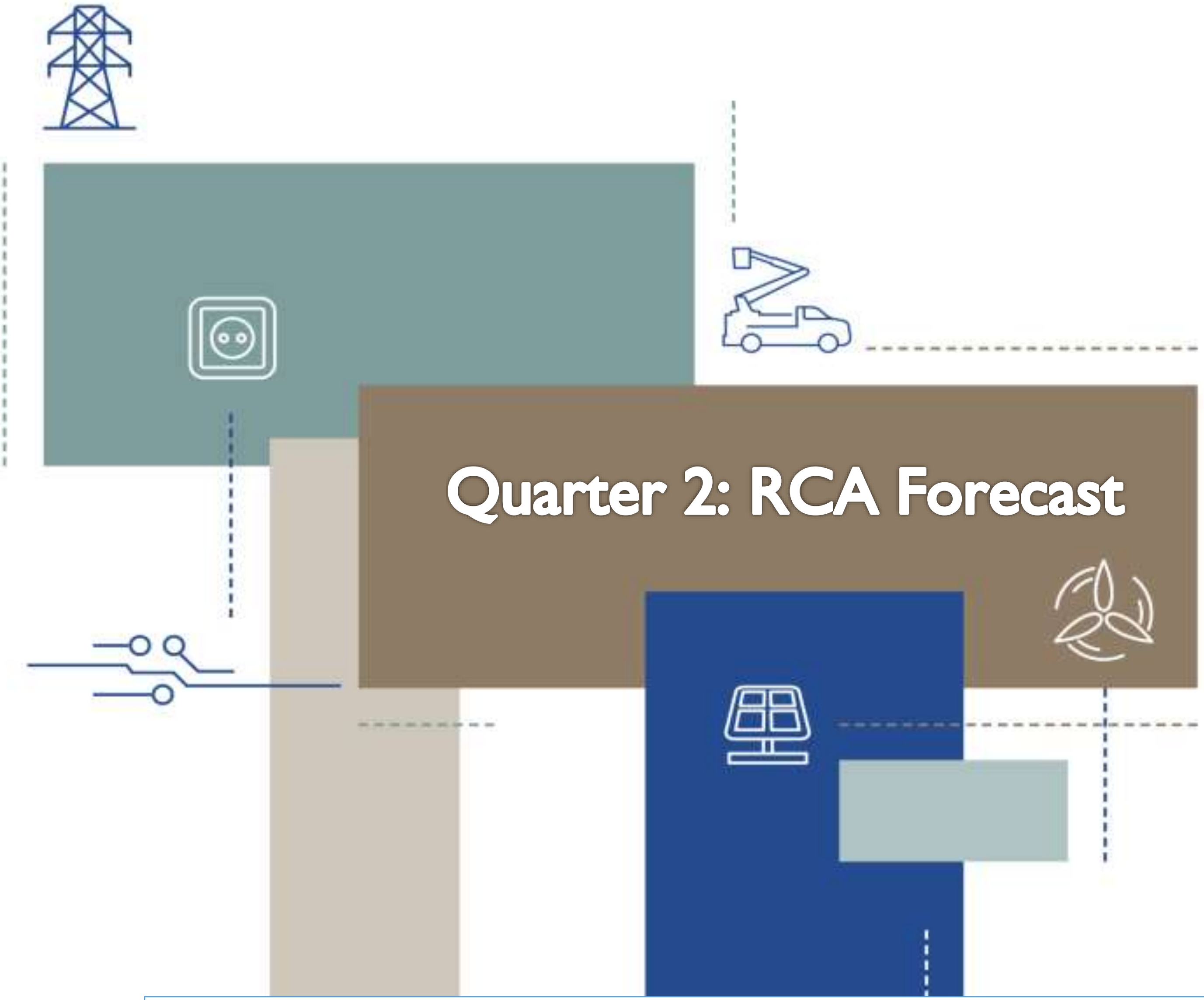

# Quarter 2: RCA Forecast

## RCA Quarterly Forecast: FY 2019/20

Based on Quarter 2 YE Projections as at 30 Septermber 2019

November 2019

Eskom

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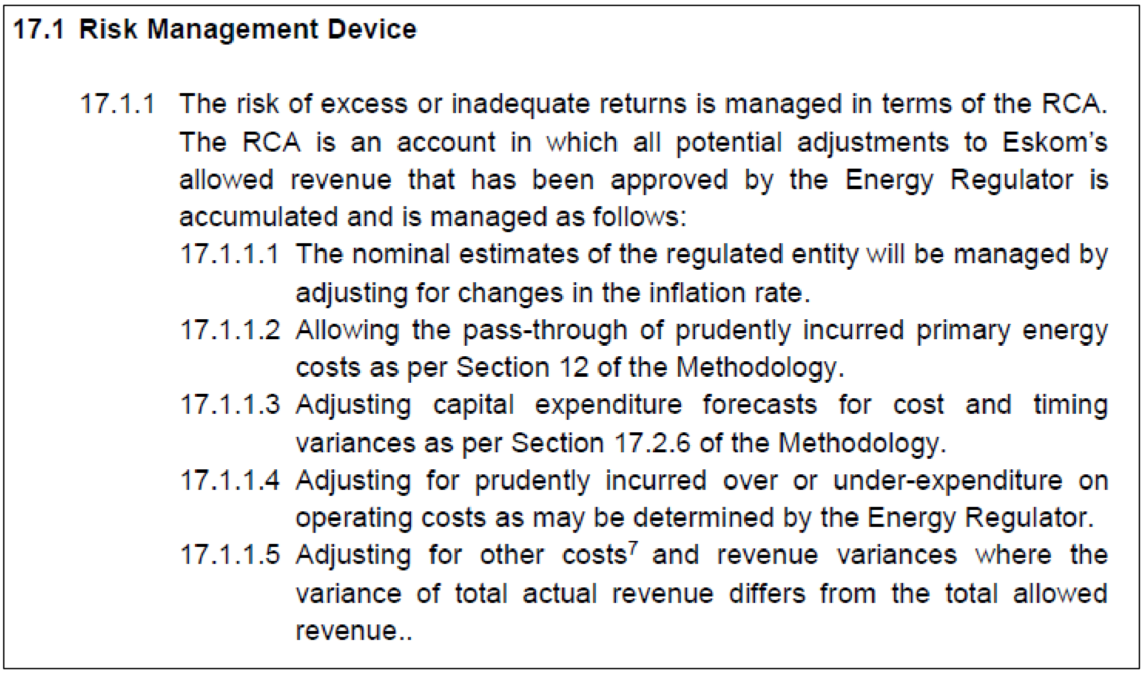
# 1 About this report

This document summarises information submitted by Eskom Holdings (SOC) Ltd to the National Energy Regulator of South Africa (hereafter referred to as NERSA, or the Energy Regulator) pertaining to the Eskom's Regulatory Clearing Account (RCA) in accordance with the Revised Multi-Year Price Determination Methodology (hereafter referred to as the 'MYPD Methodology') published during October 2016.

This report provides a forecast for the RCA balance relating to the FY 2019/20 financial year based on Quarter 2 year-end projections. The projected RCA has been based on high level assumptions pertaining to primary energy, the regulatory asset base and operating expenses.

## 1.1. The basis of submission

The basis of this submission is derived primarily from section 17 of the MYPD Methodology which provides for a Risk Management Device (S. 17.1) administered by way of the RCA (S. 17.2) i.e.:



**17.1 Risk Management Device**

17.1.1 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 that has been approved by the Energy Regulator is accumulated and is managed as follows:

17.1.1.1 The nominal estimates of the regulated entity will be managed by adjusting for changes in the inflation rate.

17.1.1.2 Allowing the pass-through of prudently incurred primary energy costs as per Section 12 of the Methodology.

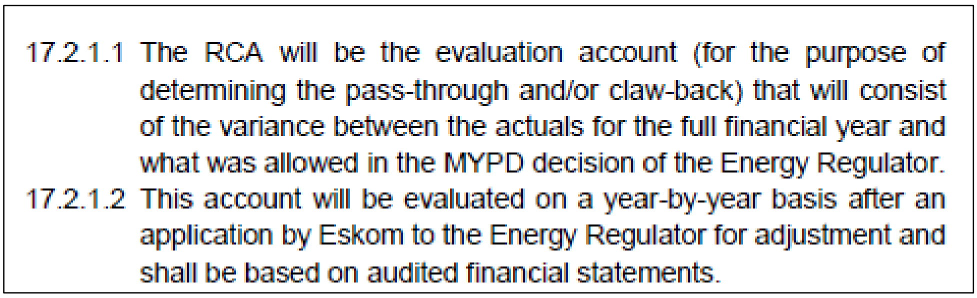
17.1.1.3 Adjusting capital expenditure forecasts for cost and timing variances as per Section 17.2.6 of the Methodology.

17.1.1.4 Adjusting for prudently incurred over or under-expenditure on operating costs as may be determined by the Energy Regulator.

17.1.1.5 Adjusting for other costs[7] and revenue variances where the variance of total actual revenue differs from the total allowed revenue..

Section 17.1 confirms that the RCA is intended to mitigate and manage the risk of excess or inadequate returns, and further that it does so by adjusting regulated revenue. Section 17 further sets out that the costs and cost variances (to be recovered through such revenue adjustment) will be assessed for prudency.

Based on the revised methodology the RCA is required to be evaluated on a year by year basis based on audited financial statements.



17.2.1.1 The RCA will be the evaluation account (for the purpose of determining the pass-through and/or claw-back) that will consist of the variance between the actuals for the full financial year and what was allowed in the MYPD decision of the Energy Regulator.

17.2.1.2 This account will be evaluated on a year-by-year basis after an application by Eskom to the Energy Regulator for adjustment and shall be based on audited financial statements.

The FY 2019/20 MYPD decision is not determined quarterly and therefore the RCA is not computed quarterly. Hence this RCA projection for FY 2019/20 is merely an indication of the potential adjustment to Eskom allowed revenue and is calculated over a full year based on Quarter 2 projections for FY 2019/20.

### 1.2. Objective

This projected FY 2019/20 Q2 RCA provides a high level indication of the deviations from the FY 2019/20 MYPD decision and reasons for variances between projected actual results and the assumptions as made for purposes of the FY 2019/20 revenue decision.

In summary, the RCA mechanism allows Eskom the opportunity to firstly achieve the initial revenue that was allowed during the FY 2019/20 revenue decision that results from sales volume variances; and secondly, for Eskom to be in a position to recoup efficiently incurred costs in delivering electricity to South Africans during the FY 2019/20 financial year.

# 2 Summary

The RCA for FY 2019/20 requires implementation of the revised MYPD methodology published during October 2016. This projected RCA balance is calculated using Q2 projections for FY 2019/20 and is based on high level assumptions regarding primary energy, operating expenditure and the Regulatory Asset Base. The projected RCA based on FY 2019/20 Q2 projections is R19 007m, driven by revenue under recovery of R6 531m, primary energy variance of R4 031m and operating expenses and other variance of R8 462 m. Included in this variance is an amount of approximately R2.6bn due to errors made in the NERSA decision.

### Table 1 : Summary RCA FY 2019/20 Q2 Projection for year end

| RCA projection for FY 2019/20 - R'm | MYPD 19/20 Decision | FY 2020 Q2 Projection | Variance | RCA Adjustments | Projected RCA 19/20 |
|---|---|---|---|---|---|
| **Total Electricity revenue** | **214 348** | **198 603** | **15 745** | **-9 214** | **6 531** |
| Coal | 59 332 | 59 753 | 421 | - | 421 |
| Open Cycle Gas Turbines (OCGTs) | 1 902 | 1 647 | -255 | - | -255 |
| Other primary energy (includes reconciling item) | 5 550 | 9 769 | 4 219 | - | 4 219 |
| Independent Power Producers | 30 462 | 29 133 | -1 329 | - | -1 329 |
| International Purchases | 3 059 | 3 754 | 695 | - | 695 |
| Environmental levy | 7 443 | 7 723 | 280 | - | 280 |
| Demand Market Participation (DMP) | 306 | 288 | -18 | - | -18 |
| **Total primary energy** | **108 054** | **112 067** | **4 013** | **-** | **4 013** |
| Depreciation | 55 867 | 55 867 | - | - | - |
| Return on Assets | -8 752 | -8 752 | - | - | - |
| Operating **costs** | 51 404 | 59 528 | 8 123 | 339 | 8 462 |
| **FY2020 Projected RCA balance** | | | | | **19 007** |

*The revenue adjustment is related to revenue recognised for regulatory purposes but not recognised for financial reporting purposes due to non-recovery. Non-recovery of revenue is currently dealt with in a different manner under the regulatory framework. The adjustment in the operating costs is related to arrear debt impairment limited to 0.5% of gross debtors.*

# 3 Factors driving the RCA forecasts

## 3.1 Revenue variance

The revenue variance of R6 531m is primarily as a result of lower electricity sales volumes of 2 680 GWh.

Projected revenue (net of revenue capitalised, before IFRS adjustments) of R207.8bn is R6.9bn, or 1.3%, lower than decision, mainly due to an unfavourable local sales volume variance of 3.5TWh which was offset by a favourable international sales volume variance of 0.8TWh.

Overall year-to-date sales volumes recorded is lower than the NERSA decision mainly due to lower local sales arising from declining sales to the mining (0.4TWh), industrial (1.1TWh) and residential (including prepayment) (0.6TWh) sectors. This was partially offset by higher international sales to NamPower, Eswatini Electricity Company (EEC, formerly SEC) and in the day-ahead market within the Southern African Power Pool.

## 3.2 Primary energy

The RCA balance forecasts are driven by higher primary energy costs of R4 013m. It should be noted that of the R4 013m variance, R2 220m is due to an error in the revenue determination related to primary energy. NERSA in its decision, taking individual primary energy cost items, allows Eskom to recover primary energy costs of R110 274m. However, only R108 054m is accounted for in the revenue determination (Refer to Table 2 in the NERSA Reasons for Decision). This anomaly causes primary energy to have a natural and unavoidable variance of an additional R2.2bn before looking at any actual spend. Thus Eskom will not be in a position to recover these primary energy cost during the financial year due to the error made in the NERSA reason for decision. Thus the only option is for Eskom to include this amount in the RCA application and be able to recover when the RCA is liquidated. This natural variance due to the error in the decision resulted in a lower allowable revenue – which would have resulted in an increase of a further more than 1% increase in the NERSA MYPD 4 decision, if the addition was done correctly.

The remainder R1.8bn variance is linked primarily to variance in coal related costs, gas and oil for coal fired start-ups, international purchases and slightly higher nuclear costs. Specifically, the start-up gas and oil year-end projection for FY 2019/20 is R3 511m against the NERSA decision of R1 751m. This indicates a variance of R1 760m in favour of Eskom. Fuel oil costs at the reserve storage power stations (Grootvlei, Hendrina and Komati) were set at zero for the MYPD 4 period. Due to system constraints, these 3 power stations are projected to produce electricity during 2020 to minimise load shedding. Unplanned outages (UCLF) and unit trips are projected to be higher for this financial year than anticipated at the time of the MYPD 4 Application: UCLF for the fleet is projected to be 22% versus the MYPD 4 application assumption of 19% for FY 2019/20. The main contributors are Tutuka, Kriel, Arnot, Medupi, Kendal and Matla  power stations.

There was lower utilisation of Eskom OCGTs in the first half of the financial year  (however this projection does not factor in the increased usage of OCGTs during October 2019 as this was not anticipated at the end of the second quarter), as well as marginally lower RE-IPP production volumes. In addition lower water usage costs were also achieved mainly due to tariff savings as a result of changing consumption patterns. The variance in environmental levy is due to lower sales volumes.

With regards to international purchases, NERSA did not consider that the Cahora Bassa tariffs were reviewed which resulted in higher tariffs than assumed by NERSA in its MYPD 4 decision. This accounts for the resultant variance.

### 3.3 Regulatory Asset Base (RAB) Adjustments

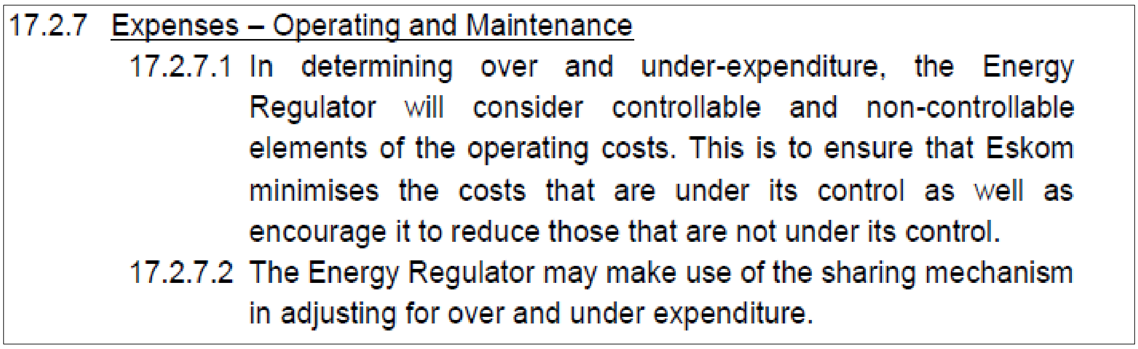
Under the new methodology all movements in the RAB are now re-measurable (Para 17.2.6.2) as opposed to only variances due to capital expenditure in the previous version of the MYPD methodology. The actual RAB must be derived by adjusting for the movements in actuals for capital expenditure, transfer to commercial operation and other movements (i.e. impact of reserve storage, disposals etc.).

The RCA balance application must therefore now include variances for depreciation and return on assets. However for projection purposes, due to the complexity of considerations surrounding the allowed return and exclusions from RAB, no detailed review has been done as yet. This will be undertaken at the end of the financial year, with the utilisation of audited actuals. For the purposes of these projections, depreciation and return have been assumed to be that as allowed by NERSA. The review of the Eskom decision in the High Court will also have an impact on this aspect of the RCA balance application.

The assumed NERSA decision allowed capital expenditure of R13bn with Eskom projecting a capital spend of R31bn. The variance in capital expenditure will contribute towards the changes in the RAB and will be considered only when the actuals are determined at the end of the financial year.

### 3.4 Operating costs

Under the revised MYPD Methodology, variances in both controllable and non-controllable operating costs are required to be included in determining the RCA as per Para.17.2.7 (refer extract below).



17.2.7 Expenses – Operating and Maintenance

17.2.7.1 In determining over and under-expenditure, the Energy Regulator will consider controllable and non-controllable elements of the operating costs. This is to ensure that Eskom minimises the costs that are under its control as well as encourage it to reduce those that are not under its control.

17.2.7.2 The Energy Regulator may make use of the sharing mechanism in adjusting for over and under expenditure.

As per Para.17.1.14, the revised methodology allows for adjusting for prudently incurred over and under-expenditure on operating costs as may be determined by the Energy Regulator. During FY 2019/20 the operating costs expenditure are projected at R59 867m exceeding the decision of R51 404m by R8 463m. Eskom's application for operating costs in relation to the FY 2019/20 financial year was less than inflation when compared to the actuals for the FY 2018/19 financial year. However, the NERSA decision was lower than the actuals for the FY 2018/19 year and almost the same as the decision for the FY 2018/19 year. This results in an untenable situation.

The main driver of the operating cost variance is attributable to employee benefits costs. Employee benefit costs are projected to have a variance of R4 821m. As in the previous revenue decision, the basis of the employee benefit decision was based on amount of energy. This does not consider the actual and projected changes in the business. In addition, even when this inappropriate measure is used, the rate has a significant change from one year to the next. It was assumed that employee numbers would be reduced in reserve storage stations. However, to minimise load shedding, the utilisation for these employees needed to be reassessed.

A contributor the variance in employee benefit costs is the need for additional overtime. In addition, Eskom assumed a higher attrition rate in its revenue application. To date this has not materialised. There is a potential for the assumed attrition rate to again increase in the second half of the financial year. This will only be able to be factored into the next quarter's projections. However, there is a risk associated with achieving this reduction, as the plan is premised on a possible voluntary separation process, while current indications are that this will not be realised during the current year.

Maintenance variance of approximately R1bn due to costs associated with delivering on the Generation nine-point programme and variance on increased unplanned maintenance. Maintenance of Grootvlei, Komati and Hendrina Power Stations was required, due to their role in contributing towards the minimisation of load shedding.

Other operating expenditure has a variance of R2.6bn. It should be noted that as in the case with primary energy, R366m of costs have been excluded by NERSA in the final revenue determination amount. When reconciling individual cost elements allowed in the decision to what was carried forward to the revenue determination this shortfall results in a variance even before analysing actual costs. With regards to insurance, NERSA's decision assumed an increase by inflation. However, the commissioning of new assets which would require insurance seemed to have not been adequately considered. In addition NERSA did not allow any IDM costs.

### 3.5 Conclusion

This submission provides the projections for the 2020 financial year, as at the end of the Quarter 2, 30 September 2019. The RCA balance projected to March 2020 based on the forecasts is R19 007m.

The purpose of this submission is only to provide an indication of the forecasted RCA for FY 2019/20. **It is by no means a formal RCA submission**.

A formal submission will be made once audited financial results for the 2020 financial year are available and the RCA balance has been computed in terms of NERSA's revised MYPD Methodology published October 2016.