

# Opinion & Analysis

## Eskom's call for new tariff hikes is unreasonable

### BENCHMARK RETURNS

Brian Kantor and David Holland

**E**SKOM, the state-owned utility with a near monopoly over electricity production and distribution, has historically posted very poor operating returns.

Encouraged by a surplus of coal-fired generating capacity, years of sub-inflationary price increases made electricity in South Africa extremely cheap. Highly competitive electricity charges supported the country's growth and helped relieve poverty. However, over time, demand for electricity grew with the economy, absorbing all that excess capacity. This made investment in additional capacity to generate and distribute electricity essential to the purpose of growing the economy.

However, the lack of sufficient cash flow from Eskom's operations and the cost of funding to expand generation capacity has put paid to the idyll of endless sub-inflationary price increases for electricity.

Electricity prices have rocketed since 2008, putting Eskom's operations and finances into a much more favourable state, and sensibly so. With its latest plan, Eskom hopes to become a truly great business over the next five years by charging still more for electricity. If it gets its way on pricing - and sells as much electricity as it plans to deliver - the economy and its citizens will be paying an exorbitant price for a financially all-powerful Eskom.

Eskom submitted its third multi-year price determination (MYPD3) application to the National Energy Regulator of SA (Nersa), in which it is requesting annual electricity increases of 16 percent until March 31, 2018, of which 3 percent is targeted to support the introduction of independent power producers. This leaves a monstrous increase of 10 percent above inflation annually for five years, which threatens the livelihood of small, energy-intensive businesses and citizens.

On what basis does Eskom argue for such vigorous price demands?

Our main issue with this request is that it is based on the assumption that a regulated electricity company should earn a real return on capital of 8 percent.

Eskom's stated cost of capital is a real rate of 8.16 percent. Last year, the median cash flow return on operating assets (CFROI) was 3.2 percent for the 100 largest listed electricity companies globally. CFROI represents the real economic return on inflation-adjusted capital and is comparable across borders and over time, making it an excellent benchmarking metric. The CFROI for power companies has been remarkably stable, averaging 3.5 percent over the past decade.

For example, Electricite de France (EDF), one of the largest power companies in Europe, has a 10-year median CFROI of 3.6 percent. Malaysia's Tenaga Nasional Berhad posted a 10-year median CFROI of 2.6 percent. Regulated utilities are generally fortunate to be granted a 4 percent real return on capital. There is no precedent for a real return as high as 8 percent for a regulated utility and Nersa should dismiss such assumptions about what is an appropriate return for a utility. A real return on capital of 4 percent should be more than sufficient in a country that requires greater growth to put people to work and place poverty behind us.

Eskom appears to have succeeded in convincing the regulator that 8.16 percent is a "reasonable (real) return on assets". The market-implied real cost of capital for listed South African industrial companies has averaged 5.5 percent over the past decade. Listed firms, where shareholders are subject to the possibility of 100 percent downside, are far riskier than a parastatal utility. Less risk should mean less return. A real return on capital of far less than 5.5 percent strikes us as reasonable for Eskom. Our benchmarking points to a 3.5 percent a year real return as being globally competitive.

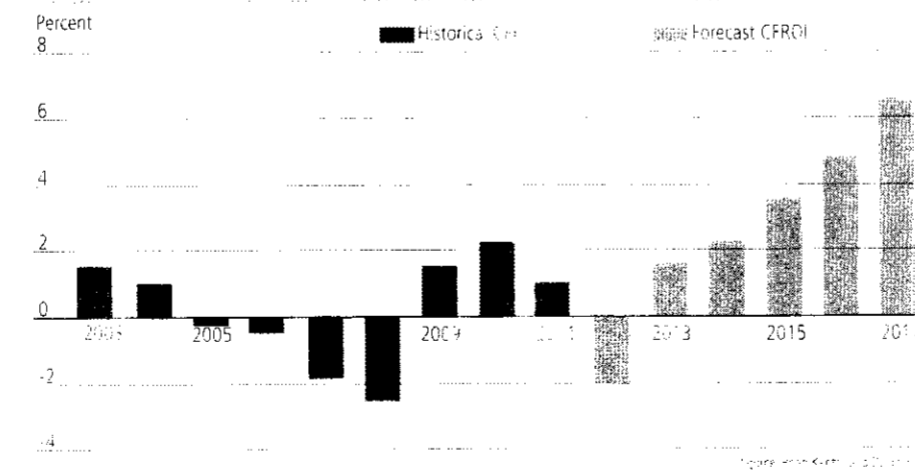
This can be tested in the market. If the government promised a 4 percent CFROI to prospective global powerhouses, its inbox would be filled with bids backed by yield-hungry global investors. Eskom, supported by rapid increases in prices, plans to achieve an extraordinarily high real return on capital of about 8 percent by April 2018 and to maintain this exceptionally high real rate of return thereafter.

This would make it the envy of the world of low-risk regulated public utilities and bless its balance sheet with assets at replacement cost worth over R1 trillion and debt of R300 billion. It would have lenders falling over themselves to do business with Eskom, as is its intention. But Eskom's success in strengthening its balance sheet would be at the cost of all electricity users in South Africa. Advantaging Eskom and disadvantaging the local economy makes no economic sense.



The calculation in the figure below includes non-productive construction-in-progress, which although necessary, dilutes the observed return on capital. The year refers to the beginning of the financial year.

Eskom's historical and projected real economic return on capital values (CFROI)



We don't disagree with Eskom's complaints about low profitability and insufficient cash flow to fund expansion before the last round of price increases. Eskom's median CFROI over the past decade was 0.4 percent - which for the sake of further argument is in line with the 10-year median CFROI of 0.3 percent for Brazil's massive Centrais Eletricas Brasileiras. Eskom was starved of a sufficient return on capital for many years. This has been recognised in the form of very significant increases in electricity prices over recent years. Prices should be high enough to provide a return on capital invested that

makes economic sense. And prices have increased sharply and sensibly over recent years - at well above the rate of inflation. The price charged by Eskom per kilowatt-hour was 16.2c in 2006, which nearly doubled to 31c in 2010. These charges have since nearly doubled to 61c/kWh. On top of these steep increases, municipalities charge their industrial and household customers more than the Eskom price.

Eskom's CFROI troughed at a negative level (minus 2.5 percent) in March 2009 at a time new generating capacity was essential to the functioning of the South African economy. If we strip out the R159bn of

presently non-productive construction-in-progress, Eskom's CFROI improved to an internationally competitive 3.3 percent by March 2012. Our sense is that such a return, if maintained, would be sufficient to justify investment in additional capacity. Given appropriate control of costs - including employment costs and "other operating expenses" - revenue so generated will deliver enough cash from operations to support the balance sheet of a utility company that can typically sustain comparatively high debt ratios - given the essentially low-risk nature of its business.

The lack of capacity expansion struck its nadir with the power outages and mine shutdowns in 2008. If the country is to grow, it clearly needs more power. But who's got the power? If we take Eskom's cash flow estimates from the proposed MYPD3 and forecast its profitability, we estimate that Eskom's CFROI rises to at least 4.8 percent by March 2017 and conservatively 6.6 percent by the plan's close of March 2018. Eskom didn't publish sufficient forecast data for us to make more accurate calculations.

Economic returns of this level are simply unnecessarily high for Eskom and far too onerous for the country. Eskom and the government should show less concern about Eskom's debt level, which is naturally high for most regulated utilities - a median of 53 percent book leverage for our sample of 100 global listed electricity companies - and will not be threatened by much more modest price increases. The concern should be for providing additional power at an economically sensible price that is sufficient to provide a real return on additional capital invested of no more than 4 percent a year. The increases suggested in MYPD3 are unreasonable. The public must show who's got the power.

### QUOTE OF THE DAY

Tell the truth, or someone will tell it for you.

- Stephanie Klein, American blogger and author

## Commodity curve flattens as Chinese growth dips



### TRADING AGENDA

Ethel Hazelhurst

**G**ROWTH in China has slowed from a peak of more than 14 percent in 2007, according to the International Monetary Fund (IMF), to an estimated 7.8 percent this year. The sharp deceleration has changed the outlook for commodities and the companies that produce them.

The impact on prices can be seen in the Thomson Reuters Jefferies CRB commodities index, which plunged from a peak of 473 points in July 2008 to a trough of 200 in December that year. It recovered to 370 points in April last year before falling to 307 last week.

Other commodity indices show a similar pattern.

Hein Boegman, the PwC African mining leader, said last week that gold was the only commodity to gain value this year.

"A weakening rand over the period managed to shield the South African mining industry from the decline, with [rand] prices remaining relatively flat. However, flat prices will not support the industry's significantly increased cost base."

So a lot is riding on China's performance - the IMF has forecast 8.2 percent next year. But the future is more complicated than that. China is in need of economic reform. Its reliance on capital investment and exports to boost economic growth proved very effective - for three decades.

But in 2008 the nature of the world changed. The apparently endless consumption in the West was reined in sharply by the financial crisis of 2007-08 and the global recession of 2008-09. And demand for China's goods suddenly slumped.

The return of recession to Europe this year has driven the message home.

Analysts expect the new political dispensation in China and economic pressures to change the focus of the economy to the domestic market. Stronger local consumption will make the country and the Asia-Pacific region less reliant on the health of the rest of the world.

Writing in the Sydney Morning Herald, investment strategist Michael Feller noted: "Assuming that such change will involve less reliance on fixed asset investment to generate growth and a greater focus on social welfare, market liberalisation and domestic consumption, this will have major ramifications for Australia as well."

South Africa, like Australia, benefited from the sudden emergence of a new market for its commodity exports. Now, with