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Urgently unbundle Eskom to unlock private investment

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AS SA's latest integrated electricity resource plan nears completion, two key questions arise: what is the optimal mix of power generation sources to meet future demand, and who will build and finance these power stations?

The power plan will indicate how much generation capacity is required, by when, and which technologies should be used.

However, the plan will probably not indicate whether Eskom or the private sector should build particular plants. Nor will it solve Eskom's most pressing challenge — how to raise finance for these capacity expansions.

Eskom has yet to secure the necessary funding to complete its second new coal power station, Kusile, and has halted development of further plants. Is the stage finally set for independent power producers (IPPs) to enter the market?

In contrast to much of the developing world, SA has failed to attract IPP investments. Other African countries have done much better: about 50 grid-connected IPPs are already operating across the continent and IPPs generate the bulk of electricity in Latin America.

The government has had positive intentions for IPPs for some time. The 1998 white paper on energy promised a gradual liberalisation of the power sector. In 2001, the Cabinet announced that IPPs would account for 30% of generation. And the energy regulator proposed attractive feed-in tariffs for renewable energy power providers nearly two years ago.

Despite these intentions, progress has been painfully slow, with requests for proposals halted midstream, standard power purchase agreements still in the making, and uncertainty about grid access. To be fair, Eskom recently signed power purchase agreements with industrial cogenerators for about 200MW, but in contrast to the utility's build programme of more than 10000MW this is paltry. The procurement process took nearly five years to reach this point and it will be some time before the power is available.

So why does SA have such a poor record, and what should be done to fix it?

Investors point out that Eskom has had few incentives, and indeed no obligation, to contract with IPPs.

This is understandable to a degree. Dominant monopolies usually believe they can do a better job than new entrants. But time has now run out and the government must kick- start private investment if we are to sustain social and economic development.

The experience of other countries points the way. Kenya, which already has five IPPs operating, recently tendered for three more and is negotiating an off-take agreement for Africa's largest wind farm. What enabled Kenya to progress so much faster than SA?

In 1997, Kenya unbundled its national utility into a generation company (Kengen) and a separate grid company (KPLC). Besides being responsible for system operations, KPLC was mandated to prepare long-term generation plans (under the supervision of the regulator) and to procure new generation capacity from either Kengen or IPPs. Initially, KPLC relied on transaction advisers but has over time become an effective independent entity capable of running competitive international tenders and negotiating contracts with winning bidders.

Earlier this year President Jacob Zuma and Energy Minister Dipuo Peters announced that an independent system operator (ISO) would be established to address Eskom's conflict of interest and attract IPPs. Not surprisingly, the proposal has been met with some scepticism from Eskom and its shareholder in the government, the Department of Public Enterprises.

The argument has been raised that a major restructuring could jeopardise Eskom's credit ratings at a time when the utility is desperately trying to raise debt from international capital markets.

But a cursory examination of Eskom's balance sheet should alleviate this concern. The carrying value of Eskom's transmission assets is a mere R10,5b n, compared with the utility's total asset base of R246b n. This fraction will drop further as new generation assets are added. Vertical unbundling is not an unusual event for international lenders and should not be an obstacle, as long as it is well managed.

In the meantime, Eskom has promoted the concept of an "interim independent system and market operator (Ismo)" as a ring-fenced entity within its systems operations and planning division. While some form of interim arrangement will be necessary, policy makers must not be diverted from the main debate. Our immediate priority is to attract IPP investment.

In our view, the current debates around the ISO or Ismo do not fully capture what needs to be done. We believe Eskom's system operations and transmission divisions should be unbundled and a new utility (perhaps called Central Power) should be established with six main functions. First , it must prepare regular plans for the future generation mix and the evolution of the transmission system to transport power to where it is needed. Second , it must allocate new build opportunities between Eskom and IPPs, either on the basis of government policy or through competitive bidding. Third , it must procure and contract with successful bidders to ensure a secure power supply for the country. In doing so it must treat supply-side and demand-side resources on an equal basis.

Fourth , it must blend or aggregate historic and new power purchase agreements to achieve an average wholesale electricity price to electricity distributors. Fifth , it must operate the system in real time to balance supply and demand. And, finally, it should own and operate the national transmission system, to ensure that no generator has preferential access to this critical infrastructure.

The governance of this new state-owned enterprise must be independent and ensure that no generator, consumer or other interested party has undue influence over these important functions. The governing board must have a reasonable degree of authority to evolve market rules over time, within the constraints of government policy and the oversight of the regulator.

An important market design decision will be whether to establish the new entity as a mandatory single buyer or to allow for bilateral trades from the outset — as is permitted by current legislation. The economic benefits of older, depreciated power stations must obviously be reserved for the general consumer base. Narrow interests should not be allowed to capture this benefit.

That said, there is no reason why consumers should not be allowed to contract directly with future generators for their specific power requirements — be these for green power, more secure power or possibly even imported power. The network operator should wheel this power from the producer to the consumer on an open-access and nondiscriminatory basis, within the physical constraints of the system.

The unbundling of Eskom is not only desirable, it is now inevitable. The government must release an unambiguous policy statement on the future market structure and translate this into legislation as swiftly as possible. The more certain the policy, the quicker the six functions can be transferred out of Eskom and into the Central Power company. This will attract IPPs, diversify our power mix and ensure security of supply.

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