

**IN THE HIGH COURT OF SOUTH AFRICA  
GAUTENG DIVISION, PRETORIA**

Case no        /2018

In the matter between

**ESKOM HOLDINGS SOC LIMITED**

Applicant

and

**NATIONAL ENERGY REGULATOR OF SOUTH AFRICA**

Respondent

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**FOUNDING AFFIDAVIT**

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I, the undersigned

CALIB CASSIM

state under oath that

1. I am the Chief Financial Officer (Acting) of the applicant (“Eskom”) of Megawatt Park, Maxwell Drive, Sunninghill, Johannesburg.
2. The facts contained herein are within my own personal knowledge and are true and correct.
3. I am duly authorised by Eskom to depose to this affidavit in support of the notice of motion setting out the relief sought by Eskom.

## THE PARTIES

4. The applicant is Eskom Holdings Limited, a state-owned company established in terms of the Eskom Conversion Act 13 of 2001, with its address at Megawatt Park, Maxwell Drive, Sunninghill, Sandton, Gauteng.
5. The respondent is National Energy Regulator of South Africa (NERSA), a regulatory body established in terms of the National Energy Regulator Act 40 of 2004 with its address at Kulawula House, 526 Madiba Street, Pretoria, Gauteng.

## INTRODUCTION

6. This application has been precipitated by the irregular conduct and omissions of NERSA in relation to decisions which adversely affect the liquidity of Eskom and have potentially catastrophic consequences for the South African economy as a whole.
7. On 15 December 2017, NERSA announced its decision (“the NERSA 2018/19 decision”) to approve an average increase of 5.23% to Eskom’s tariffs for the 2018/19 financial year. The NERSA 2018/19 decision was conveyed to Eskom in a letter dated 15 December 2017. That letter is attached as Annexure “**FA1**”.
8. The NERSA 2018/19 decision was *ultra vires* the Electricity Regulation Act 4 of 2006 (“the ERA”) and inconsistent with section 15 thereof and the Multi Year Price Determination Methodology (“MYPDM”) adopted by NERSA to determine tariff increases. A copy of the MYPDM governing the NERSA 2018/19 decision, MYPDM4, is attached as Annexure “**FA2**”. The NERSA 2018/19 decision was also substantively irrational and unjustifiable.

9. The NERSA 2018/19 decision compromised the liquidity outlook of Eskom to such an extent that, after consulting Eskom's external auditors, Sizwe Ntsaluba Gobodo, Eskom's board concluded that they could not file financial statements prepared on the basis that Eskom would remain a going concern without a commitment from the National Treasury to support Eskom financially. As a result of this, Eskom's interim financial statements for the period ending 30 September 2017 were only able to be published over a month late, i.e. on 30 January 2018, after the National Treasury had made such a commitment to the satisfaction of the Eskom Board in consultation with its external auditors.
10. The NERSA 2018/19 decision came on the back of four consecutive years of tariff increases that were inadequate to meet Eskom's expenses. These tariff increases were governed by a 5-year Multi-Year-Price-Determination-Methodology ("MYPDM3") which is attached as Annexure "**FA3**". During the period governed by MYPDM3 period, the NERSA imposed tariffs resulted in Eskom experiencing a shortfall of R225bn between what was applied for and what was awarded.
11. MYPDM3 contains the Regulatory Clearing Account ("RCA") process which provides for tariffs to be adjusted *ex post facto* to take account of the difference between the assumptions on which tariffs were set for a particular financial year and the actual experience of that financial year.
12. However, this process has not been applied by NERSA because it has been interrupted by legal challenges. On 1 March 2016, NERSA authorised Eskom to recover an amount of R11.2 billion in additional revenue through additional price increases to offset under recovery of revenue in the 2013/14 financial year following an Eskom RCA application for that year. This decision of NERSA was taken on review in the *Borbet* case. The review was initially upheld in the Gauteng High Court. Therefore, NERSA's decision was

ultimately vindicated only in 2017 when the Supreme Court of Appeal ruled in favour of NERSA on 6 June 2017 in *NERSA v Borbet SA (Pty) Ltd* [2017] ZASCA 87 and the Constitutional Court dismissed an application for leave to appeal against the SCA judgment on 16 August 2017.

13. The 2017/18 tariff year ended on 31 March 2018. When the audited financial results from this year are available, Eskom will submit an RCA application to NERSA for recovery of the amounts due to it in terms of the RCA process. It anticipates an RCA claim in the region of R20 billion for the 2017/18 tariff year. It has already submitted the following RCA applications to NERSA (“the pending RCA applications”) in respect of the 2014/15 to 2016/17 financial years:

- 13.1. an application submitted in July 2016 for recovery of R19.2 billion in respect of the 2014/15 financial year, attached as Annexure “**FA4**” – as appears from Annexure “**FA4**”, R8.787 billion of the amount claimed by Eskom in respect of the 2014/15 financial year was due to variances between actual revenue and NERSA’s assumption relating to revenue;

- 13.2. an application submitted in July 2016 for recovery of R23.6 billion in respect of the 2015/16 financial year, attached as Annexure “**FA5**” – as appears from Annexure “**FA5**”, R15.578 billion of the amount claimed by Eskom in respect of the 2015/16 financial year was due to variances between actual revenue and NERSA’s assumption relating to revenue; and

- 13.3. an application submitted in July 2017 for recovery of R23.9 billion in respect of the 2016/17 financial year, attached as Annexure “**FA6**” – as appears from Annexure “**FA6**”, R20.016 billion of the amount claimed by Eskom in respect of the 2016/17

financial year was due to variances between actual revenue and NERSA's assumption relating to revenue.

14. NERSA irregularly failed to process the pending RCA applications while it waited for finality on the *Borbet* judgment. For more than seven months after the SCA judgment was handed down, NERSA still did not commence processing these applications. On 23 January 2018, NERSA announced that it would process these pending RCA applications on a timetable that will yield a decision only at the end of August 2018. With the replacement of the Eskom Board in January 2018, the newly appointed CEO, Mr Hadebe, engaged with NERSA in an attempt to persuade it to process the three pending RCA applications in time for implementation in the 2018/19 tariff year, but NERSA has declined to do so. The best it would offer was a decision by 21 June 2018 which is too late for implementation in the 2018/19 local government financial year. So, the outcome of these three pending RCA applications, for an aggregate recovery of R66.7 billion (of which an aggregate amount of R44.381 billion, is directly attributable to NERSA overestimates of electricity consumption) will not be capable of implementation in the 2018/19 tariff year, in respect of municipalities.
15. The failure of NERSA to decide the three pending RCA applications has deprived Eskom of R66.7 billion to which it claims it is entitled and which has materially compromised Eskom's liquidity. While NERSA has failed to process the RCA claims, Eskom has funded the R66.7bn of the expenditure that is the subject of the RCA claims by raising debt which has further exacerbated its financial position.
16. The inadequate tariff increase allowed in the NERSA 2018/19 decision will materially increase the strain on Eskom's liquidity. Without the RCA tariff increases to which Eskom is entitled, the patently inadequate increase provided for in the NERSA 2018/19 decision

presents a material risk of catastrophic consequences not only to Eskom, but also to the South African national economy. In order to tide itself through the 2018/19 financial year, Eskom will have to find other sources for funds which ought to have come from tariffs lawfully imposed by NERSA.

17. If NERSA's irrational approach to the 2018/19 decision and dilatory conduct in relation to the pending RCA applications is repeated, there is a real risk that Eskom will not be able to continue as a going concern.
18. Eskom accordingly brings this application to review and set aside the NERSA 2018/19 decision, to remit that decision to NERSA for re-determination and to declare NERSA's delays in determining the pending RCA applications to be unconstitutional;
19. I have structured this affidavit as follows:
  - 19.1. First, I describe Eskom's liquidity difficulties and show how the NERSA 2018/19 decision and its failure to decide the pending RCA applications in time for their implementation in the 2018/19 financial year compounds these difficulties and raises the risk of catastrophic harm to Eskom and the National Government finances.
  - 19.2. Thereafter, I describe the statutory framework governing electricity tariff determinations and the MYPDM applied by NERSA. In the process I distinguish between the ordinary annual tariff application and the RCA tariff adjustment process.
  - 19.3. I describe the events relating to the 2013/14 to 2016/17 RCA applications and the essential features of the three RCA applications that are still pending.

19.4. Then I summarise the Eskom 2018/19 tariff increase application and the NERSA processes relating to this application.

19.5. I analyse the NERSA 2018/19 decision and show that it is inconsistent with the ERA and the MYPDM and is substantively irrational and unjustifiable.

19.6. Finally, I briefly set out the basis for the relief claimed in this application.

### **ESKOM'S LIQUIDITY PROBLEM, THE INADEQUACY OF THE 2018/19 NERSA'S TARIFFS AND THE RISK OF CATASTROPHIC HARM TO ESKOM AND THE NATIONAL ECONOMY**

20. Historically, electricity prices in South Africa were maintained at artificially low levels by pricing electricity without adequately accounting for the capital cost of generating and transmitting electricity. This was a plausible approach when most of the grid was supplied by power stations that had been constructed decades ago and funded by debt guaranteed by central Government, which had been largely redeemed already through revenue from electricity tariffs. However, it ceased to be a sustainable pricing model when South Africa's aging fleet of power stations had to be replaced and supplemented with newly constructed power stations and the transmission network had to be upgraded.

21. Over the last ten years, Eskom has had to embark on an ambitious build program with the construction of 3 large scale power stations and the upgrade of its Transmission network. Eskom's balance sheet weakened over this period due to above inflationary cost increases and low tariffs which yielded inadequate revenue and increased the reliance on borrowings to fund the build program.

22. Given the artificially low tariffs in place, Eskom applied for an annual price increase of 16% during the five-year MYPD3 period while NERSA allowed only 8%. This had a substantial impact on Eskom's finances and Government had to provide support to

Eskom with a R23 billion equity injection, the conversion of a sub-ordinated R60 billion loan into equity and guarantees to Eskom amounting to R350 billion.

23. The too low NERSA tariffs remained a major problem for Eskom. By 2017/18, the Eskom average standard tariff was only 89c/kWh. By way of comparison:

23.1. In its submissions on the MYPD3 five-year tariff determination, Energy Intensive User Group (“EIUG”) (Representing intensive electricity users in South Africa) had indicated that Eskom required tariff increases in the range of 10% to 13% to support its viability and fundability over the period up to 2017/18. Increases in this range would have produced a 2017/18 average standard tariff of between 97.69c/kWh and 111.76c/kWh. At the mid-point of this range of projected tariffs for 2017/18, the price of 105.98/kWh in Eskom’s application for 2018/19 would have represented only a 1.20% increase on the 2017/18 tariff. An extract from the relevant submission of EIUG is attached as Annexure “**FA7**”.

23.2. In its submissions on the MYPD3 five-year tariff determination, the Business Unity of South Africa, through its representatives, GENESIS proposed a set of increases over MYPD3 that would culminate in a 2017/18 total average tariff of 101.7/kWh. On this projected tariff for 2017/18, the standard tariff price of 105.98/kWh in Eskom’s current application for 2018/19 is equivalent to a total average tariff of 102/kWh. If the BUSA proposal was implemented by NERSA, then Eskom’s 2018/19 application would have translated into a nil increase in total average price. An extract from the relevant submission of BUSA (through Genesis) is attached as Annexure “**FA8**”



24. It is therefore not surprising that, in downgrading the credit ratings of Eskom all three major rating agencies have repeatedly stressed the uneconomic nature of the tariffs Eskom is allowed by NERSA to charge:

24.1. In its downgrade report of 11 April 2017 (attached as “**FA9**”), Fitch noted that one of the factors that may lead to further negative rating action was a failure “*to achieve more cost-reflective tariffs, in the absence of increased government support resulting in an unsustainable financial profile and a reduction in Eskom’s debt service capability.*”

24.2. In its report of 17 November 2017 placing Eskom on ratings watch negative (attached as “**FA10**”), Fitch stated that

24.2.1. The negative outlook was linked to “*weak cashflows driven by lower-than-expected tariff increases due to delays in implementing outstanding regulatory clearing account applications.*”

24.2.2. Its negative outlook for Eskom was issued on the basis of its expectation of a low double-digit tariff increase for 2018/19, and a higher tariff increase would lead to a rating affirmation and the removal of the negative outlook.

24.2.3. Fitch also noted the worsening of Eskom’s liquidity over the course of 2017 with cash balances likely to reduce to about R1.2 billion at end-November 2017. It stated that even on the assumption of a double-digit tariff increase: “*We expect free cash flow to remain negative and for Eskom to need to access external funding on a continuous basis.*”

24.3. Even after the recent steps taken by President Ramaphosa to address corporate governance issues at Eskom, on 31 January 2018 Fitch further downgraded

Eskom from BB+ to BB-. In a press release accompanying the downgrade (attached as “**FA11**”) Fitch made clear that this further downgrade was due, in part, to the NERSA 2018/19 tariff decision. It stated:

*“Liquidity Challenges: We estimate Eskom needs a significant liquidity boost during the next two months and that the recent government initiatives, including the new board and CEO nominated on 20 January 2018 as well as steps towards releasing interim financial statements on 30 January 2018, should offer sufficient comfort to investors to address their concerns regarding corporate governance.*

*However, we believe that further tangible support from the government may also be needed as the National Energy Regulator of South Africa (NERSA) recent tariff announcement has introduced further funding uncertainty over the medium term.”*

24.4. On 2 May 2018, Fitch maintained Eskom’s rating at BB- with a negative ratings watch outlook. In a press release accompanying its decision it made clear that ratings were unlikely to improve in the immediate future and that factors that might avoid a further downgrade included

*“Higher tariff increases supported by positive outcome on the RCA applications”*

A copy of the press release is attached as Annexure “**FA11A**”.

24.5. In its credit opinion of 30 June 2017 (attached as “**FA12**”), following its downgrade of Eskom on 13 June 2017, Moody’s stated that

24.5.1. Its downgrade of Eskom reflected *“a challenging regulatory framework for tariffs relative to operating and capex costs in the context of an ageing electricity system”*

24.5.2. *“South Africa's energy tariffs have historically been amongst the lowest in the world. Against a background of low investments during the 1990s and - until around 2007 - tariff increases often below inflation, it has been a significant challenge for the regulator to increase tariffs without harming users unduly. The regulator and Eskom's principal stakeholders have accepted that prices have to rise in real terms in order to finance the company's increasing investment needs, and this has been the case since 2008.*

*Section 15 of the Electricity Regulation Act 2006 states that regulation must allow an efficient licensee to recover the full cost of its licensed activities, including a reasonable margin or return. In practice however, fully cost-reflective tariffs have yet to be implemented. The costs of the electricity system have been so far in large part borne by Eskom, not consumers.”*

24.5.3. *“NERSA has capped the tariff increase for 2017/18 at 2.2%, which is well below inflation levels which we expect to reach around 6% in 2017. ...The modest 2.2% increase in tariffs in the current financial year, combined with high operating costs, will further exacerbate the funding needs of Eskom, putting more pressure on the company's weak credit metrics.”*

24.5.4. It noted that going forward, any change in Eskom's financial strength would depend on three factors, one of which was *"the evolution of tariffs, which currently do not fully incorporate some costs."*

24.6. Like Fitch, Moody downgraded Eskom further in late January 2018, after the recent steps taken by President Ramaphosa to address corporate governance issues at Eskom. A copy of the Moody's Eskom downgrade press release of 26 January 2018 is attached as Annexure **"FA13"**. As appears from this press release, Moody's applauded the steps taken by President Ramaphosa but emphasized the inadequate tariffs allowed to Eskom as a threat to its ongoing sustainability. Moody's stated:

*"The rating action also factors in the December 2017 decision by the National Energy Regulator of South Africa (NERSA) to allow Eskom to increase revenue by 5.23% in FY2018/19, well short of the 19.9% proposed by the company. This decision follows a 2.2% tariff increase for 2017/18 and will put further pressure on the company's already weak cash flow."*

*"In addition to low tariff increases and a lack of visibility around their future development, the company faces (1) stagnant demand, potentially driving declining output from coal fired generation plants as renewables output increases; and (2) a large committed capex programme including the final units of the coal fired Medupi and Kusile power plants. Absent significant tariff increases or reductions in costs and investment, Eskom's large debt burden, amounting to ZAR365 billion as of 31 March 2017, will continue to rise - to potentially unsustainable levels -- and will, in any event, continue to weigh on its very weak financial metrics."*

24.7. In its ratings research update of 6 April 2017 (attached as **"FA14"**), following the downgrade of Eskom's credit rating on 3 April 2017, Standard & Poors stated that:

24.7.1. *“Our view of ESKOM's weak business risk profile reflects our assessment of a weak regulatory framework supervised by NERSA. Although the regulator recently introduced multi-year tariff determinations to improve the predictability and stability of tariff-setting, the framework has been subject to negative intervention aimed at protecting consumers, which has hurt ESKOM's credit quality.”*

24.7.2. *“Weak metrics are a result of continued delays in implementing tariffs that reflect costs, investment needs, and the rising debt associated with ESKOM's large capex program.”*

24.7.3. *“our base-case scenario hinges on ESKOM receiving at least an 8%-10% tariff increase for fiscal 2019 and beyond. We may decide to revise our base case if NERSA is unable to repeal the decision by the courts on the ESKOM tariffs (a decision which we currently anticipate around end-July 2017) and, at the same time, does not grant ESKOM a guarantee tariff increase of 8%-10% in fiscal 2019.”*

24.7.4. *“Liquidity*

*Our assessment of ESKOM's liquidity as weak reflects the pressure ESKOM faces with revenues insufficient to compensate higher costs, higher capex, and the continued challenging operating environment. ...*

*In addition, we consider that prospects for liquidity to improve are now substantially reduced following NERSA's decision to grant just a 2.2% tariff increase for fiscal 2018. ...*

*... a substantial amount of revenue and earnings growth will remain tied to future tariff evolution, which at present is difficult to predict”*

24.8. On 17 January 2018 Standard and Poors was quoted as stating that Eskom was now facing the clear danger of a debt default and that the lower than expected tariff increase for 2018/19 should be a priority for the country. In this regard, I attach as “**FA15**” copy of a Fin24 report of 18 January 2018.

24.9. On 27 February 2018 Standard and Poors downgraded Eskom from B- to CCC+. In its ratings report of that date (attached as “**FA16**”) it stated:

*“The downgrade reflects our view that the possibility of a distressed exchange or default in the next six months continues to hang over Eskom despite the utility having secured South African rand (ZAR) 30 billion (around \$2.5 billion) in short term funding commitments from local and international funders over January-February of this year”*

*“Furthermore, the 5.2% sub-inflation tariff increase awarded by the regulator (NERSA) in fiscal year 2019 (ending March 31, 2019), against a budgeted 10.5% increase, is likely to exacerbate negative cash flow generation and weigh on already low investor sentiment. We therefore anticipate pronounced pressure on Eskom's fiscal 2019 financing plans, which include capital expenditures (capex) of around ZAR55 billion and negative free cash flow, as well as refinancing ZAR20 billion in bridge financing due Aug. 31, 2018, and about ZAR20 billion in scheduled debt maturities. Consequently, Eskom remains at risk of facing a distressed exchange situation of default in the next six months.*

*“We acknowledge that Eskom is addressing its structural and liquidity challenges, including reducing its fiscal 2018 funding requirements by ZAR14 billion to ZAR54 billion, with the debt issuance reduction compensated by lower capex and operational cash outflows. However, given that the company has already rationalized its capital and operating*

*expenditures significantly, we see limited additional scope for cost cuts in fiscal 2019.”*

*“In addition, we consider that prospects for liquidity improvements continue to be slim given the current depressed local issuance activity, and recent approval by the regulator of sub-inflation tariff increases, which exacerbate the level of negative cashflow generation.”*

25. All three ratings agencies have downgraded Eskom **after** the new Eskom Board and CEO have taken office. So, whatever the situation may have been in the past, the current financial difficulties faced by Eskom are not an issue of corporate governance.
26. In the public debates about Eskom’s financial position it is sometimes suggested that Eskom’s financial predicament is caused by inefficiency and mismanagement. This glib suggestion is simply unfounded. As pointed out above, in motivating its 27 February 2018 downgrade of Eskom, Standard and Poors observed:

*“given that the company has already rationalized its capital and operating expenditures significantly, we see limited additional scope for cost cuts in fiscal 2019.”*

27. This observation of Standard and Poors is consistent with the findings of the World Bank. In August 2016, the World Bank published a study of the financial viability of electricity sectors in Sub-Saharan Africa. The title page, table 6 and chapter six of the study are attached as Annexure “**FA17**”. Table 6 of the study shows that South Africa’s electricity tariffs are among the lowest in Sub-Saharan Africa. Chapter 6 of the study analyses on a country by country basis the “hidden costs” i.e. costs that are hidden from the view of consumers by not being recovered through tariffs, thus preventing the relevant electricity utility from achieving full cost-recovery on the basis of benchmark performance. The study concluded that in the case of Eskom

- 27.1. 15% of the hidden costs were due to overstaffing;
  - 27.2. 4% of the hidden costs were due to inadequate debt recovery;
  - 27.3. none of the hidden costs were due to transmission and distribution losses; and
  - 27.4. 81% of the hidden costs were attributable to inadequate tariffs.
28. Since 2016/17, the tariff problem has been compounded by the below inflationary 2.2% increase for the 2017/18 tariff year and will be compounded further by the 2018/19 NERSA tariff decision. As noted by Standard and Poors, Eskom has not only rationalized its capital expenditure, it has also made material savings on its operational expenses. By way of illustration, its interim financial statements for the six months ending 30 September 2017 show that expenditure on employees had not increased with inflation relative to the six months ending 30 September 2016 but had dropped from R17.46 bn to R16.71 bn. Notwithstanding savings on operational expenses, Eskom's liquidity problems have worsened. Table 1 below reflects the Eskom cash flow and the deterioration of its cash position:



R Million	Audited year to 31 March 2015	Audited year to 31 March 2016	Audited year to 31 March 2017	Reviewed 6 months to 30 Sept 2017
Cash from operations	27 311	37 242	45 841	22 631
Cash flow used in investing activities	(56 386)	(58 590)	(62 286)	(29 663)
Cash flows from financing activities	17 954	17 927	7 855	(4 561)
Cash equity injection		23 000		
Increase (decrease) in cash position	(11 121)	19 579	(8 590)	(11 593)
Cash and cash equivalents	8 863	28 454	20 425	8 507

**Table 1: Eskom's Cash Flow**

29. The deterioration of Eskom's cash position is reflected in the decline of all of its key financial ratios over the first half of the current financial year:

29.1. Its cash interest cover ratio has dropped from 1.82 at the end of the 2017 financial year to 1.09 at the end of the second quarter of the current financial year;

29.2. Its cash debt service cover ratio has dropped from 1.37 at the end of the 2017 financial year to 0.68;

29.3. Its free funds from operations as a percentage of gross debt has dropped from 11.69% at the end of the 2017 financial year to 9.36%;

29.4. Its free funds from operations after interest as a percentage of gross debt has dropped from 5.20% at the end of the 2017 financial year to 2.34%.

- 29.5. Its gearing ratio (debt / equity) has increased from 2.11 at the end of the 2017 financial year to 2.54.
30. The inadequate tariff increase allowed in the NERSA 2018/19 decision materially increases the strains on Eskom's liquidity. Moreover, a shortfall in revenue for Eskom is likely to turn its liquidity issues into a self-fulfilling prophecy:
- 30.1. Eskom has material funding requirements (exceeding R68bn in 2018 alone) in order to meet its operating expenditure and committed capital expenditure requirements;
- 30.2. In the 2018/19 financial year, Eskom will have to repay just under R40 billion in capital and interest repayments. It then enters a three-year cycle in which its debt repayments will be between R50 billion and R60 billion per annum. (The debt maturity profile for Eskom as at 31 March 2017 is attached as Annexure "FA18")
- 30.3. Eskom's short-to-medium term liquidity issues are well known. This will materially disincentivise lenders and other investors from providing critical new funding to the business – as pointed out above, all three ratings agencies have downgraded Eskom further in the first two months of 2018, notwithstanding the appointment of a widely acclaimed new Eskom Board;
- 30.4. This in turn will further exacerbate the liquidity issues, potentially to breaking point – the most recent ratings report, the Standard and Poors report of 27 February 2018 expressly states that Eskom is at risk of default within the next six months.
31. Table 2 below describes Eskom's planned borrowings over the current financial year and the 2018/19 financial year. These borrowings will be materially adversely affected by the inadequate 5.23% tariff increase.

32. International bonds represent R29.7 billion of the planned borrowings. International bonds are usually issued on an unguaranteed basis. However, given the impact of the inadequate 5.23% increase, Eskom will have to explore issuing its international bonds on a guaranteed basis. This will significantly impact the other planned guaranteed debt as the available State guarantees are limited and Eskom had not planned for international bonds to be backed by State guarantees.
33. The committed facilities of R34 billion mainly represent existing loan facilities from which Eskom can draw down. The DFI and ECA committed facilities are “project specific” and allocated to the following projects:
- 33.1. Medupi – project specific funding in the form of ECAs/DFIs.
- 33.2. Kusile – partially financed, though DFIs and ECAs.
- 33.3. Distribution projects are partially financed.
34. Suspension or cancellation of the relevant projects will result in these facilities having to be repaid or can trigger an event of default on the loan agreements. At each drawdown, or interest payment, Eskom has to warrant that no circumstances exist that will jeopardize its ability to honor the obligations under the loan agreement, which includes repayment of the loan as well as the ability to complete the project. I refer in this regard to a document entitled “Response to NERSA Loan Covenants” which Eskom sent to NERSA on 14 December 2017 and is attached hereto as Annexure “**FA19**”). There is a material risk that this warranty may not be possible given the impact of the 5.3% increase. Misrepresentation is an event of default.

	Period 2017/18		Period 2018/19		Combined 2018-2019	
	Sources	Committed	Sources	Committed	Sources	Committed
<b>Execution progress fund raising initiatives for period April 2017 till March 2019</b>						
Swap Restructuring	2.5	2.5	0.0	0.0	2.5	2.5
Signed DFI's	19.7	19.7	6.8	6.8	26.4	26.4
Signed ECA's	4.2	4.2	0.9	0.9	5.2	5.2
<b>Total Committed &amp; Signed (R Bn)</b>	<b>26.4</b>	<b>26.4</b>	<b>7.7</b>	<b>7.7</b>	<b>34.1</b>	<b>34.1</b>
		49%		12%		29%
Domestic Bonds	3.0	2.0	6.0	0.0	9.0	2.0
Commercial Paper/ Short Term Notes	5.8	2.6	6.0	0.0	11.8	2.6
International Bonds	13.2	0.0	16.5	0.0	29.7	0.0
<b>Total Signed Documentation in Place</b>	<b>22.0</b>	<b>4.6</b>	<b>28.5</b>	<b>0.0</b>	<b>50.5</b>	<b>4.6</b>
		9%		0%		4%
Other	0.0	0.0	0.0	0.0	0.0	0.0
New DFI's	0.1	0.0	19.7	0.0	19.8	0.0
New ECA's	4.9	0.0	9.3	0.0	14.3	0.0
<b>Currently Under Negotiation</b>	<b>5.0</b>	<b>0.0</b>	<b>29.0</b>	<b>0.0</b>	<b>34.0</b>	<b>0.0</b>
<b>Total (R Bn)</b>	<b>53.4</b>	<b>31.0</b>	<b>65.2</b>	<b>7.7</b>	<b>118.6</b>	<b>38.7</b>
		58%		12%		33%

**Table 2: Eskom's Planned Borrowings 2017/18 and 2018/19**

35. All the guaranteed debt has to be used for the funding of the capital programme. Cutting capital expenditure to meet the 5.23% tariff increase can impact the existing and future guaranteed debt in the following ways:

35.1. Given Eskom's credit rating, it has become increasingly difficult to access funding without a government guarantee. The government guarantees can however only be used for loans that will be utilized to fund the capital programme.

35.2. Tables 3 and 4 below list Eskom's planned guaranteed and non-guaranteed borrowings for the period 2020 to 2024 with a high-level indication of the capital

projects to be funded. If these projects have to be cut from the capex programme then the planned funding will also not materialize. As has been pointed out above, where the funding is necessary to complete existing projects that are already partially funded (e.g the more than R60 billion funding earmarked for Kusile) a failure to obtain this funding can trigger the breach of obligations in terms of existing loan agreements where funds have been drawn to pay for those projects.

<b>New Loans</b>	<b>Total 2020</b>	<b>Total 2021</b>	<b>Total 2022</b>	<b>Total 2023</b>	<b>Total 2024</b>	<b>Total</b>
<b>Development Financing Institutions (New)*</b>	<b>13 033 443 384</b>	<b>14 043 740 534</b>	<b>11 192 660 498</b>	<b>9 602 432 762</b>	<b>3 228 553 127</b>	<b>51 100 830 305</b>
				4 527 873 000	0	25 657 947 000
CDB Longterm (Kusile)	7 546 455 000	7 546 455 000	6 037 164 000	0	0	1 680 000 000
AFDB Public Sector (Transmission) ZAR	560 000 000	560 000 000	560 000 000	0	0	431 226 000
AFDB Public Sector (Transmission) USD	143 742 000	143 742 000	143 742 000	0	0	1 312 000 000
AFD (First Tranche EUR 100m now in ZAR) Transmission	479 000 000	652 000 000	181 000 000	0	0	1 431 778 127
AFD (Tranche 2 EUR 150m each) Transmission	75 356 744	251 189 145	753 567 435	1 431 778 127	0	2 511 891 451
AFD (Tranche 3 EUR 150m each) Transmission	0	75 356 744	251 189 145	753 567 435	1 431 778 127	2 511 891 451
EIB Transmission New Development Bank (BRICS) Transmission/ Environmental	502 378 290	251 189 145	376 783 718	0	0	1 130 351 153
New Development Bank (BRICS) FGD	517 471 200	517 471 200	517 471 200	517 471 200	0	2 069 884 800
KFW Transmission New DFI Funding- JICA	574 968 000	574 968 000	574 968 000	574 968 000	0	2 299 872 000
FGD	837 297 150	1 674 594 300	0	0	0	2 511 891 450
	1 796 775 000	1 796 775 000	1 796 775 000	1 796 775 000	1 796 775 000	8 983 875 000

**Table 3: Planned borrowings 2020 – 2024 (Guaranteed)**

35.3. All the above loans will be covered by a government guarantee and are project specific. The lenders have also indicated that they will need to reassess Eskom's financial position based on the 5.23% increase and the rating downgrades, and

may also internally downgrade Eskom which will result in an increase in the cost of debt.

35.4. The ECAs listed in Table 4 are not government guaranteed, but as with the government guaranteed debt, they are also project specific. It remains to be seen whether lenders will be amenable to providing loans to Eskom without guarantees after the inadequate 5.23% tariff increase for 2018/19. With international bonds now threatening to consume a significant portion of Eskom’s remaining available guarantees, it may not be possible for Eskom to procure guarantees for the debt contemplated by these ECAs.

New loans	Total 2020	Total 2021	Total 2022	Total 2023	Total 2024	Total
<b>Export credit facilities (New) *</b>	<b>4 407 944 316</b>	<b>3 838 170 136</b>	<b>3 168 332 416</b>	<b>0</b>	<b>0</b>	<b>20 015 367 505</b>
- Koeberg SGR (EUR 264m-158m=EUR106)	355 013 992	355 013 992	177 506 996	0	0	1 775 069 958
- Kusile FGD (EUR90m)	602 853 948	301 426 974	0	0	0	1 507 134 870
- Kusile C & I (HERMES) (Two loans total EUR70m) (HSBC)	185 138 499	0	0	0	0	690 815 296
- Kusile C & I (SACE) (EUR70m) (HSBC)	83 208 707	0	0	0	0	489 462 981
- ICBC Huawei Sinosure (USD150m)						2 156 130 000
- ECA Framework (EUR1.6bn)	3 181 729 170	3 181 729 170	2 990 825 420	0	0	13 396 754 400

**Table 4: Planned borrowings 2020 – 2024 (Non-Guaranteed)**

36. Having regard to all the factors described above, it is critical that Eskom not only has sufficient revenue to justify further lending commitments from local and international financiers, but also that Eskom is perceived by financial markets to have such sufficient revenue. In this context, the NERSA 2018/19 tariff decision was particularly harmful to Eskom and would inevitably damage market perceptions of Eskom’s financial sustainability as is reflected in the reports of the ratings agencies. As pointed out above,

36.1. All of the ratings agencies have consistently flagged the inadequacy of tariffs as a major problem for Eskom,

- 36.2. All of the ratings agencies have emphasized the inadequacy of the 5.23% tariff increase in their latest downgrades of Eskom 2018, after the appointment of the new Eskom board.
37. In fact, the problems created by the NERSA 2018/19 decision go beyond market perceptions and have affected the very sustainability of Eskom as a going concern. By confining the standard tariff increase to 5.23%, the NERSA 2018/19 decision compromised the liquidity outlook of Eskom to such an extent that Eskom's capacity to continue as a going concern was now unclear. After consulting Eskom's external auditors, Sizwe Ntsaluba Gobodo, on 19 December 2017, the Eskom Board accordingly concluded that unless the South African Government, as shareholder, indicated that it would provide adequate additional financial support to Eskom, Eskom could not file its interim financial statements for the period ending 30 September 2017 on the basis that it remained a going concern. Ultimately, these interim financial statements were able to be published only on 30 January 2018 after the National Treasury had made commitments to support Eskom that satisfied the Eskom Board after further consultation with its auditors that Eskom would be able to continue as a going concern.
38. A copy of the interim financial statements for the period ending 30 September 2017 is attached as Annexure "**FA20**". As appears from the auditor's report on p 3 of these financial statements, while the auditors accepted Eskom's ability to continue as a going concern, they recorded an "emphasis of matter" in this regard and drew specific attention to note 2 of the financial statements. I draw attention to the following statements in note 2 which appears at p 8 of the financial statements:

*"The tariff increase of 5.23% for the 2019 financial year will have a negative impact on the liquidity of the group."*

*“Eskom is pursuing finalization of the outstanding regulatory clearing account submissions”*

*“Eskom is continuously engaging the shareholder, the department of Public Enterprises, and National Treasury to ensure that the challenges that Eskom is being faced with are addressed satisfactorily within a reasonable timeframe.*

*Government has indicated that Eskom is an important component of the economy and continues to support Eskom as a going concern.”*

39. Eskom’s audited financial statements for the 2017/18 financial year must be filed within 90 days of the close of that year on 31 March 2018 ie by 29 June 2018. If, by that stage, no further financial support from Government is forthcoming, it is likely that these financial statements will contain a going-concern qualification.
  
40. In this context, without the RCA tariff increases to which Eskom is entitled, the inadequate increase provided for in the NERSA 2018/19 decision presents a material risk of potentially catastrophic consequences not only to Eskom, but also to the South African national economy. This is due to the following:
  - 40.1. Eskom’s pre-existing liquidity difficulties exacerbated by the failure of NERSA to decide the three pending RCA applications,
  
  - 40.2. The extent of Eskom’s existing debt (over R350 billion at the end of financial year 2017, with an additional borrowing program of R338 billion planned for the financial years 2018 to 2022, and Eskom’s debt now standing at R362 bn as at the end of December 2017),



- 40.3. Eskom's related debt service obligations, which will increase in relation to new borrowings or any re-financings due to recent ratings downgrades and the more challenging environment Eskom is operating in,
- 40.4. The fact that significant portions of existing drawn down debt are project specific and subject to warranties in relation to Eskom's ability to complete the relevant projects,
- 40.5. The manner in which much of Eskom's debt is interlinked, so that default on one facility can trigger default on other facilities with full amounts due becoming potentially payable immediately and/or being placed on demand by lenders, (see Annexure "**FA19**" in this regard),
- 40.6. The fact that certain lenders may call in the full amounts of their debt if minimum Debt Service Cover ratios are not met (which has been the case for several years and will be the case on the NERSA 2018/19 decision) and if they are not satisfied with Eskom's ability to recover to satisfactory liquidity positions. (See Annexure "**FA19**" in this regard),
- 40.7. The guarantees furnished by the South African State in respect of Eskom's debt (total guarantees available of R350 billion with R274.7 billion already committed and another R63.6 billion under negotiation), and
- 40.8. The manner in which South African State debt is itself interlinked, so that a failure to meet any demand made on South Africa by any creditor of Eskom with the benefit of the South African State's Eskom guarantees would also potentially trigger acceleration of the full liability of South Africa's own debt which can be

accelerated if any such demand is not met when made, potentially exposing over \$64 billion (over R760 billion) of international debt of South Africa.

## **THE STATUTORY FRAMEWORK AND THE MYPDM**

41. The statutory framework governing Eskom electricity tariff increases is set out in the *Borbet* judgment of the SCA. It is summarized as follows.
42. NERSA was established in terms of the National Energy Regulator Act 40 of 2004 (NERA), with the mandate to, *inter alia*, regulate the generation, transmission and distribution of electricity. Section 4 of NERA sets out NERSA's functions and provides, amongst others, that NERSA is to undertake the functions set out in s 4 of the ERA.
43. The objects of ERA include
  - 43.1. to achieve the efficient, effective, sustainable and orderly development and operation of electricity supply infrastructure in South Africa;
  - 43.2. to ensure that the interests and needs of present and future electricity customers and end-users are safeguarded and met, having regard to the governance, efficiency, effectiveness and long-term sustainability of the electricity supply industry within the broader context of economic energy regulation in the Republic;
  - 43.3. to facilitate investment in the electricity supply industry; facilitate a fair balance between the interests of customers and end-users, licensees, investors in the electricity supply industry and the public.
44. Section 4 of ERA sets out the powers and duties of NERSA and these include consideration of applications for licenses and issuing of licences for the operation of

generation, transmission or distribution facilities and regulation of electricity prices and tariffs.

45. Section 14(1) of ERA under the title 'Conditions of licence' provides, *inter alia*:

*“(1) The Regulator may make any licence subject to conditions relating to –*

*... .*

- (d) the setting and approval of prices, charges, rates and tariffs charged by licensees;*
- (e) the methodology to be used in the determination of rates and tariffs which must be imposed by licensees”*

46. Section 15 of ERA sets out the 'Tariff principles' as follows:

*“(1) A licence condition determined under section 14 relating to the setting or approval of prices, charges and tariffs and the regulation of revenues –*

- (a) must enable an efficient licensee to recover the full cost of its licensed activities, including a reasonable margin or return;*
- (b) must provide for or prescribe incentives for continued improvement of the technical and economic efficiency with which services are to be provided;*

*... .*

*(2) A licensee may not charge a customer any other tariff and make use of provisions in agreements other than that determined or approved by the Regulator as part of its licensing conditions.”*

47. The effect of these provisions was summarized by the SCA as follows in paragraph 12 of the *Borbet* judgment:

*“The provisions set out above create a situation where licensees are the ones empowered to charge a tariff for electricity consumption within parameters set by the Regulator. Licences, as can be seen from the provisions of ss 14(1)(d) and (e) of ERA, may contain conditions relating to the setting and approval of prices, charges, rates and tariffs to be charged by licensees. Licences may be made subject to conditions relating to the methodology to be used in the determination of rates and tariffs which must be imposed by licensees (s 14(1)(e)). NERSA is therefore responsible for determining whether a licence should be granted; the terms of the licence; the methodology by which tariffs and charges are to be determined and the imposition of that methodology on the licensee by way of a licence condition; and the tariffs and charges that the licensee may recover from its customer. All of these are embodied directly or indirectly in the licence and the obligation to adhere to them flows from the licence.”*

48. The MYPDM is the methodology developed by NERSA to determine the allowable tariffs and tariff increases to be charged by licensees to consumers. The MYPDM provides for Eskom tariffs to be determined by NERSA at intervals of 3 to 5 years. The first determination for ESKOM business activities (i.e. generation, transmission and distribution of electricity) was from 1 April 2006 to 31 March 2009 (“MYPD1”). The second MYPD was for the period 1 April 2010 to 31 March 2012 (“MYPD2”). Currently the MYPD process is approaching the end of its third cycle which terminates on 31 March 2018. The RCA applications were accordingly governed by MYPDM3. A new cycle will commence on 1 April 2018. It is governed by MYPDM4. (A copy of MYPDM4 is attached as Annexure “**FA2**”).
49. Although the NERSA 2018/19 decision was a single year tariff decision (as opposed to a multi-year determination), it was taken in terms of MYPDM4. MYPDM4 is accordingly the methodology against which the NERSA 2018/19 decision is to be tested.

50. MYPDM3 and MYPDM4 are similar documents. They list the identical set of objectives in section 2.2 which states the following:

*“2.2 In developing the MYPD Methodology, the following objectives were adopted:*

- 2.2.1 to ensure Eskom’s sustainability as a business and limit the risk of excess or inadequate returns; while providing incentives for new investment;*
- 2.2.2 to ensure reasonable tariff stability and smoothed changes over time consistent with socio-economic objectives of the Government;*
- 2.2.3 to appropriately allocate commercial risk between Eskom and its customers;*
- 2.2.4 to provide efficiency incentives without leading to unintended consequences of regulation on performance;*
- 2.2.5 to provide a systematic basis for revenue/tariff setting; and*
- 2.2.6 to ensure consistency between price control periods.”*

51. Both MYPDM3 and MYPDM4 provided for a “cost plus” system of tariffs. Tariffs were to be set to recover Eskom’s “allowable revenue” on the basis of projected electricity consumption. The formula in MYPDM4 for determining “allowable revenue” is set out in section 5.2 which states the following:

*“The following formula must be used to determine the AR:*

$$AR=(RAB \times WACC)+E+PE+D+R\&D+IDM \pm SQI+L\&T \pm RCA$$

*Where:*

*AR = Allowable Revenue*

*RAB = Regulatory Asset Base*

*WACC = Weighted Average Cost of Capital*

*E = Expenses (operating and maintenance costs)*

*PE = Primary Energy costs (inclusive of non-Eskom generation)*

- D* = Depreciation
- R&D* = Costs related to research and development programmes/projects
- IDM* = Integrated Demand Management costs (EEDSM, PCP, DMP, etc.)
- SQI* = Service Quality Incentives related costs
- L&T* = Government imposed levies or taxes (not direct income taxes)
- RCA* = The balance in the Regulatory Clearing Account (risk management devices of the MYPD)'''

52. The only difference in the formula used in MYPDM3 was that AR also included transmission and network costs under MYPDM3 *i.e* it was an AR that covered all of Eskom's licensed activities. Under section 5.6 of MYPDM4 there is now an AR for each respective licence activity (or "division") hence the costs of generation and transmission activities are now treated as pass-through costs at distribution level.
53. The MYPDM4 methodology then provides details of how each one of these cost components and the projected sales volumes are to be determined so that there is a detailed system for projecting the total revenue upon which the tariffs will be based:
  - 53.1. Section 6 governs how sales volumes are to be forecast,
  - 53.2. Section 8 prescribes how the weighted average cost of capital is to be determined,
  - 53.3. Section 9 prescribes how the regulatory asset base is to be quantified and how depreciation is to be calculated,
  - 53.4. Section 10 prescribes how operating and maintenance expenses are to be determined,
  - 53.5. Section 11 regulates the costing of research and development,

- 53.6. Section 12 deals with the quantification of primary energy costs in respect of Eskom generated electricity and section 13 deals with the primary energy costs in respect of electricity purchased from independent power producers,
- 53.7. Sections 14 and 15 prescribe what revenues may be claimed in respect of integrated demand management and service quality incentives respectively,
- 53.8. Section 16 identifies the taxes and levies that may be claimed for the purposes of the allowable revenue calculation.
54. The last element in the allowable revenue formula is the balance in the Regulatory Clearing Account (the "RCA"), or more accurately the amount of the RCA balance that is allowed to be recovered or paid back in a particular financial year. The pending RCA applications are in respect of financial years in MYPD3. They are therefore governed by MYPDM3, not MYPDM4. The relevant provision of MYPDM3 is section 14 which states the following:

*'14.1 Risk Management Device*

*The risk of excess or inadequate returns is managed in terms of the RCA. The RCA is an account in which all potential adjustments to Eskom's allowed revenue which has been approved by the Energy Regulator is accumulated and is managed as follows:*

- 14.1.1 The nominal estimates of the regulated entity will be managed by adjusting for changes in the inflation rate.*
- 14.1.2 Allowing the pass-through of prudently incurred primary energy costs as per Section 8 of the Methodology.*
- 14.1.3 Adjusting capital expenditure forecasts for cost and timing variances as per Section 6 of the Methodology.*
- 14.1.4 Adjusting for prudently incurred under-expenditure on controllable operating costs as may be determined by the Energy Regulator.*

14.1.5 *Adjusting for other costs and revenue variances where the variance of total actual revenue differs from the total allowed revenue. In addition, a last resort mechanism is put in place to trigger a re-opener of the price determination when there are significant variances in the assumptions made in the price determination.'*

14.2 *The Regulatory Clearing Account:*

*The RCA is used to debit/credit all the aforementioned potential adjustments to Eskom's allowed revenue and must be used as follows:*

14.2.1 *The RCA will be created at the beginning of the financial year and continuously monitored. The evaluation of the account (for the purpose of determining the pass-through and/or claw-back) will be done with actuals for the full financial year.*

14.2.2 *This account must be updated quarterly so as to use it for regular alerts to customers of any possible adjustment in the coming year. Eskom must therefore submit actual financial data on a quarterly basis.*

14.2.3 *The RCA balance will be measured as a percentage of total allowed revenue and will act as a trigger for re-opener as follows:*

14.2.3.1 *If the RCA balance is less than or equal to 2 % of the allowable revenue, then there will be no immediate pass-through adjustment, but the RCA balance will be carried over to the next financial year.*

14.2.3.2 *If the RCA balance is between 2 % and 10 %, the amount is allowed as a pass-through in the next financial year without the need for a full stakeholder consultation process.*

14.2.3.3 *If the balance is greater than 10 % of the allowable revenue, there will be a full stakeholder consultation process before any pass-through is allowed.*

14.2.4 *The adjustments to be included in the RCA and balance of the RCA will be approved by the Energy Regulator in terms of the MYPD Methodology. The Energy Regulator will only have to determine the timing of when it should be passed through or clawed-back.*



- 14.2.5 *Eskom will, on a quarterly basis, present the Energy Regulator with possible adjustments based on the Methodology, the costs to date and the projections to year-end.*
- 14.2.6 *The Energy Regulator will then review Eskom's submission and make a preliminary assessment of any adjustments required in the subsequent financial year's tariff adjustment.*
- 14.2.7 *The review will be performed on receipt of audited statements from Eskom."*

55. As is made clear by these provisions of MYPDM3 (and the corresponding provisions of Section 17 of MYPDM4) the RCA is a crucial element of the methodology for determining Eskom tariffs. It is a risk management device which ensures that Eskom (and consumers) are protected against the consequences of projection based tariffs that prove to be inappropriate in the light of actual experience. The RCA provides for allowable revenue to be adjusted *ex post facto* on the basis of a retrospective comparison of actual financial facts in respect of a particular financial year with the projections upon which the tariff for that year was determined.

## **THE RCA APPLICATIONS**

### **The 2013/14 RCA Application and the *Borbet* Case**

56. The relevant facts in relation to the 2013/14 application appear from the SCA judgment in the *Borbet* case and were, in any event, common cause.

56.1. On 10 November 2015, Eskom submitted to NERSA its RCA application for tariff increases to recover R22.789 billion in respect of the 2013/14 tariff year.

56.2. On 1 March 2016 NERSA upheld the application in part. NERSA disallowed R11.549 billion of the claim. That left an amount of R11.241 billion of the claim

which NERSA upheld. It authorised Eskom to recover this amount by way of an additional increase to the tariff for the 2016/17 year, which was the next tariff year. A copy of the NERSA decision is attached as Annexure “**FA21**”.

56.3. In the course of 2016 Borbet took the NERSA decision on review, and on 16 August 2016, the Gauteng Division of the High Court, Pretoria granted Borbet’s application and reviewed and set aside the NERSA decision on the 2013/14 RCA application.

### **The Pending RCA Applications**

57. In May 2016 Eskom applied to NERSA for recovery of R19.2 billion in respect of the 2014/15 financial year. The 2014/15 application has been attached as Annexure “**FA4**”. I confirm the correctness of the facts set out in this application. As is reflected at various points in Annexure “**FA4**”, the 2014/15 RCA submission was prepared by Eskom in accordance with the approach applied by NERSA in adjudicating the 2013/14 RCA application. So the reasoning applied by NERSA that led to approximately 50% of the 2013/14 claim being disallowed was addressed in the 2014/15 application and Eskom has every reason to believe that, if NERSA acts consistently, very little of the R19.2 billion will be disallowed.

58. A summary table of the 2014/15 RCA submission appears at p 16 from Annexure “**FA4**” as Table 1. It shows that that the bulk of the R19.185 billion claim related to two items

58.1. R8.787 billion was claimed by Eskom due to variances between actual revenue and NERSA’s original assumption relating to revenue, and

58.2. R10.539 billion was claimed by Eskom due to variances between actual primary energy costs and NERSA’s original assumptions in relation to these costs after

adjusting for R12.8 billion of the actual variance that was not allowed in terms of the approach applied by NERSA in the 2013/14 RCA determination (see table 14 of Annexure “**FA4**” read with para 14.1 on p 41.

59. Also in July 2016, Eskom submitted its RCA application for recovery of R23.6 billion in respect of the 2015/16 financial year. The 2015/16 application has been attached as Annexure “**FA5**”. Like the 2014/15 application, the 2015/16 application was prepared with the benefit of access to the approach applied by NERSA in determining the 2013/14 RCA claim. So Eskom has every reason to believe that most of its 2015/16 claim will be upheld, provided that NERSA acts consistently.
60. A summary table of the 2015/16 RCA submission claim appears at p 16 of Annexure “**FA5**” as Table 1. It shows that, as was the case in the 2014/15 claim, the bulk of the R23.633 billion claim for 2015/16 related to variances in relation to revenue and primary production costs
  - 60.1. R15.578 billion was claimed by Eskom due to variances between actual revenue and NERSA’s original assumption relating to revenue, and
  - 60.2. R8.058 billion was claimed by Eskom due to variances between actual primary energy costs and NERSA’s original assumptions in relation to these costs after adjusting for R5.065 billion of the actual variance that was not allowed in terms of the approach applied by NERSA in the 2013/14 RCA determination.
61. Following the High Court decision in *Borbet* in August 2016, NERSA apparently took a decision not to process the 2014/15 and 2015/16 RCA applications from Eskom. There was no reason to delay processing of the 2014/15 and 2015/16 applications while the

Borbet judgment was taken on appeal. The ratio of the Borbet High Court judgment was twofold:

61.1. First, the Court held that if Eskom failed to lodge quarterly projections of possible RCA adjustments (as required by MYPDM3 section 14.2.5) or failed timeously to apply for its RCA tariff adjustment, NERSA could not entertain its RCA application without inviting comment from members of the public as to how they would be prejudiced by Eskom's failure to comply with its RCA obligations in terms of MYPDM3;

61.2. Second, the Court held that it was irrational for NERSA to make adjustments based on lower than projected sales volumes if these were due to Eskom's negligence.

62. Nothing prevented NERSA from processing the pending RCA applications in accordance with these two principles that flowed from the High Court judgment. On the contrary, the primary logic of the High Court judgment was that the scheme of the RCA methodology was subverted if RCA applications were processed after lengthy delays. That logic dictated that NERSA should not delay processing the pending RCA applications while it appealed the High Court judgment, but should process them as soon as possible.

63. On 18 October 2016, Eskom wrote to NERSA in a letter attached as Annexure **"FA22"** pointing out the problems that delays in the RCA determinations would have:

63.1. It would lead to tariff spikes when the RCA applications were ultimately approved, causing difficulties for consumers who would have been budgeting on the basis of unrealistic tariffs that had been set too low;

- 63.2. It would create a cash flow problem in relation to R54 billion that would interfere with Eskom's planned R327 billion borrowing programme over the next five years. Government was unlikely to remove this cash flow problem by increasing its support to Eskom by R54 billion;
- 63.3. The cash flow problem would set back the new build programme and further delay completion of Medupi, Kusile and Ingula;
- 63.4. The unavailability of funds would interfere with Eskom's maintenance programmes and may result in load shedding, or at least additional expenses as a result of having to resort to Gas Turbines and diesel for generation;
- 63.5. It would result in the substantial erosion of equity within Eskom and negate the effect of government's assistance to Eskom in converting a R60 billion loan into equity in the 2016 financial year. It would make recourse to the debt markets more expensive and may put questions over Eskom's ability to continue as a going concern; and
- 63.6. It would place added pressure on South Africa's national credit rating and may contribute to a rating downgrade to levels below investment grade.
64. On 3 February 2017, Eskom wrote again to NERSA attaching the letter of 16 October 2016 and repeating the concerns expressed in that letter. A copy of Eskom's letter of 3 February 2017 is attached as Annexure "**FA23**".
65. While the *Borbet* case moved through the courts, however, NERSA still did nothing to process the 2014/15 and 2015/16 RCA applications and continued to treat the 2017/18 tariff increase as having been determined in the original 5 year MYPDM tariff determination that had repeatedly been shown to have been flawed. Eskom's tariff

increase for 2017/18 was accordingly limited to 2.2% which was the balance of the original 8% increase still remaining after the effect on the 2016/17 price of the RCA increase that had been set aside by the High Court in *Borbet*.

66. In the meantime, on 27 July 2017 Eskom submitted to NERSA its RCA claim for recovery of R23.9 billion in respect of the 2016/17 financial year. The 2016/17 RCA application has been attached as Annexure “**FA6**”.
67. A summary table of the 2016/17 RCA submission appears at p 13 of Annexure “**FA6**” as Table 1. It shows that the bulk of the R23.9 billion claim comprised R20.016 billion claimed in respect of variances between actual revenue and NERSA’s original assumption relating to revenue. As was the case with the other pending RCA applications, the 2016/17 RCA application was prepared by Eskom with the benefit of guidance from the approach applied by NERSA in the 2013/14 RCA decision. Eskom therefore has every reason to believe that its claim will, in all material respects, be upheld, provided that NERSA acts consistently.
68. Following the SCA decision reinstating the 2013/14 RCA decision of NERSA, NERSA still did not process the pending RCA applications. Even after the Constitutional Court dismissed Borbet’s application for leave to appeal, NERSA did not process the pending RCA applications.
69. On 25 October 2017, NERSA’s electricity sub-committee intimated at a public meeting that it would be processing the pending RCA decisions with a view to implementation through tariff adjustments from 1 April 2019. On 25 October 2017, Eskom wrote to NERSA seeking written confirmation that this would take place and indicating that this would be important for the going concern status of Eskom and would provide comfort to lenders and credit rating agencies who were concerned about Eskom’s liquidity. A copy

of Eskom's letter is attached as Annexure "**FA24**". At the time that it addressed this letter to NERSA, Eskom still anticipated a reasonable tariff increase in the NERSA 2018/19 decision.

70. On 5 December 2017, Eskom wrote again to NERSA requesting confirmation that the pending RCA decisions would be processed and repeating Eskom's concerns about the impact that the delays in relation to the pending RCA applications were having on Eskom's liquidity. A copy of this letter is attached as Annexure "**FA25**".
71. The NERSA 2018/19 decision was announced on 15 December 2017 and immediately threatened Eskom's capacity to continue as a going concern. On 20 December 2017, Eskom wrote to NERSA and repeated the urgency for NERSA to finalise and process the RCAs. Eskom asked NERSA to ensure that the RCAs were processed in time for Eskom's next tariff increase on 1 April 2018. It emphasized that Eskom's liquidity difficulties were hampering its ability to service and raise debt and were now threatening to create events of default that would make Eskom a burden on the fiscus. A copy of the letter is attached as annexure "**FA26**".
72. On 5 January 2018, NERSA wrote to Eskom that it would commence with public consultations pertaining to the RCA before the end of January 2018. A copy of the letter is attached as Annexure "**FA27**". It gave no indication of whether or not it would process these applications in time for 1 April 2018 as requested in Eskom's letter of 20 December 2017.
73. On 15 January 2018, Eskom wrote to NERSA repeating the request that NERSA urgently process the RCA to allow implementation on 1 April 2018. With the letter, Eskom provided NERSA with information showing that as at March 2018, Eskom forecast a

liquidity shortfall of R10. 684bn and at March 2019 a shortfall of R40.537bn. A copy of the letter is attached as Annexure “**FA28**”.

74. On 22 January 2018, NERSA wrote to Eskom indicating its attitude to a request that Eskom had made in a letter of 17 November 2017 relating to the confidentiality of certain material in Eskom’s RCA applications. Again it gave no indication of whether or not it would process the RCA applications in time for 1 April 2018 as repeatedly requested by Eskom. A copy of the NERSA letter of 22 January 2018 is attached as Annexure “**FA29**”.
75. Eskom immediately responded to NERSA on 23 January 2018, giving its consent for the relevant materials to be disclosed publicly. In its letter, Eskom reiterated the urgency of the situation and asked now that a decision on the RCA applications be taken at least in time to liquidate a portion of the RCA balance by 1 July 2018 (the commencement of the municipalities’ financial years) to address the liquidity challenge that Eskom is facing. A copy of the Eskom letter of 23 January 2018 is attached as Annexure “**FA30**”.
76. Later on 23 January 2018, NERSA published a media statement and Explanatory Note in which it set out the process and “indicative timeline” for the processing of Eskom’s RCAs. The timeline contemplates that public hearings will be conducted from 7 to 25 May 2018 and that NERSA will make a decision on the RCAs only on 29 August 2018 which will be too late for any tariff increases to take effect prior to 1 April 2018 (or even prior to 1 July 2018 which is that start of the municipalities’ financial year). Copies of NERSA’s media statement and explanatory note are attached as Annexure “**FA31**” and “**FA32**”. From the indicative timeline, it is clear that NERSA was not moved by Eskom’s call to process the RCAs urgently.



77. On 30 January 2018. Eskom wrote again to NERSA, repeating its concerns about delays in the processing of the RCA applications and requesting that NERSA reconsider its proposed timelines with a view to making a decision early enough for implementation before 1 July 2018 and the start of the municipalities' new financial year. A copy of Eskom's letter is attached as Annexure "**FA33**".
78. On 13 February 2018, Eskom's Interim Group CEO and its Board chairperson, met with NERSA's CEO and the chairperson. In the discussion concerning the RCAs, NERSA informed Eskom that NERSA would make a recommendation on the RCAs by 10 July 2018.
79. On 16 February 2018, Eskom again wrote to NERSA requesting that NERSA revise its proposed RCA processing timelines which envisage that NERSA's Electricity Sub-Committee will make a recommendation on the RCAs on 10 July and that the Energy Regulator will make a decision thereon on 25 July 2018. Eskom requested that NERSA make the decision approving revised RCA processing timelines by 23 February 2018. Eskom requested that NERSA make an RCA decision by 15 May 2018 and explained that it required a decision before it finalised its annual financial statements end June 2018. Eskom also stated that a decision by 15 March 2018 will accommodate the municipal budgeting and approval process and enable the Minister of Public Enterprises to table in Parliament timeously on 15 May 2018. Eskom pointed out to NERSA that a decision on RCAs before finalization of Eskom's AFS would positively contribute towards assuring Eskom's going concern status; that liquidation of a portion of the RCA on 1 July 2018 would contribute towards the repayment of a R20bn loan which becomes due on 31 August 2018 and the RCA balance decision would serve as a guarantee during Eskom's International Bond roadshow at the end of July 2018. A copy of the letter is attached as Annexure "**FA34**".

80. On 20 February 2018, NERSA responded to Eskom's letter of 16 February 2018. In the letter, NERSA committed itself only to making a decision on the RCAs by end of August 2018. NERSA also stated that it would approve the RCA processing timelines on 5 March 2018. A copy of the letter is attached as annexure "**FA35**".
81. On 27 February 2018, Eskom wrote to NERSA and re-iterated the importance for NERSA to approve by 1 March 2018, revised timelines for decisions on the RCAs. Eskom also explained that it required a decision on the RCA balance and the liquidation thereof by 15 May 2018 in order to implement the adjusted price increase effective 1 July 2018 for all customers. Eskom also explained that the decision would enable the Board of Eskom to declare a going concern in the finalization of annual financial results that must be finally approved by end of June 2018. In the same letter, Eskom also drew to NERSA's attention that the Institute for Accountability had raised concerns about Eskom trading recklessly as a result of its liquidity problems. A copy of the letter is attached as annexure "**FA36**".
82. On 5 March 2018, the NERSA Electricity Sub-Committee of the Board decided that the RCA decisions would be taken only by 10 July 2018. Following this decision, Government made representations to NERSA emphasizing the need for a quicker decision on the pending RCA applications. However, at its meeting of 15 March 2018, the only proposal considered by the NERSA Electricity Sub-Committee in this regard was a proposal to decide the pending RCA applications by 21 June 2018. This would be too late for implementation in the 2018/19 municipal financial year.
83. On 15 March 2018, the Minister of Finance approved an application made by the Minister of Public Enterprises at the request Eskom to extend to 15 May 2018 the deadline in terms of section 42(5) of the Municipal Financial Management Act 56 of 2003 ("the

MFMA”) for the tabling of increases in the prices charged by Eskom to municipalities. A copy of a letter sent by the Minister of Finance to the Minister of Public Enterprises in this regard on 15 March 2018 is attached as Annexure “**FA37**”.

84. On 22 March 2018, the CEO of Eskom wrote to NERSA referring to the new deadline of 15 May 2018 set by the Minister of Finance and made one final request to NERSA to process the pending RCA applications in time to meet that deadline. A copy of the letter of the CEO of 22 March is attached as Annexure “**FA38**”.
85. Notwithstanding the letter of the CEO, NERSA decided to stay with its timetable that was geared towards a 21 June 2018 decision on the pending RCA applications. A copy of the revised timetable published by NERSA at the end of March 2018 is attached as “**FA38A**”. Public hearings of the pending RCA applications have now proceeded in accordance with this timetable.
86. So the current position is the following
  - 86.1. If Eskom defaults on its debt, there is a real risk of catastrophic harm to the South African economy.
  - 86.2. Eskom has serious liquidity problems.
  - 86.3. It has an aggregate debt of R382 billion and is currently dependent on borrowing to cover both operational and capital expenditure.
  - 86.4. In the 2018/19 financial year, Eskom will have to repay just under R40 billion in capital and interest repayments. It then enters a three year cycle in which its debt repayments will be between R50 billion and R60 billion per annum.

- 86.5. Until they were satisfied that the South African Government would support Eskom financially, Eskom's Board after consulting its external auditors were not satisfied that Eskom could continue as a going concern.
- 86.6. Issues relating to Eskom's liquidity and its capacity to continue as a going concern will come to a head again when Eskom has to file its audited financial statements for the 2017/18 financial year by 29 June 2018.
- 86.7. While it faces this liquidity and going concern crisis, Eskom has had R66 billion in RCA claims that have already been pending for between 8 and 20 months but nothing on its balance sheet to show for these claims.
- 86.8. Mindful of Eskom's position, the Minister of Finance extended the deadline in section 42(5) of the MFMA to 15 May 2018 to grant NERSA time to process the pending RCA claims in time for implementation in the 2018/19 municipal financial year.
- 86.9. In terms of the scheme of MYPDM3, all of these claims ought already to have been processed. But NERSA's attitude is that these claims must be processed on a timeline that will not generate any cash flow for Eskom for another fifteen months.

#### **THE 2018/19 TARIFF APPLICATION AND THE NERSA PROCESSES**

87. It has always been clear that Eskom's MYPD3 five-year cycle would come to an end on 31 March 2018.
88. On 1 March 2016, NERSA gave notice to Eskom requiring that it submit its MYPD4 revenue application for the period 1 April 2018 to 31 March 2021 by June 2016. On 31

October 2016, Eskom requested NERSA that only a single year application is to be made (as opposed to a multi-year application). Following discussion and explanation, NERSA agreed that Eskom submit the application by 1 April 2017 and on 23 February 2017, NERSA approved that Eskom submit a single year revenue application for 2018/2019. Although this submission was for a single year only, it was to be governed by the methodology set out in MYPDM4.

89. On 19 April 2017, Eskom consulted with the South African Local Government Association (SALGA) as required by the Municipal Finance Management Act 56 of 2003 regarding the 2018/2019 revenue application.
90. On 19 June 2017, Eskom submitted the revenue application 2018/2019 to NERSA, with the proviso that condonation aspects will be addressed during the analysis phase and on 25 August 2017, Eskom submitted an updated 2018/19 revenue application to NERSA for an overall average price increase of 19.9% to an average standard tariff customer tariff of 106.87 c/kWh for 2018/2019. A copy of the updated application is attached as Annexure “**FA39**”. It did not include any RCA adjustments.
91. The substantial percentage increase sought by Eskom is directly due to the disruption of the RCA process by the High Court Borbet judgment. Had the 2017/18 price been increased to take account of the more than R42 billion RCA claims of Eskom in respect of 2014/15 and 2015/16 (as is contemplated in MYPDM3), 106.87 c/kWh would have represented, at most, a low single-digit increase off the RCA adjusted price for 2017/18.
92. On 13 September 2017, NERSA published Eskom’s 2018/2019 revenue application on the NERSA website for comment from stakeholders. In the period 30 October to 20 November 2017 NERSA held public hearings in which it received representations from individuals, small users, energy-intensive users, environmental activists and government

organisations, including the National Treasury. Eskom made its own presentations at these hearings. There is substantial overlap between the various Eskom presentations made to the hearings. Nevertheless, the primary focus of each presentation differed. So we attach all of the Eskom presentations:

92.1. The Eskom presentation to public hearings in Cape Town on 30 October 2017 is Annexure “**FA40**”.

92.2. The Eskom presentation to public hearings in Nelson Mandela Bay on 1 November 2017 is Annexure “**FA41**”.

92.3. The Eskom presentation to public hearings in Durban on 2 November 2017 is Annexure “**FA42**”.

92.4. The Eskom presentation to public hearings in Kimberley on 6 November 2017 is Annexure “**FA43**”.

92.5. The Eskom presentation to public hearings in Mbombela on 10 November 2017 is Annexure “**FA44**”.

92.6. The Eskom presentation to public hearings in Klerksdorp on 13 November 2017 is Annexure “**FA45**”.

92.7. The Eskom presentation to public hearings in Bloemfontein on 14 November 2017 is Annexure “**FA46**”.

92.8. The Eskom presentation to public hearings in Cape Town on 30 October 2017 is Annexure “**FA47**”.

92.9. The Eskom presentation to public hearings in Midrand on 16 November 2017 is

Annexure “**FA48**”.

92.10. The Eskom closing presentation to public hearings in Midrand on 20 November 2017 is Annexure “**FA49**”.

93. In the course of the public hearings process, NERSA asked Eskom to address certain issues with follow up submissions. The concerns of NERSA were addressed in submissions dated 14, 23 and 24 November 2017. The three follow up submissions are attached as Annexures “**FA50**” to “**FA52**” respectively.
94. As appears from slides 20 and 21 to the closing presentation to public hearings on 20 November 2017 (“**FA49**”), Eskom revised its projections of sales volume. This enabled it to adjust the amount it had budgeted for from IPPs and to revise its proposed increase to 18.91%.
95. Following the public presentations, in its letter dated 5 December 2017, Annexure “**FA25**”, Eskom pointed out to NERSA that its decision on the 2018/2019 tariff increase would be important to address the concerns of the rating agencies and Eskom’s lenders and external auditors about the going concern status of Eskom.
96. On 14 December 2017, Eskom wrote to NERSA setting out the circumstances which place Eskom in breach of its contracts. These include a failure to comply with its financial obligations under any finance document and a change in the business operations or assets, the financial position or the results of operations of Eskom or any other company of the Eskom Group such that in the lender’s reasonable judgment, the performance of Eskom’s obligations under the agreement will be jeopardised or substantially delayed. A copy of the submission to NERSA has been attached as Annexure “**FA19**”.

97. On 15 December NERSA notified Eskom of its decision for the 2018/2019 tariff interval. Notwithstanding the information and warnings provided to NERSA by Eskom, NERSA awarded only an increase of 5.23%. As pointed out above, this increase left Eskom in a position where, after consultation with Eskom's auditors, the Board were of the view that Eskom could not continue as a going concern unless Government undertook to support it financially.

## **NERSA'S DECISION FALLS TO BE REVIEWED AND SET ASIDE**

### **Introduction**

98. NERSA published the reasons for its 2018/19 decision on 5 March 2018. A copy of the published reasons is attached as Annexure "**FA53**". The reasons are in large part unintelligible because they do not make reference to calculations or reasoning that is necessary to make sense of them. On 6 March 2018, Eskom addressed a letter to NERSA identifying the documentation and reasoning that Eskom required in order meaningfully to be able to engage with the reasons. A copy of this letter is attached as Annexure "**FA54**". NERSA will have to disclose the necessary documentation in terms of Rule 53 processes relating to the Part B review relief and Eskom will engage fully with the final reasons of NERSA when it files its supplementary affidavit in terms of Rule 53. For the purposes of the Part A relief, I will confine myself in this affidavit to a high-level critique of the NERSA 2018/19 decision in the light of the reasons by pointing out certain obvious procedural irregularities and substantive flaws in the decision. For this purpose, a useful starting point is provided by the summary tables in NERSA's announcement of the decision on 15 December 2017 (Annexure "**FA1**").
99. Table 1 on Annexure "**FA1**" indicates that NERSA accepted Eskom's revised projection of 188 082 GWh for standard tariff sales (compare slide 20 of Annexure "**FA48**"). So



NERSA made its decision on the basis that the R22.922 billion difference between a 5.23% increase and an 18.91% increase in standard tariffs can be made up by Eskom in saved expenditure.

100. Table 2 on Annexure “**FA1**” indicates how NERSA believes Eskom can find these savings. Eskom is expected

100.1. to find R11.099 billion savings in operating expenditure (approximately 19%),

100.2. to find R10.777 billion savings in primary energy costs (approximately 19%),

100.3. to reduce its depreciation by R4.237 billion,

100.4. to free up R511 million apparently by abandoning its demand management programme entirely, and

100.5. to free up another R533 million in respect of IPP purchases over and above the R7 080 million that Eskom included in its revised application in its closing submission to the public hearings in Gauteng on 20 November 2017 (See slide 21 of Annexure “**FA48**”).

101. NERSA’s reasons show that

101.1. its decision-making process was procedurally irregular because the decision flagrantly disregarded MYPDM4 which declares itself to *be “the basis on which the National Energy Regulator (NERSA) will evaluate the price adjustment applications received from Eskom”* (clause 2.1) and states that it *“shall be used for the evaluation of Eskom’s MYPD and Regulatory Clearing Account (RCA) applications”* (clause 4.2), and

101.2. the 2018/19 decision is substantively unjustifiable and irrational in several respects.

102. I address these substantive and procedural flaws in the NERSA 2018/19 decision under the following headings:

102.1. coal costs,

102.2. the calculation of the value of the regulatory asset base for the purposes of depreciation,

102.3. integrated demand management costs,

102.4. the permissible return on the weighted average cost of capital, and

102.5. employee benefit costs.

## **Coal Prices**

103. In relation to coal costs, MYPDM4 states in clauses 12.1 and 12.2:

*“12.2.1 The Energy Regulator will approve the coal benchmark price (i.e. average R/ton) per contract type (Cost Plus, Fixed Price, Medium-Term and Short-Term) and Alpha for each contract type in the final MYPD decision.*

*12.2.2 **The R/ton coal price and R/ton/km transport cost (rail and road) shall be escalated using the formula in the contracts.** Contract parameters (mining input costs like steel, labour, diesel, spare parts, rubber, electricity and tyres) in the indexation formula shall be adjusted using the industry accepted level of inflation available in the public domain.” (emphasis added)*

104. NERSA simply ignored the methodology in this regard and decided instead to apply a measure which escalated prices approved in respect of the 2013/14 RCA process by an industry composite index (see Table 13 and para 58.7 on p 43 and p 44 of the reasons) so that Eskom's average R/ton price for 2018/19 was assessed on the basis that it should drop by 20% on average from that submitted in the application. NERSA expects Eskom to reduce its coal cost year on year by approximately 17% from its current costs to 2018/2019 in nominal terms. Apart from the fact that there was no mandate for such an approach in MYPDM4 (nor any suggestion to Eskom that such an approach should replace the approach demanded by MYPDM4), the approach was irrational because the bulk of Eskom's coal purchases take place at prices which are fixed in medium term and fixed price contracts to operate as a hedge against industry inflation. Moreover, this purchasing practice that hedges coal purchase prices ensures that Eskom is able to obtain good value for the prices that it pays for coal. Coal which is yet to be procured is done so through a procurement process which is prescribed under the PPPFA framework. Eskom's current average cost of coal excluding transport is approximately half of that paid on the export market. There is an increasing demand for Eskom type coal from the Eastern countries like India and Pakistan. The ability to conclude coal contracts cheaper than the existing contracts is thus limited in the current environment given the export demands and pricing pressure. This is illustrated in slide 13 of Eskom's presentation at the Mbombela hearings on 10 November 2017 (Annexure "FA44").
105. In another irregular and irrational departure from MYPDM4 without notice to Eskom, NERSA decided that Eskom could reduce its coal costs by putting Arnot power station (which has a high R/Ton price) in cold reserve (see clauses 58.7.1(a) and 58.7.2) of the reasons. Apart from the fact that there is no mandate for such an approach in MYPDM4, this "reason" breaks down because Eskom rationalizes its coal burn according to price.

So cheaper coal is used first across all power stations and if Arnot's generation has to be made up by other coal fired power stations the additional coal available to be burned at those stations will not be available at the average price of the Eskom fleet (as was used by NERSA for calculating their cost saving) but at a much higher price.

106. So the R10.033 billion "saving" found by NERSA in relation to coal burning costs (see Table 16) is the product of a decision that was procedurally irregular, irrational and unjustifiable.

### **The Valuation of the Regulatory Asset Base**

107. The Regulatory Asset Base is used in MYPDM4 to calculate depreciation and return on assets.

107.1. Clause 9.1.1 of MYPDM4 states

*"The Regulatory Asset Base (RAB) must represent assets used **and usable** to provide regulated service by each of Eskom business operations" (emphasis added)*

107.2. Clause 9.1.8 states:

*"Only assets used in regulated business operations that meet the following criteria will be included in the RAB to allow the licensee to earn a reasonable return on assets based on the WACC:*

*9.1.8.1 Fixed assets must be used and useable, which means that **assets should be in a condition that makes it possible to supply demand in the short-term (within 12 months)**.*

*9.1.8.2 Fixed and other assets that are not used **and/or in a useable form** will therefore not be included in the RAB."*

(emphasis added)

107.3. Clause 9.6.22 of MYPDM4 provides for the inclusion of owners development cost in capex in the RAB. It states

*“9.6.2 Capital WUC should be stated at cost consisting of the cost of material and direct labour and any cost directly attributable to bringing it to its present location and condition”*

108. The Arnot and Hendrina power stations are currently being used for electricity generation. In Eskom’s application both Arnot and Hendrina formed part of the Eskom RAB. NERSA, however, decided that these power stations should be removed from the Regulatory Asset Base because Eskom had surplus generating capacity (see paras 52.5 and 84.5.2.1 of the reasons). It accordingly disallowed the depreciation that Eskom had claimed in relation to these two power stations.

109. This approach was clearly at odds with clauses 9.1.1 and 9.1.8 of MYPDM4. It was also unlawful in that it presupposed that the two power stations would have to be mothballed or decommissioned, both of which processes require an amendment to Eskom’s generation licence. A copy of the generation license is attached as Annexure “FA55”. Clause 4 thereof provides as follows:

*“4.1 The licensee shall offer **all available units forming part of its generating stations to the Eskom Power Pool** for dispatch by the national Licensed Transmitter.*

*4.2 **The Licensee shall not effect any changes to the generation stations listed in schedule 1 with respect to the design, capacity, generating process or status of any generation station, without the approval of the National Energy Regulator.***

*4.3 The Licensee shall comply with any restrictions and conditions imposed by relevant environmental and safety agencies.”*

Both Arnot and Hendrina are listed as operational power stations on Schedule 1 to the licence. Without following a procedure that is fair to interested parties (like Eskom itself and its employees' trade unions), NERSA cannot change the operational status of these two power stations.

110. Furthermore, the notional closure of Arnot and Hendrina would, to the knowledge of NERSA, expose the country to a material risk of load shedding. In paragraph 52.3 of the reasons, NERSA states that on the basis of the Medium Term System Adequacy Outlook, the excess capacity for 2018/19 could conservatively (ie assuming a “high” growth rate of 2% - see paragraph 52.1) be estimated at about 3912 MW. The combined capacity of Hendrina (approximately 1800MW) and Arnot (approximately 2200MW) is over 3912MW.
111. Finally, the approach to the proposed “cold storage” of Arnot and Hendrina was irrational from an accounting perspective. If the plants were effectively going to be shut down in the 2018/19 financial year, their depreciated value at the end of the 2017/18 financial year ought to have been depreciated to zero in the 2018/19 financial year. So, far from disallowing depreciation in respect of Arnot and Hendrina, on its own logic NERSA ought to have allowed their full values to have been depreciated during Eskom's financial year 2018/19 (R8 939 million in the case of Arnot and R6 171 million in the case of Hendrina – see paragraphs 84.5.2.1 of the reasons).
112. In another departure from MYPDM4, NERSA disallowed from the Regulatory Asset Base an undisclosed portion of costs aggregating to R7 227 million on the basis that these were owner development costs “*and do not belong under Capex*” and (see paragraphs 84.9.2 and 84.10.3 of the reasons). This approach is directly inconsistent with clause 9.6.2 of MYPDM4 which has been quoted above.

## **Integrated Demand Management Costs**

113. Clause 14 of MYPDM4 deals with integrated demand management costs. These relate to energy efficiency programmes and demand reduction programmes. Clause 14.6 regulates in fine detail how the integrated demand management revenue requirement will be calculated, and clause 5.2 makes clear that integrated demand management costs are a prescribed component of the allowable revenue.
114. Eskom applied for R511 million for integrated demand management costs. NERSA allocated it nothing in this regard. In effect, NERSA ignored the requirements of MYPDM4 and decided that because Eskom had excess capacity, all integrated demand management costs were superfluous (see paragraph 73 of the reasons).
115. This aspect of the NERSA reasoning was manifestly inconsistent with the requirements of MYPDM4. It was also unconstitutional and irrational. It was unconstitutional because it is inconsistent with section 24 of the Constitution for NERSA actively to disincentivize energy efficiency programmes.
116. It was irrational because, to the knowledge of NERSA (see Table 38 and paragraph 73.2 of the reasons), much of the expenditure in relation to integration demand management
- 116.1. was expenditure to which Eskom was already contractually committed and thus could not be saved from Eskom's actual expenditure, and/or
- 116.2. related to peak demand savings and thus would result in increased expenditure elsewhere (for example in open cycle gas turbines to supplement peak demand) if it was simply cut.

## Return on Weighted Average Cost of Capital

117. Clause 8 of MYPDM4 prescribes how the Weighted Average Cost of Capital (WACC) is to be calculated. Clause 5.2 provides for the allowable costs to include a return on capital calculated by multiplying the value of the Regulatory Asset Base by the WACC.
118. NERSA calculated the real WACC before tax to be 6.9% (see Table 42 of the reasons). In terms of the requirements of MYPDM4, it ought therefore to have included in the allowable revenue a return of 6.9% on the value of the Regulatory Asset Base. NERSA valued the Regulatory Asset Base at R702 929 million (see Table 43 of the reasons). The return prescribed by MYPDM4 was accordingly R48 502 million. However, without any reasoning beyond the bald statement that it was taking account of “*economic impact considerations and Eskom’s liquidity and debt servicing requirements*” NERSA reduced the allowable return to 4% on the value of the Regulatory Asset Base or R28 117 million (see Table 2 and paragraph 82 of the reasons) which is more than R20 billion less than the prescribed 6.9% return.
119. At various points in its reasons NERSA trumpets the fact that the return that it allowed Eskom was more than that for which Eskom applied. At face value, this is true. Eskom applied for a return of only R22 690 million and was granted a notional return of R28 117 million. However, Eskom’s application was made on the basis that NERSA would apply MYPDM4 properly and would grant it the allowable revenue for which it had applied, and which already reflected Eskom’s proposal to forfeit a part of its entitled return on assets without jeopardizing its 2018/19 liquidity or going concern status, for the sake of a more gradual migration towards prices reflective of prudent and efficient costs. In that context it asked only for a 2.97% return. Had it been aware of the fact that NERSA intended to grant allowable revenue of only R190 348 million as opposed to the R219 514 million for



which it applied, it would have insisted on the full 6.9% return to which it was entitled so as to make up more than R20 billion of the shortfall between what it needed and what NERSA granted.

### **Employee Benefit Costs**

120. NERSA concluded that Eskom was overstaffed by 6 232 employees and disallowed R3 785 million in employee costs (paragraph 94.23 of the reasons). In reaching this conclusion it arbitrarily chose to benchmark Eskom in terms of a ratio of sales (GWh / employee) and to choose 2007/8 as its base year. 2007/8 was the year in which electricity sales peaked prior to the financial crisis, and when demand outstripped supply to such an extent that load shedding had to be introduced. In order to meet demand in 2007/8 Eskom's power stations were required to operate at output levels well above their design parameters or industry norms, thus artificially reducing the ratio of staff to electricity output. The choice of 2007/8 as the benchmark year for sales per employee was accordingly one which was calculated to find that Eskom was overstaffed.
121. The choice of sales per employee as the ratio to determine appropriate staffing levels was also procedurally unfair. There is nothing in the MYPDM which points to such a ratio and the ratio NERSA had previously used was generating capacity per employee. Thus in its reasons for its MYPD3 decision (attached as Annexure "FA56"), NERSA benchmarked staffing levels in terms of employee per megawatt. In paragraph 96 of those reasons it stated the following:

*"Eskom's existing employee headcount is 35 834 and is expected to grow by 2 165 to 37 999. This translates to growth of 1.1% in the headcount over the MYPD3 control period. The headcount growth is considered reasonable and compares well within the international benchmark ratio of 1:1.2 (employee per*

*megawatt) as determined by VGB PowerTech. The Eskom average over the MYPD3 control period is 1:1.24.”*

If the employee per megawatt benchmark would have been retained for 2018/19, NERSA would have found that Eskom met the benchmark of 1.1.2 employee per megawatt.

122. The benchmarking in terms of sales / employee also fails to take account of developments in Eskom’s business between 2007/8 and the present. The figures in Tables 5 and 6 below compare 2007/8 with 2016/17 which is the latest financial year for which audited financial statements are available. They show how the nature of Eskom’s business has transformed since 2007/8 in ways that require additional employees. By way of illustration

<b>Criteria</b>	<b>FY 2007/8</b>	<b>FY 2016/17</b>
Number of customers	4 152 312	5 976 557
Total all power lines	376 124	384 712
Total transformed capacity, MVA	215 696	276 583
Total transformers, number	324 435	372 995
Sales (total) (GWh)	224 366	214 121
Total installed Capacity (MW)	43 037	46 407

**Table 5: Significant developments in the business between FY2007/8 and FY2016/17 (Cumulative)**

Additional Capacity added (MW)	1 061	8 363
Transmission line installed (km)	246	6 747
Transmission MVA installed	1 295	34 390
IPPs (GWhr)	0	11 529
Households connected	168 538	207 189
Employees	32 954	41 940

**Table 6: Comparison between FY 2007/8 and FY 2016/17**

122.1. The number of Eskom's customers has increased over this period by more than 1.8 million (i.e. 44%). With the increase in the customer base, comes the need to service these customers as well as further maintenance and support. The same applies to increase in generating capacity, lines, transformers, etc.

122.2. The ongoing construction projects at Medupi and Kusile are not reflected in increased sales but require substantial numbers of additional employees.

122.3. The extended maintenance and refurbishment of existing power stations so as to avoid the load shedding crisis of 2007/8 similarly is reflected in increased numbers of employees without increased sales.

## **Conclusion**

123. As stated above, Eskom will fully motivate its causes of action for review of the NERSA 2018/19 decision when it has been afforded access to the record of decision in terms of Rule 53. For present purposes I refer to what I have set out above and respectfully submit that even without access to the Rule 53 Record there is a clear case to review and set aside the NERSA 2018/19 decision on procedural and substantive grounds.

124. The basic proposition underlying the NERSA 2018/19 decision is that by reducing expenditure efficiently, Eskom can put itself in a position where, on a 5.23% tariff increase, it will be able to cover all of its costs and secure an additional return of R5.427 billion. This proposition is patently wrong. In this regard, I point out that this proposition has been expressly rejected by Standard and Poors in its most recent downgrade report of Eskom and the World Bank report of 2016 found that in order merely to cover costs (let alone secure a return on capital), any operational savings and improved debt recovery

would address less than 20% of Eskom's problem – 81% of that problem had to be addressed through increasing tariffs to an appropriate level. Moreover, the World Bank report was filed before the cost recovery position of Eskom was compromised further by the sub-inflationary 2.2% tariff increase granted for the 2017/18 financial year. It follows that Eskom could never be expected to cover its costs, still less secure a reasonable return on its capital with an increase of only 5.23% for the 2018/19 financial year.

125. I respectfully submit further that the mere fact that, in the aftermath of the 2018/19 NERSA decision, Eskom's Board and auditors were not satisfied that Eskom could continue as a going concern until Government undertook to provide adequate financial support for Eskom, is evidence that NERSA failed properly to apply their minds to their decision or to have regard to relevant considerations in making that decision, and that NERSA acted *ultra vires* section 15 of the ERA. The tariff principles set out in section 15 of the ERA and MYPDM4 do not authorise NERSA to set Eskom tariffs at a level where it is unable to continue as a going concern. On the contrary, they expressly require NERSA to ensure that Eskom, by operating efficiently, will be able to recover the full cost of its licensed activities, including a reasonable return.

## RELIEF

### The review of the 2018/19 NERSA decision

126. I refer to what I have stated above under the heading “NERSA’S DECISION FALLS TO BE REVIEWED AND SET ASIDE” and respectfully submit that the 2018/19 NERSA decision falls to be reviewed and set aside under sections 6(2)(b), 6(2)(c), 6(2)(e)(iii) and (vi), 6(2)(f)(ii), 6(2)(h) and 6(2)(i) of the Promotion of Administrative Justice Act 3 of 2000 because it is a decision that

126.1. Is inconsistent with section 15(1)(a) of the ERA;

126.2. was taken by means of unfair procedure;

126.3. was taken without proper regard to relevant considerations and with regard to irrelevant considerations;

126.4. is arbitrary and capricious;

126.5. is not rationally related to the purpose for which it was taken, the purposes of the ERA and the MYPDM, the information before NERSA or the reasons furnished by NERSA;

126.6. is so unreasonable that no reasonable administrator could have taken such a decision; and

126.7. is inconsistent with section 24 of the Constitution.

127. Eskom will supplement its grounds of review in relation to the 2018/19 NERSA decision when it files its supplementary affidavit after NERSA has forwarded the record of the decision in terms of Rule 53.

## **The ancillary relief in prayer 2**

128. The additional tariff revenue which the unlawful decision of NERSA decision has deprived Eskom is tariff revenue to which it was entitled in the 2017/18 financial year. Eskom should accordingly be put in a position where this additional revenue is made available to it as soon as possible after the order of this Court.
129. Prayer 2 is designed to ensure that when NERSA redetermines the 2017/18 tariff application, it does so within 60 days and that the additional allowable revenue so determined is recovered by Eskom in the next tariff year. I respectfully submit that Eskom is entitled to such relief as just and equitable ancillary relief flowing from its primary review relief.

## **The unlawfulness of NERSA's unreasonable delay in deciding the pending RCA applications**

130. I refer to what I have set out above and respectfully submit that there is no reasonable basis for NERSA's failure to process the pending RCA applications.

130.1. There was no reasonable basis for NERSA not to process the pending RCA applications while the *Borbet* appeal was pending;

130.2. *A fortiori* there was no reasonable basis for NERSA not to process the pending RCA applications after the SCA handed down judgment in favour of NERSA on 6 June 2017.

131. NERSA's unreasonable delay in processing the pending RCA applications accordingly amounted to

131.1. unlawful administrative action in breach of section 6(2)(i) of PAJA; and

131.2. a violation of its constitutional obligation under section 237 of the Constitution to perform its constitutional obligations diligently and without delay.

132. By the time that this application is heard, it is likely that NERSA will have decided the pending RCA applications. However, there will also, by that time, be an additional RCA application lodged with NERSA in respect of the 2017/18 financial year. In view of NERSA's sustained lackadaisical attitude to the pending RCA applications and its refusal to act with expedition even in the face of Eskom's liquidity crisis which threatens the finances of the entire country, there is every reason to believe that it will adopt a similar dilatory attitude to the 2017/18 RCA application unless Eskom obtains an order declaring the unconstitutionality of its conduct in relation to the pending RCA applications.
133. In the circumstances, I respectfully submit that Eskom is entitled to the order that it seeks in prayer 3 of the Notice of Motion.

## **CONCLUSION**

134. For the reasons set out above, Eskom prays for an order in the terms set out in the notice of motion.

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**DEPONENT**

I hereby certify that the deponent has acknowledged that he/she knows and understands the contents of this affidavit, that he/she does not have any objection to taking the oath, and that he/she considers it to be binding on his/her conscience and which was sworn to and signed before me at \_\_\_\_\_ on this the \_\_\_\_\_ day of MARCH 2018, and that the administering of the oath complied with the regulations contained in Government Notice R.1258 of 21st of July 1972, as amended.

\_\_\_\_\_  
Commissioner of Oaths

Full Name:\_\_\_\_\_

Address:\_\_\_\_\_