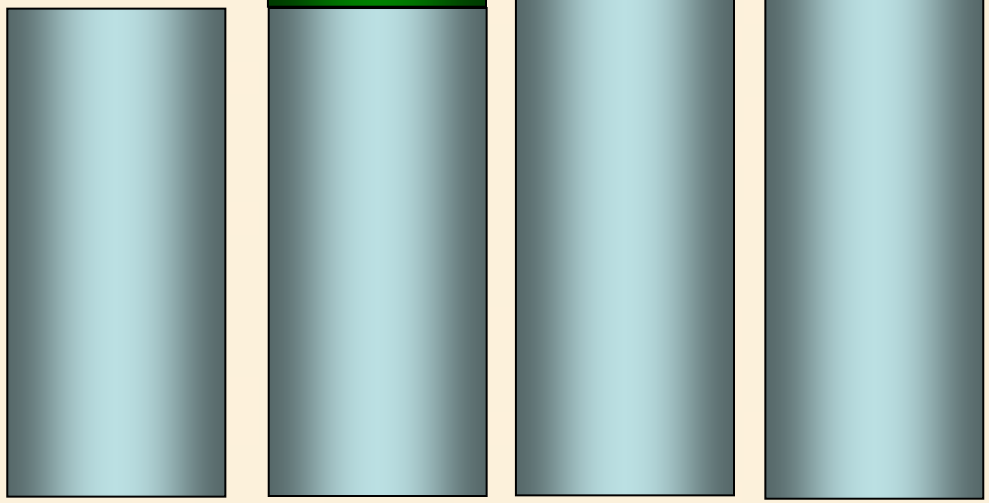
As a result Eskom's Average Selling Price has been declining



If prices kept up with inflation alone since 1990, this would translate to a tariff level close to what is achieved with a 60% increase in 2008/09



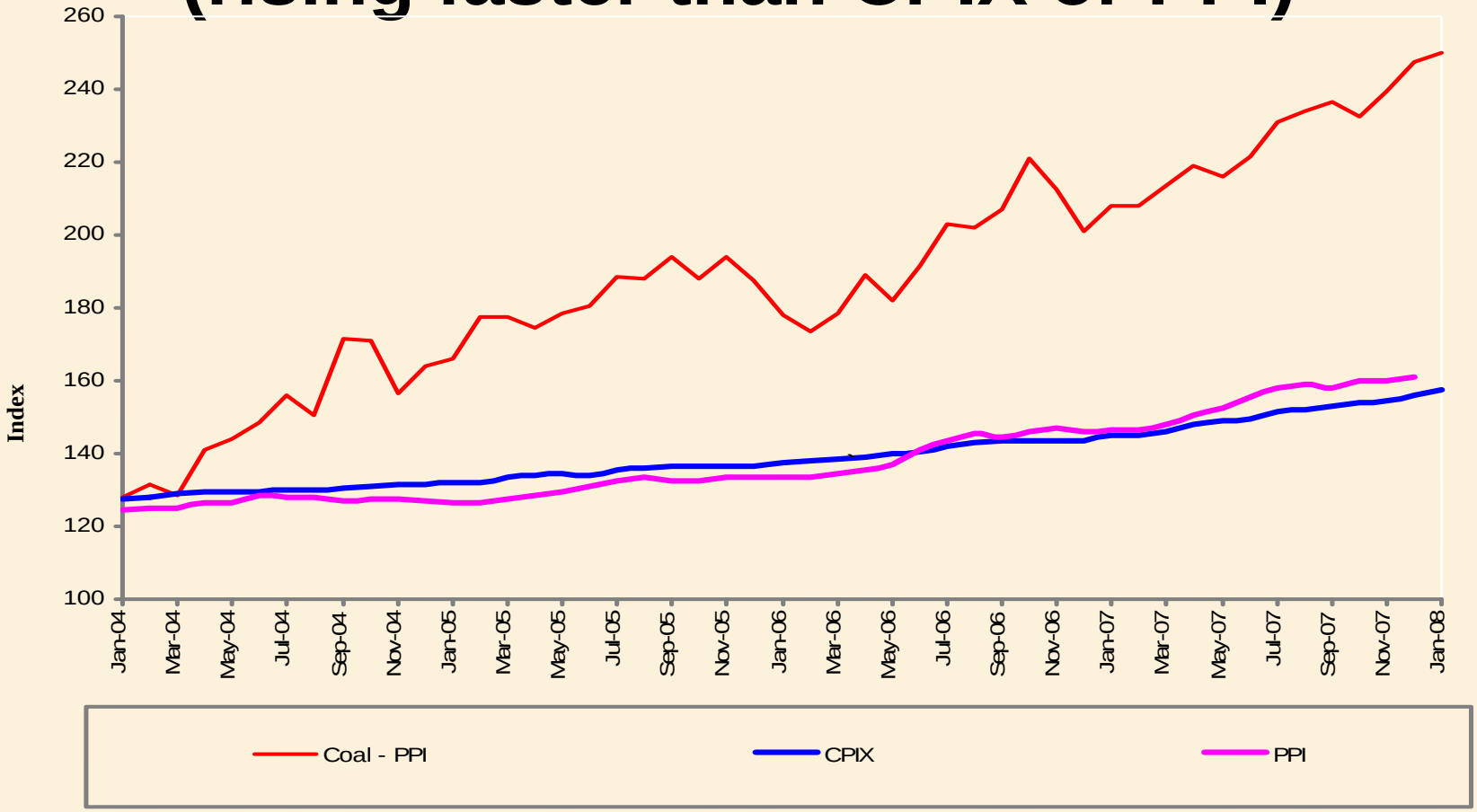
The resultant tariff is within 7% of what is currently requested by Eskom



Input Costs

- Coal and Diesel form a large part of Eskom's input costs
- Prices of these two Primary Energy sources have been rising at a rate much higher than inflation whilst Eskom's prices have been declining in real terms
- Input Costs have been rising at a rate higher than inflation vs. Eskom's price which has been declining in real terms

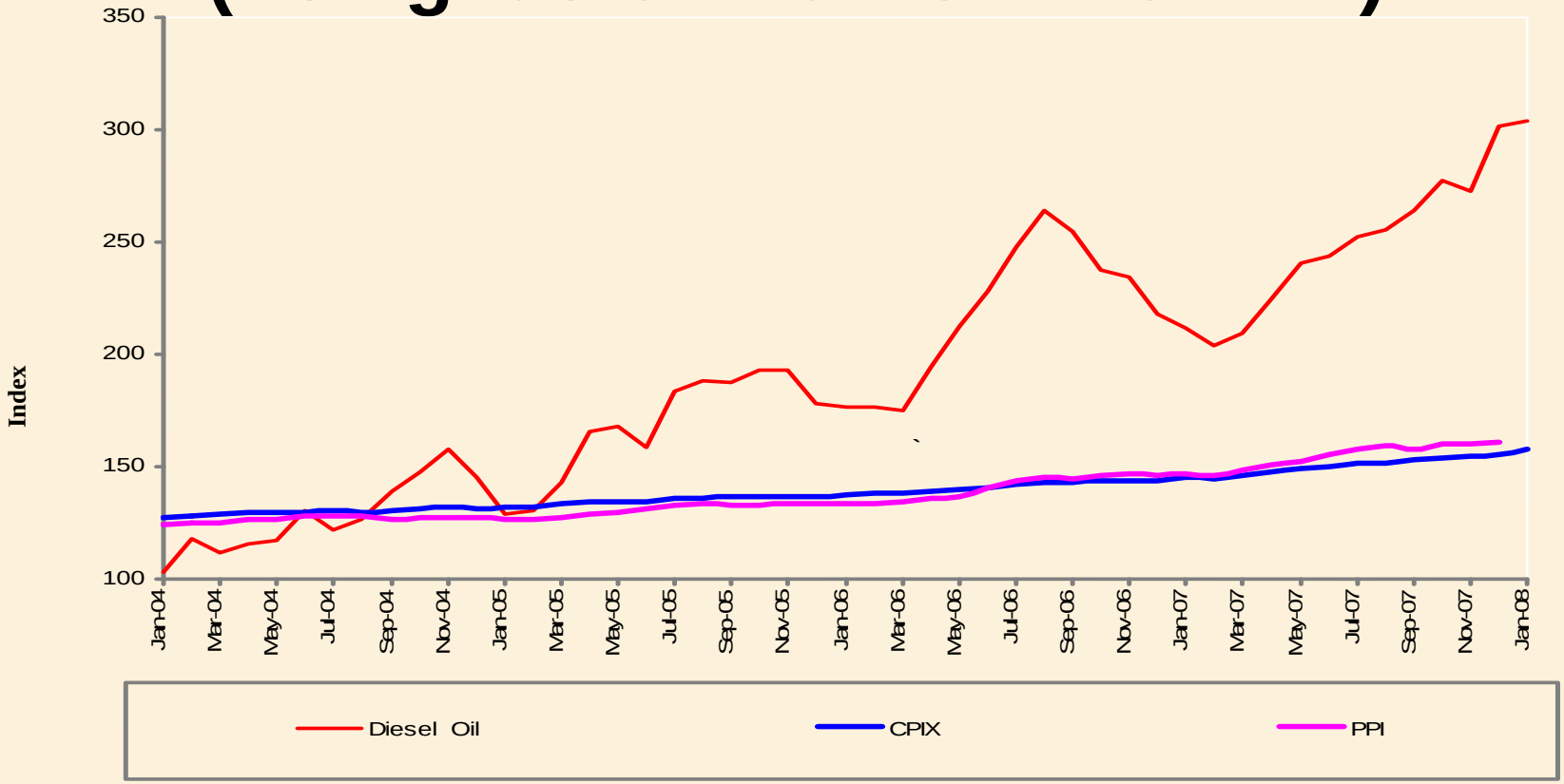
Producer Price Inflation – Coal (rising faster than CPIX or PPI)



Since January 2004, Coal index has increased by 93% compared to PPI of 29%

Source: StatsSA P0142.1 PPI Report Table 14, Mining and Quarrying - Coal

Producer Price Inflation – Diesel (rising faster than CPIX or PPI)



Since January 2004, Diesel index has increased by 190% compared to PPI of 29%

Source: StatsSA P0142.1 PPI Report Table 16, Diesel Oil- Coast and Witwatersrand

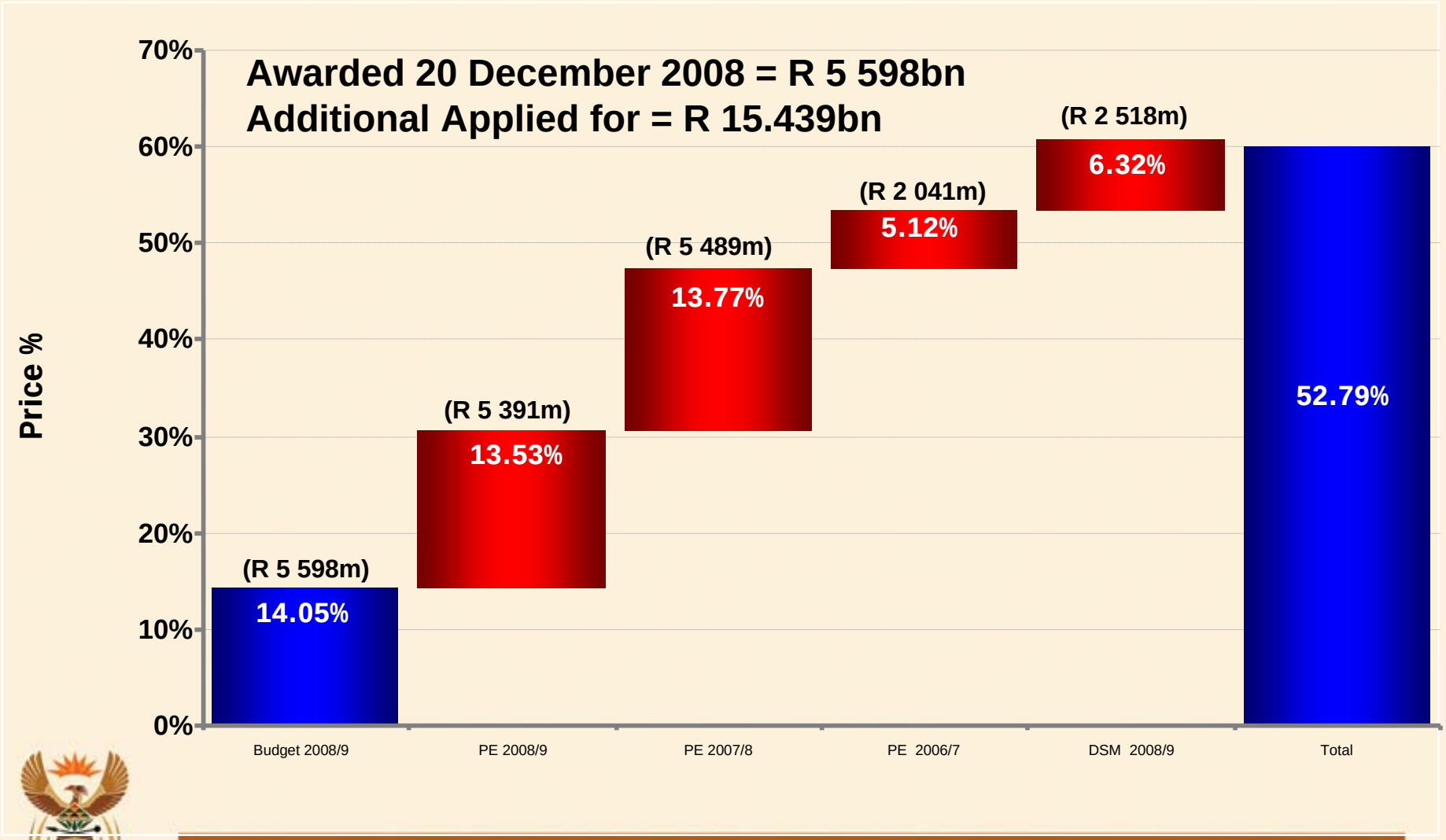
What has Eskom Applied for?

Application for Review of 2008/9 Price Increase based on:

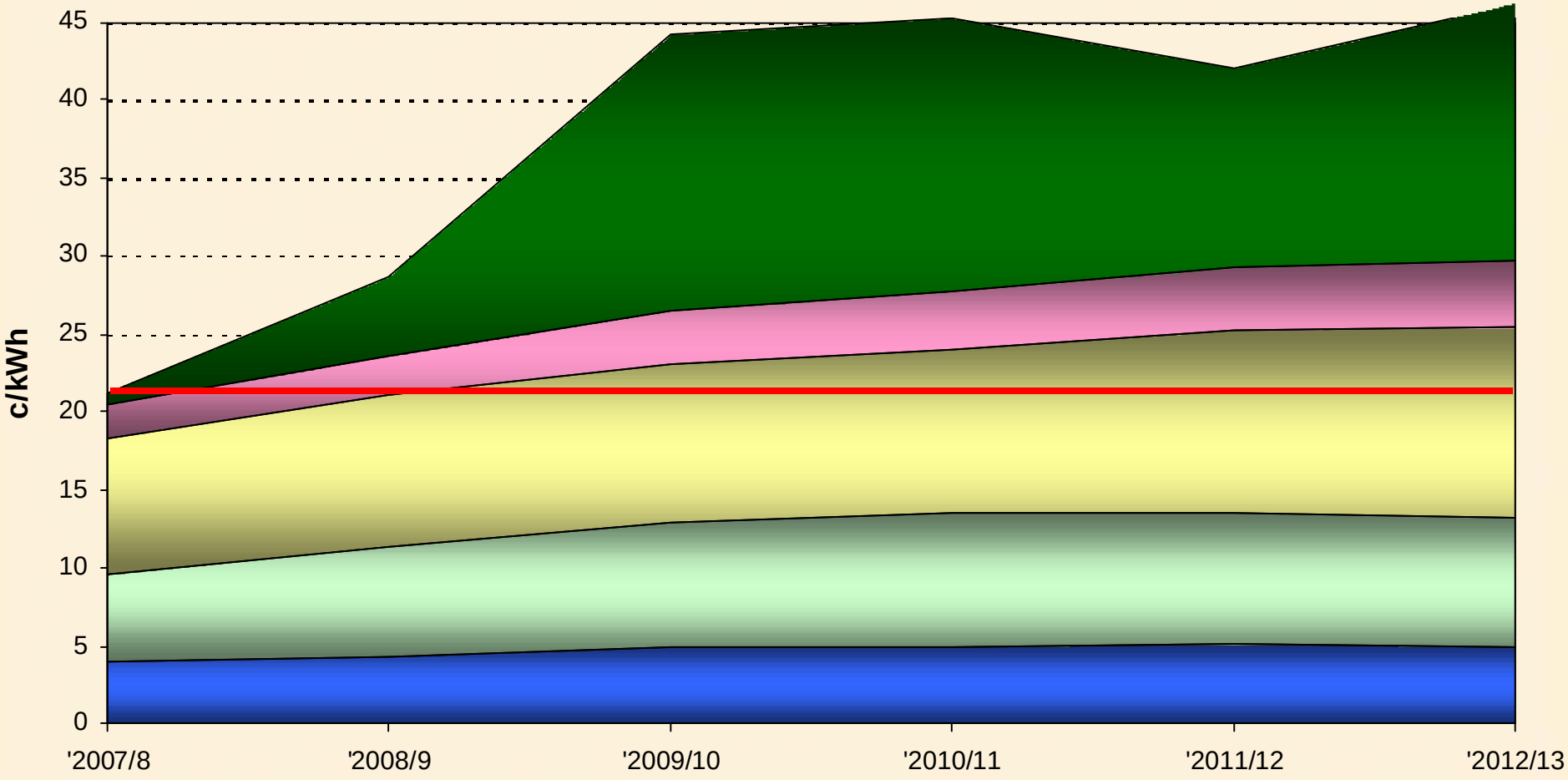
- Primary Energy Expenditure > MYPD Allowance of R 12.921bn over the current 3 year period:
  - 2006/7 (Actual) = R 2.041bn
  - 2007/8 (Projected) = R 5.489bn
  - 2008/9 (Forecast) = R 5.391bn
- Accelerated Demand Side Management Expenditure > MYPD Allowance of R2.518bn over the current 3 year period (Target increased from 459MW to 1414MW):
  - 2006/7 (Actual) = R 226m
  - 2007/8 (Projected) = R 279m
  - 2008/9 (Forecast) = R 2.013bn

Proposed Price Increase (53% Real/60 Nominal)

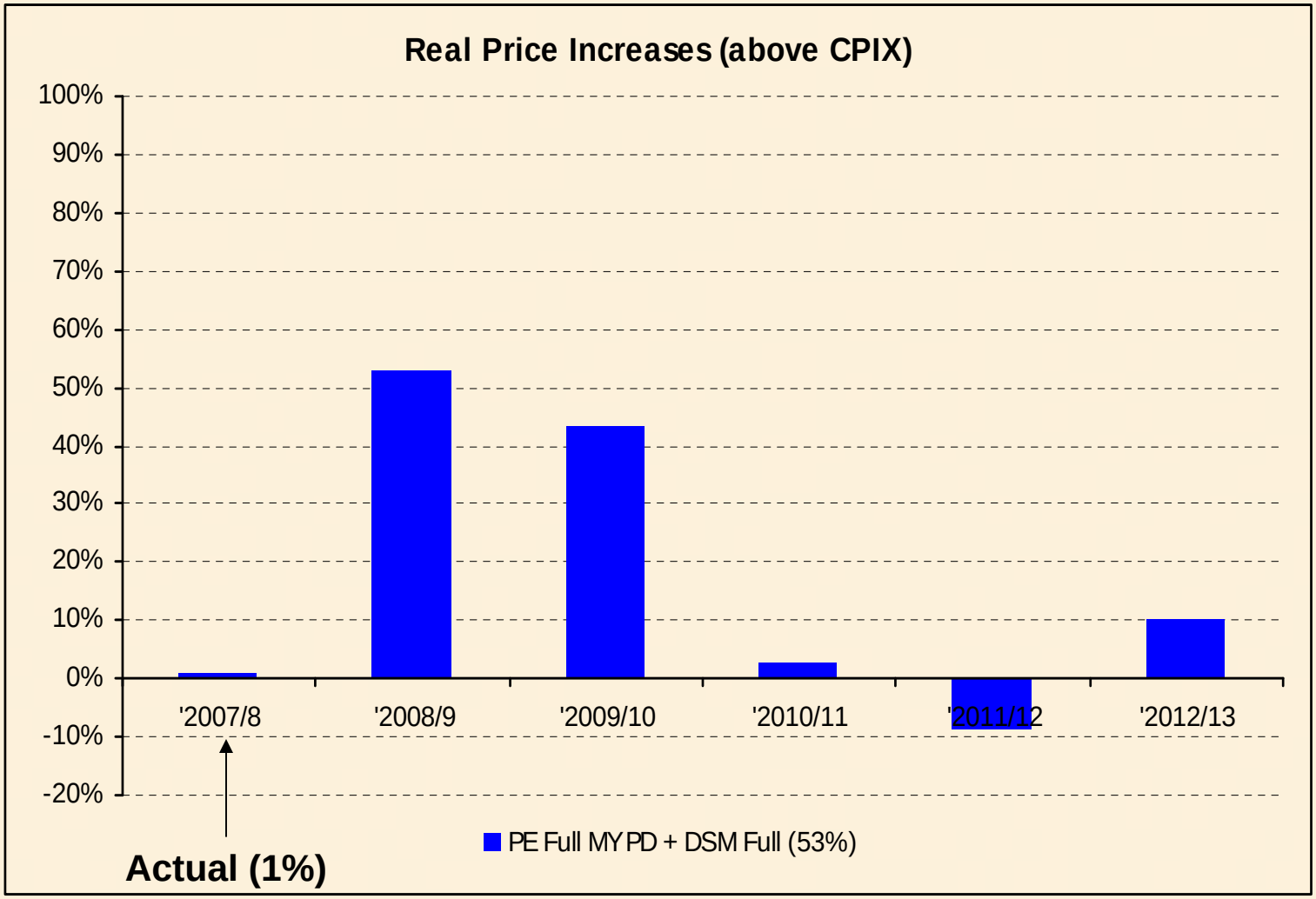
Additional Cost Recovery of R21.037bn for the MYPD (2006/7-2008/9)



Cents per kWh (Constant Rands) – 53% (real)



Annual Price Increases Going Forward (based on 53% increase in 2008/9)

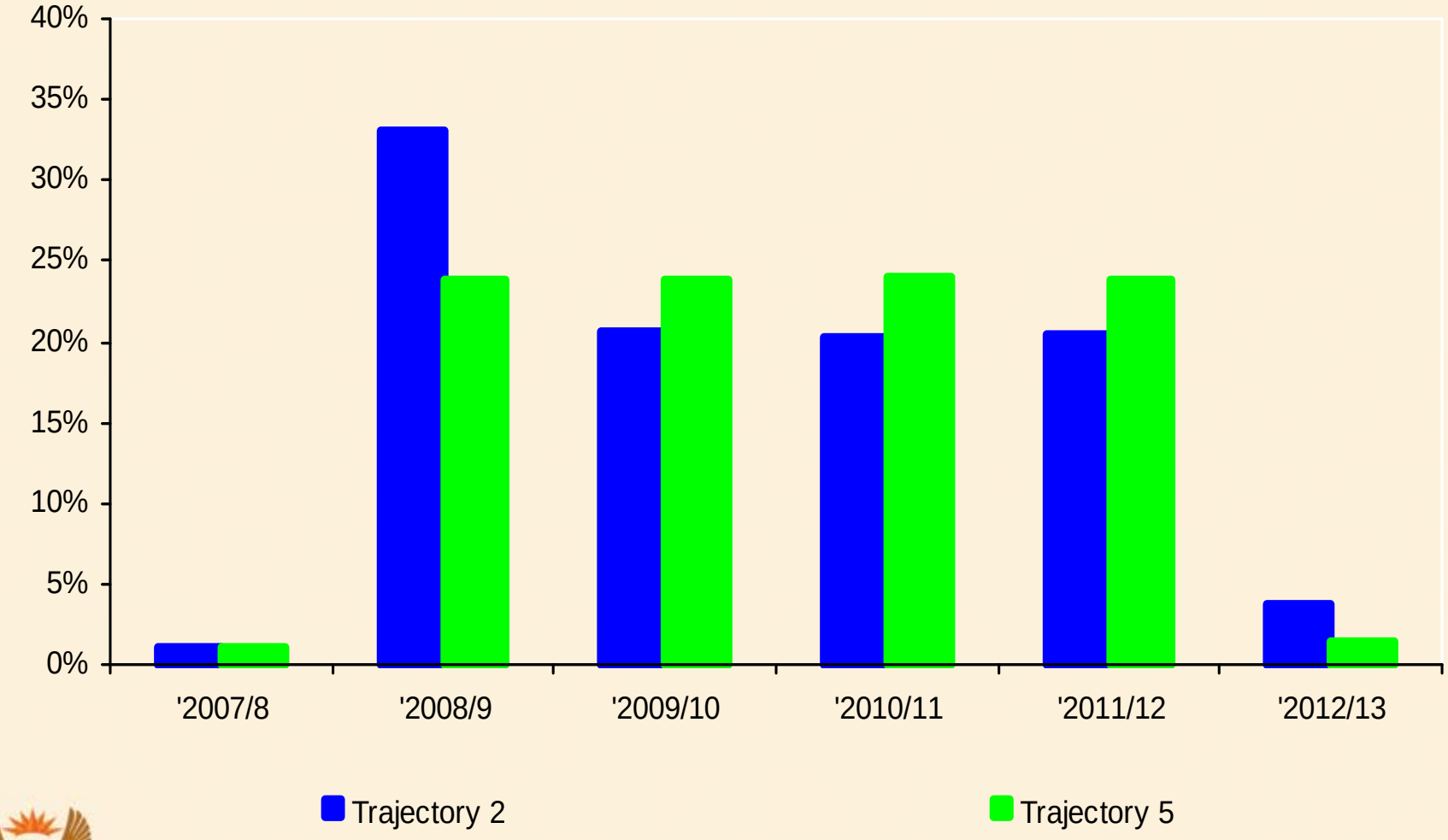


Proposed Tariff Smoothing

- To limit the negative effects of a sharp increase of tariffs on the economy and poor households
- Proposals have been developed to smooth the tariff over the next 5 years
- However it is critical that the wholesale tariff reach 46c/kwh by 2011/12, which would be Eskom's levelised costs

Proposed Smoothing Options

Real Price Increases

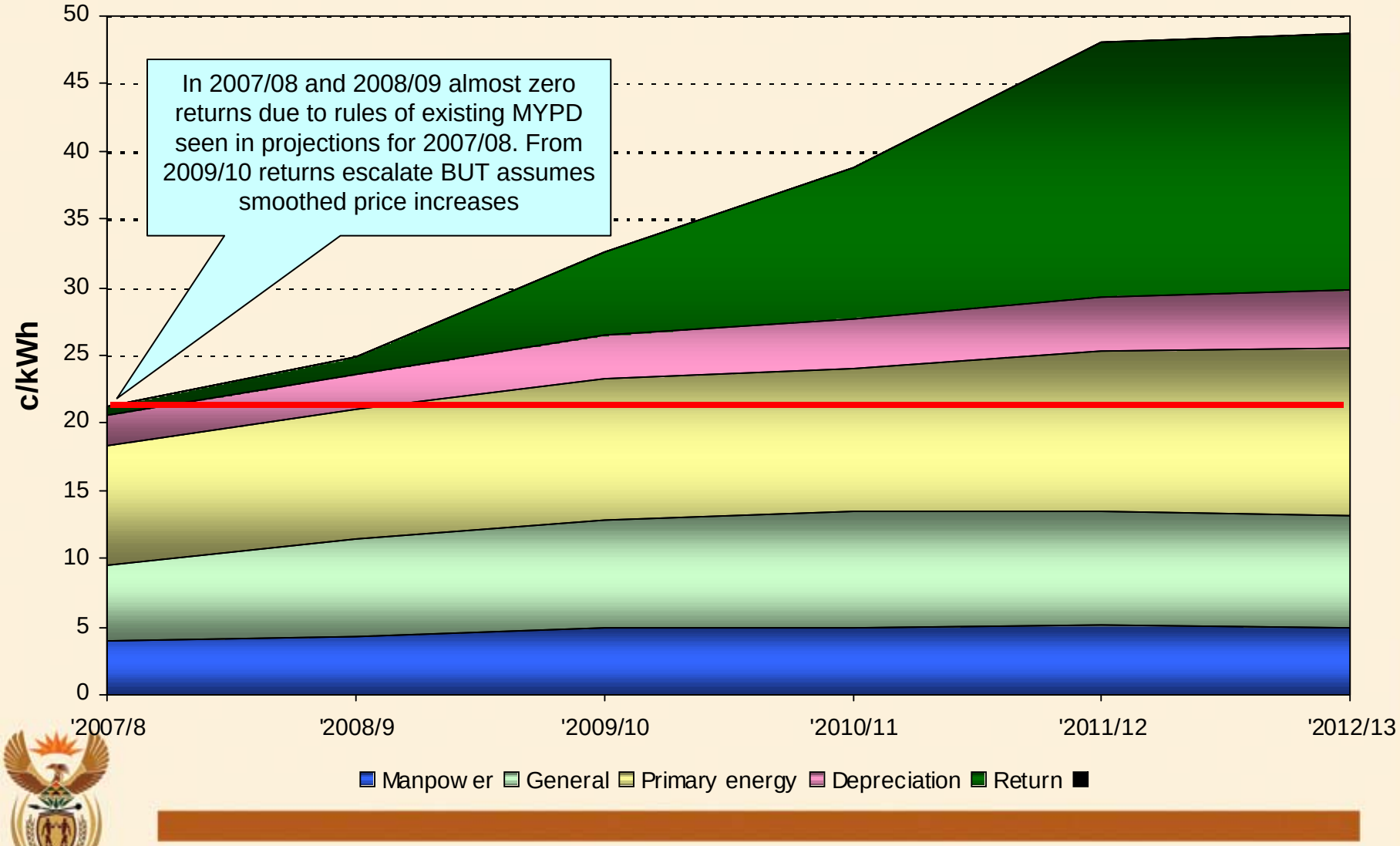


Implications of the smoothing

- Smoothing effectively means that in year 1, there is an under recovery of revenue which must be funded by an equity injection into Eskom;
- Tariff increases remain high for a longer period to allow the recovery of all allowable revenues;
- Partly as result of the smoothing of the revenue required and the current sub-prime crisis, there is significant risk of a funding shortfall for Eskom's investment programme.

Cents per kWh in Constant Rands

Trajectory 2 (33% Real in 2008/9)



Protecting the Poor

- Implementation of Differential Tariff Increases to protect the Poor.
- Homelight is the tariff Eskom offers for the low income sector. The similar tariff type for SMME is Businessrate4.
- Note that most municipalities offer the same type of tariff for the poor (so-called “lifeline” tariffs), but it will be incumbent on Nersa to ensure Munics adopt a similar approach and implement differential tariff increases.

Differential Increases applied (Eskom Tariffs) to achieve 33% (real) revenue increase for 2008/9

Eskom Tariff	Increase (2008/9)	Average Monthly Bill		Increase (2008/9)
	(%)	2007/8	2008/9	(Rands)
Homelight 20A	15.0%	R 45.27	R 52.06	6.79
Homepower	41.9%	R 367.63	R 521.66	154.03
Businessrate1	41.9%	R 465.11	R 659.99	194.88
Businessrate4	15.0%	R 305.58	R 351.42	45.84

- The price increase is assumed over the full Eskom financial year and is expressed as a nominal value (includes inflation).
- CPI-X of 7% assumed
- Municipalities will experience a 53.5% increase in bulk tariff due to a 9 month recovery period in compliance with the MFMA

Conclusion

Why an immediate Tariff Increase?

- Eskom has already spent more on primary energy and demand side management than was budgeted for in the MYPD and will need to accelerate its spend further.
- The Eskom build programme is crucial in the light of the growing electricity demand. A sustainable balance sheet is critical as the bulk of Eskom funding is sourced from the capital markets.
- By 2012 the actual marginal costs of producing electricity will increase to about 46cents/kwh. Therefore tariffs have to approach this level over time.
- In this context smoothing is proposed given the fact that the 46 cents has to be achieved in 4 years time, therefore the tariff decreases substantially in Year 1 but remains at a relatively high level for the next 3 years before it approaches CPIX

Initiatives to control Eskom's cost drivers

- DSM – crucial in ensuring efficient energy utilisation in general
  - Reduced demand means reduced primary energy demand
- Coal strategy – working with DME to increase the amount of coal sourced from cost plus mines
- Operational efficiency and maintenance practice improvements by Eskom
  - Comprehensive benchmarking of Eskom operations
  - Modernisation of maintenance practices
- Capital inputs for the build programme
  - Local source strategy along with local manufacturing capability development

Conclusion

- Electricity tariffs must reflect the economic costs of production.
- A smoothing of the tariff is proposed over the next 5 years
- A pro-poor tariff structure is proposed for distribution customers within Eskom and Municipal supply areas.

Thank you