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Fiscal support for electricity market reform

Summary

Eskom faces serious financial challenges. To the extent that the company may not be able to meet its interest and capital payments, government has set aside a provisional allocation of R23 billion per annum in the medium-term fiscal framework. Beyond the medium term, the size of support will depend on several factors, including economic growth, tariffs, and the implementation of Eskom's strategy.

The provisional fiscal allocations will support a fundamental reorganisation of the electricity sector, with an initial focus on establishing an independent transmission company under the existing holding company. In addition, the funding should significantly reduce the immediate risks to the economy posed by Eskom.

The annexure provides details on the envisaged reconfiguration process and fundamental re-engineering of the enterprise that must accompany the fiscal support. The intention is to return Eskom and the broader electricity sector to operational and financial sustainability. Over time, in conjunction with a comprehensive operational turnaround, this will restore reliable electricity supply.

Challenges and reconfiguration

Globally, countries are shifting away from fossil fuels towards renewable energy. Growth in coal consumption is slowing in India and China, and investment in renewable energy is rapidly increasing.

There has been a dramatic fall in the prices of solar and wind energy. Energy auctions, rather than administratively determined feed-in-tariffs, have led to record low prices in the Middle East and in countries such as Chile and Mexico where bid prices have been below US$0.02 per kilowatt hour (i.e. less than R0.30 per kilowatt hour).

The nature of an efficient electricity system and grid is changing. Systems no longer resemble Eskom's vertically integrated monopoly model, with central power stations distributing power via grids to consumers. Instead, they have become increasingly decentralised, with electricity flowing from the centre to the periphery and vice versa.

International examples of energy market reform

Many other countries have implemented multi-year, complex electricity market reorganisation.

In 2002, the State Grid Corporation of China (SGCC) was created through the Power Plant – Grid Separation reform. This reform unbundled the assets of the former State Electric Power Corporation into five power generation groups, which retained the power stations, and five regional grid subsidiaries belonging to SGCC. In 2017, SGCC had nearly 1 million employees, supplied power to 1.1 billion people and reported revenue of $348.9 billion.

During the 1990s, Turkey separated the vertically integrated utility TEK into the Turkish Electricity Generation and Transmission Company (TEAS) and Electricity Distribution Company (TEDAS), both of which were state-owned companies. These changes were implemented with the aim of ensuring security of electricity supply at a time when the country was fiscally challenged. By accompanying these changes with the introduction of independent regulation and open access to the electricity network an environment was created which attracted new, private investment in generation capacity without requiring state guarantees. Improvements in operational efficiency through competition resulted in the electricity price declining.

During the 1980s the Brazilian electricity utility, Eletrobras, experienced financial distress, halting investment. From 1995, a first wave of reforms was implemented, which saw the establishment of an independent system operator that enabled non-discriminatory access to the grid. The consequence was that the frequency and duration of electricity disruptions halved within a four-year period. The efficiency in the implementation of generation projects also improved, with costs falling by 30 per cent and the time for completing the projects reducing from 6-8 years to 4 years. A second wave of reforms implemented at the start of the century, focussed on clarifying institutional responsibility for planning and ensuring security of supply.

Eskom generates 95 per cent of the South Africa's electricity, with around 75 per cent coming from coal. The large size and vertically-integrated structure of Eskom means that any challenge experienced by one part of the business threatens the entire company and places the country's electricity supply at risk.

The company's fleet performance has significantly deteriorated due to a lack of maintenance and refurbishment over the years, greatly compromising the security of supply. The situation was worsened by coal shortages and the supply of sub-standard coal. Most recently this has resulted in rotational load-shedding being implemented in November and December 2018 and again in the second week of February 2019.

From a financial perspective, Eskom is not generating sufficient cash to meet its operating costs and service its debt. It has been borrowing to make the principal and interest payments on its loans. Operating costs are excessive and have been increasing while demand for electricity has been declining.

Turnaround plan for Eskom generation

Eskom has developed a detailed turnaround plan to address its structural, operational and financial challenges. A key pillar anchoring the strategy is a focus on driving efficiency and reducing costs, which will be achieved through the following initiatives:

1. Optimising primary energy costs through prudent long-term coal sourcing, investment in cost-plus mines and reducing the cost of logistics;
2. Refining capital efficiency by reprioritising capital expenditure and optimising contract management;
3. Driving operational and cost efficiency in procurement;
4. Growing revenue with pricing incentives and the pursuit of international sales and other new growth opportunities; and
5. Improving workforce efficiency by optimising personnel costs, rationalising mid-level management, and building skills.

During the past few months Eskom has reduced costs by capping its capital expenditure, reducing operating expenditure, freezing posts and stopping bonuses and salary increases at managerial levels.

Overall Eskom is committing to accelerate cost compression to more than R20 billion per year by 2022. These savings exclude reductions to Eskom's salary bill. Government has already begun consulting labour on these matters.

As part of its broader turnaround plan Eskom has developed a nine-point generation recovery plan to deal with escalating unplanned breakdowns and coal shortages.[1] The key elements of the plan focus on resolving unplanned breakdowns, addressing the performance and reliability challenges affecting the new units at Medupi and Kusile, improving the coal stock days and strengthening human resource capacity. An independent technical audit team, comprising local and international experts, will be appointed to review the plan and evaluate the state of the power stations.

Institutional separation of Eskom

Splitting Eskom into separate companies responsible for the different functions – starting with the creation of an independent transmission entity, combined with the system operator – will set the electricity sector on a new path.[2] This proposed restructuring is in line with the 1998 Energy Policy White Paper, which intended that Eskom be restructured into separate generation and transmission companies and that independent distributors would be established.

The main benefit of separation will be to reduce information asymmetries, mitigate and distribute risks and strengthen incentives for efficiency. The process will:

- Enable greater management attention to be focused on turning around the different parts of the business and enhance accountability;
- Improve transparency, reducing the opportunities for fraud, corruption and rent-seeking;
- Mitigate the risk arising from an Eskom that is "too big to fail" and limit financial contagion from the underperforming parts of Eskom's generation business, where most of the problems originate;
- Position the electricity sector to embrace clean technology, distributed generation and respond to other changes taking place in the electricity sector;
- Diversify the generation of electricity across a multitude of power producers, thereby reducing the country's reliance on a single supplier;
- Provide a stable platform for transparently contracting least-cost and secure power;
- Provide open access to the grid and remove conflicts of interest to the procurement of power, both conventional and renewable, from independent generators;
- Generate competition in the electricity market that is expected to drive improvements in efficiency and put downward pressure on prices;
- Crowd private investment into the electricity sector; and
- Allow lenders to separately fund the different components of the business, allowing debt to be priced more tightly, as it more accurately reflects the unique risks of each individual business.

[1] See: http://www.eskom.co.za/news/Documents/StateSystemBriefing16Nov2018.pdf

[2] In the 2019 SONA speech the President stated that "of particular and immediate importance is the entity to manage an independent state-owned transmission grid combined with the systems operator and power planning, procurement and buying functions."

Creation of a transmission company

At this stage, Eskom Holdings is proposing establish separate subsidiaries, each with its own board. The assets, debts, people and licenses of the respective businesses will be migrated to the subsidiaries. In due course, Eskom will be required to provide separate, audited financial results for each of their three businesses on a preliminary basis.

Priority will be given to the creation of the transmission company by establishing a subsidiary of Eskom Holdings with an independent board appointed by mid-2019. The new company's assets will consist of all existing Eskom transmission network assets, including grid and substations and associated infrastructure, national control centre and system operator assets as well as Eskom's Peaker power stations (pumped storage, hydro and gas turbines). In addition, all transmission servitudes and property rights currently held by Eskom will also need to be migrated to the transmission company. The transmission license will need to be amended to allow for the buying and selling of electricity and transferred to the transmission company. Likewise, supply agreements with existing clients would need to be migrated to the transmission company and supply contracts concluded between the transmission and distribution companies. Following consultation and a new agreement with labour unions, the migration of people into the newly established subsidiaries will be done in terms of the Labour Relations Act and workers' rights will be respected.

Next steps

Given the magnitude of the task, many details of Eskom's turnaround and restructuring will be finalised in the months ahead. The first step will be to appoint a Chief Reorganisation Officer, who will work with the Board and management to implement the Eskom Sustainability Task Team Recommendations.

Strict conditions will be attached to the fiscal support to drive the changes that are required, including cost containment measures. Simultaneously, critical maintenance of the power plants must be undertaken and their technical performance improved. The management of the capital expenditure programme needs to be strengthened to ensure that expenditure is optimised, costs are contained and that the quality of work is closely monitored. To this end, the Eskom Board will be required to enter into a new shareholder compact with the Minister of Public Enterprises setting out these requirements. Executive remuneration will be tied to delivering on these commitments, which will be cascaded down throughout the organisation.

The corporate restructuring and turnaround will be unprecedented in South Africa. In the process of doing so, extensive consultation with all affected stakeholders will take place and the rights of labour, lenders and independent generators will be protected.