Eskom- now in good financial shape to serve the economy.

In our commentary on Eskom over recent years we raised a number of principle objections to the tariffs and borrowing arrangements that were being promoted by Eskom and the government. The essence of these proposals with which we disagreed was that much of Eskom's capital expenditure programme would have to be financed through tariffs rather than debt. Furthermore it was argued wrongly in our judgment that Eskom, when raising debt would have to stand on its own balance sheet rather than that of its only shareholder, the government. Given the small size of the Eskom balance sheet relative to the investments it would be making in additional generating and transmission capacity this made dependence on Eskom's monopoly power to levy much higher tariffs a corollary of a weak balance sheet and an inadequate credit rating.

Our argument was rather that Eskom's tariff should be no higher than that necessary to cover all the costs of generating and delivering additional electricity. Included in such costs would have to be an appropriate return on capital for the low risks attached to electrical utilities, especially those without direct competition. This cost of capital to be covered we argued should be no more than two per cent above the cost to the RSA of issuing its long term bonds.

To charge more than this we contended would harm the SA economy by taxing electricity consumption and would destroy a potential competitive advantage the economy should benefit from- and that is abundant conveniently located coal resources. It would also mean that hard pressed current generations being unfairly forced to pay more than for electricity than it really cost would be subsidising future generations who hopefully would enjoy a superior standard of living.

We argued that the appropriate method to fund capital expenditure of the Eskom kind would be with debt rather than with equity – internally generated through excessive tariffs. For this we thought a government guarantee was essential to the purpose of raising the necessary debt on favourable terms.

We are please to note that events have largely played out as we had recommended. The tariffs agreed for Eskom are well aligned with the tariffs we had simulated for a ten per cent cost of capital and the other assumptions we had made about direct operating costs. As important the government after much gnashing and grinding of Treasury teeth has finally agreed to fund Eskom through a mixture of infusions of equity and guarantees of Eskom debt.

The good sense of such actions is clearly apparent in the financial results reported by Eskom recently for the six months to 30th September 2010. There can be little doubt that Eskom in its current form, charging its current regulated tariffs is more than financially viable. It is proving more than capable of meeting its obligations to pay interest and repay principle debt on time and moreover to pay taxes and dividends to its shareholders at an impressive rate.

The Eskom tariff to its ordinary wholesale distributors and customers in the six months to Sept 2010 was 44.6 cents per kWh compared to 34 cents to September 2009 a year before, an increase of 31%. The tariff was lower at 29.9 cents in the six months to March 2010. Operating costs, compared to the comparable period a year before, including depreciation charges, rose from 26.6 to 30.6 cents per kWh, an increase of 15%. Revenue rose from R38 264b in the six months to Sept 2009 to R51 114b this past six months, an increase of 12 850b or 33.5%.

The impact of this increase in revenues on the cash flows of the utility, was nothing less than explosive. Cash generated from operating activities amounted to R16 434b an increase of 72% received in the comparable period a year before (R9512). Earnings before interest and depreciation EBITDA were reported as R18 510b up nearly four times from the R4 861b a year before. This cash flow went a long way to covering the impressive R19 433b of investing activities undertaken in the six months to September 2010. And more than sufficient to provide generous cover for Net Finance Costs of R1688b. Eskom reported income taxes at a 28% rate of R3 879b on profits for tax purposes of R13 412b compared to R2 101b and taxes paid of R746b a year before.

Eskom's profitability is are clouded by accounting for 'embedded derivatives" losses that link its charges to the aluminium and other smelters to the aluminium price. These derivatives raised an accounting charge of R1 471b this period and the losses attributed to these derivatives in the comparable period were much higher (-R5 638b) To add enormous volatility to the operating profits that are reported net of these derivatives, embedded derivatives produced a gain of no less R7 922b in the six months to march 2010- larger than the operating profit for the period of R4 719b

Further complicating the impression of Eskom as a profitable business is the revaluation adjustment made to the balance sheet this past quarter. A revaluation adjustment of R242,6 billion has been made to the Assets employed by Eskom taking Equity on an historical book value basis of R83.1b to R320b measured on a replacement cost basis. This makes the balance sheet with short and long term borrowings of approximately R57b appear a lot healthier, which indeed it is.

While revaluing the assets to replacement cost and market value makes economic sense it does drastically reduce the profit after tax. Eskom reports a 7.1% profit on assets after taxes on an historical basis and a mere 1.6% profit ratio on a replacement cost basis.

We would urge that very little attention be given to this ration when Eskom next appears before the regulator Nersa, perhaps pleading poverty in the interest of higher tariffs. In fact its current level of charges- linked perhaps to inflation are more than sufficient to cover its legitimate costs of supplying electricity and meeting the legitimate requirements of its shareholder for return on capital. Its current financials bear more than adequate testimony to a very sound financial state of affairs.

The focus of Eskom management now that it has its finances on a sound footing should be to concentrate of achieving operating efficiency- such that electricity charges can rise at less rather than more than the rate of inflation. Such an achievement would be very good for the SA economy.