Electricity prices: The NDP is missing the point

Business Report reported yesterday that the government would consider a plan by the Department of Economic Development to tax raw material exports to encourage beneficiation of them by local industry. To quote Business Day: “The government is pushing industry to process minerals locally in the hope that beneficiation will revive manufacturing. It also wants to expand rail and power capacity rapidly …”

The recently published National Development Plan (NDP) of the Minister of Planning Trevor Manuel and his technical advisers strongly supports expanding infrastructure but has serious doubts about the benefits of beneficiation given its dependence on energy consumption.

To quote the NDP: *“Electricity is the main constraint, as most of these activities are highly energy intensive. As long as electricity is scarce, there will be a trade-off between beneficiation and other more labour absorbing activities. In general, beneficiation is not a panacea because it is highly energy and capital intensive, contributing little to overall job creation.” (p 125)*

The first point to make is an economist’s one about scarcity: electricity, as with all goods and services that command a price above zero, is a scarce resource for which demand has to be rationed by supply, encouraged by the prices charged. Market forces typically establish these prices, and by so doing, direct production and consumption.

But in the absence of competing buyers and sellers, as in the case of the price charged for electricity in SA (produced by Eskom), the prices charged have a different provenance. They are now being set by the National Energy Regulator but in the past have been much influenced by Eskom itself and the Ministers of State responsible.

The NDP has much to say about the importance of better regulation: *“The quality of market competition and regulation in the energy sector has been far from optimal. The economy requires increased competition in electricity generation, along with better regulation of price, supply and quality in electricity and petroleum products.”* P141

It would be very hard to disagree with these sentiments. But as commentators have pointed out, the devil is in the detail of the policies recommended by the technocrats and hopefully to be approved by the politicians. However on the question of the right price for electricity in South Africa one may well question whether the NDP is itself on the right track.

More of this below, but what should be clear to all is that the price charged for electricity and its substitutes will have a crucial bearing on the profitability and scale of SA manufacturing. The reason SA is not beneficiating more of its mineral and metal output is that it is not profitable to do so. One could make exactly the same observation about the output of iron ore and coal in Australia. Exporting the raw stuff is highly profitable and so production for export markets is growing rapidly – Australian beneficiation for local or export markets much less obviously so.

Taxing exporters to subsidise local production will surely have the effect of discouraging the former and encouraging the latter but this will not make it good policy. It is much better to let the economic fundamentals assert themselves in such outcomes, that is to establish the right prices for crucial inputs into the industrial process, be it the price of energy or the price of labour or capital. The failure to beneficiate more in SA is not a market failure – it is broadly speaking a market outcome.

However it may well become a government failure if SA business is overcharged for electricity and other energy sources as there is now every likelihood. Here the NDP offers little comfort that SA is on the right path to establishing the right price for electricity (not too high and not too low); a matter of such crucial importance for industrial output and investment in industrial capacity.

An unwillingness to use debt

The NDP argues that users of electricity should cover the full costs of supplying them. We agree - but then what are these full costs the NDP has in mind? Here we have our doubts that the NDP and its advisers have properly understood the issues and would continue to allow Eskom to set unnecessarily high prices, greatly and wrongly influenced by debt management considerations. These debt management principles applied to the price of electricity are convenient for Eskom and highly inconvenient for the economy.

Eskom we would argue is being allowed to overcharge current consumers for its electricity because of unwillingness

to fund itself with debt rather than internally generated cash flows. These are dependent on already high prices and are due to rise much further if current policies are to be maintained. The government has contributed to this decision to finance Eskom's essential expansion by overcharging current consumers. These high prices, overcharging for electricity, will seriously inhibit SA's industrial competitiveness. The state has been reluctant to provide full guarantees for Eskom debt or to provide additional equity capital for Eskom, capital it could raise in the debt market issuing its own paper for the purpose.

We have made the point before that the prices to cover full costs are those that would provide an appropriate return on capital invested in the additional capacity, with best of breed project management, required to meet all the additional demands for electricity at these prices. This required return, given the low risk nature of electricity production and the great predictability of demand for electricity, is about two per cent per annum above the long dated RSA bond yield, currently about 8%.

Put another way, the regulated price of electricity supplied by Eskom should be set to provide a long term return on the additional capital invested by Eskom of about 10% p.a. A well managed electricity utility, especially one with the right to increase its prices in line with inflation, is a low risk business. It is also therefore a business that can raise debt on a large scale. When the utility is wholly owned by the government, its costs of finance should be no higher than that of the government, which should be willing to fully guarantee the debt of its subsidiary to minimise its costs of finance.

The NDP should note that the cost of finance (8%) is not equivalent to the required returns on capital, that is its cost of capital (10%) for Eskom, being the required returns on either debt or equity.

The NDP does not however seem to have noticed that the electricity balance in SA has already dramatically altered in favour of the producers of electricity and its municipal distributors and against the users of electricity, including the mines and factories. It talks of electricity price increases *"that are necessary to finance Eskom and private investment .."(p146), as* if this has not already happened. They argue also (and quite wrongly in our view) "*that Government has probably reached the limit of its fiscal and guarantee support for Eskom"* and that *"Eskom's access to private debt is also becoming more difficult and expensive. Failure to raise electricity prices to reflect costs will result in Eskom being unable to meet debt obligations. Maintenance and investment programmers will be delayed, and ultimately, the lights will go out…"* (p 146)

The lights are fortunately no longer going out but SA is paying too much for its electricity with the unintended negative consequences for output growth.

There is already strong evidence from the financial reports just presented by Eskom for the six months to September 2011 that the current returns being generated by Eskom, at the current wholesale price of 55c per KWH (which is 23% up on the year before), is generating returns far in excess of its cost of capital of about 10%.

Moreover the balance sheet of Eskom is being continuously and (we would say) unnecessarily strengthened, as operating profits and internally generated cash from established power plants rise dramatically in response to these higher prices. Net cash generated by its operations grew in the six months to R21.3bn compared to R22.8bn cash flows realized in the full financial year to March 2011. Eskom invested R25.5bn in the past six months in additional capacity and borrowed an additional R6.6bn. So a very large proportion of its expansion (84%) programme is not being financed appropriately with debt or additional equity capital supplied by its shareholder but from its hard pressed customers. More of the same is in the pipeline: adding further financial strength to Eskom and weakness to the economy.

Eskom (conveniently given its preference for cash over debt) reports a debt to equity ratio of an apparently large 1.4 times. But this is on the basis of historical costs. Eskom also supplies a balance sheet with its assets revalued for their current much higher earning power and present values. A revaluation amount of R279.5bn was added to its historical costs of assets, taking its assets to R651.3bn compared to debt liabilities of about R253bn, that is a debt to equity ratio significantly less than one.

We would argue that Eskom's prices are now high enough to cover its full costs. Further increases should be no more than in line with inflation. And municipalities should not be allowed to use their electricity monopolies as local cash cows that cause the industrial milk to dry up. A competitive SA economy, with scope for more beneficiation demands, requires a financially and economically sensible approach to Eskom finances. This is one that gives priority to finding the right price for electricity for its consumers and the economy; rather than one that follows economically damaging and misleading views about the right shape of the Eskom balance sheet. The same goes for many other publicly owned enterprises including the airports and roads – that have driven pricing policies in recent years. ***Brian Kantor***