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Electricity prices Anton Eberhard

Price hikes inevitable if we want to keep the lights on

ONCE again, Eskom's application to the regulator for a steep hike in electricity prices will provoke a national debate about the affordability of electricity and the financial sustainability of the power sector. We shall also have to confront implications for the security of electricity supply and questions about a more appropriate electricity market structure.

The three-year price determination for Eskom expires at the end of this month. Remarkably, Eskom has delayed its application for the next period until the last moment. Clearly there has been much behind-the-scenes lobbying. Usually the regulator would need a few months to consider the application, allow for public hearings and make its decision. Now Eskom will enter its new financial year without clarity on the electricity price path. Municipalities, whose finances depend greatly on electricity sales, do not know what to budget for the next year.

Eskom will most likely apply for a price increase of more than 80% this year and more than 50% next year. Prices could increase more than threefold over the next three years. Serious stuff! But Eskom faces extremely serious financing challenges in the short and medium term. For the first time in decades, it will make a loss in this financial year.

The core problem is the sub-economic price of electricity generation. The average Eskom electricity tariff in the 2007-08 financial year was 19,45 cents a kilowatt hour (c/kWh). The power generation component accounted for about 13c/kWh (the remainder is made up of power transmission and distribution costs). Yet the cost of new coal-fired power generation is now above 60c/kWh and nuclear and renewable energy costs are even higher. It is obvious that electricity prices must rise substantially.

But will the regulator have the political courage to make this decision? Like most countries, SA has a legally independent electricity regulator which was established to deal with exactly this kind of challenge. Cost-reflective tariffs are necessary to secure the financial viability of the utility, but at the same time there is intense political pressure to constrain price increases. This is precisely the role of the regulator. It needs to protect consumers (and it can do this through targeted pro-poor tariffs) but it also has to ensure that the utility has the resources to provide reliable electricity.

In determining an appropriate price, the regulator will use an internationally acceptable method for calculating Eskom's revenue requirement — based on its operating expenses plus depreciation and a return on assets — which allows it to finance new investments in generation, transmission and distribution. Hopefully it will value Eskom's assets appropriately and adopt a more commercial rate of return. The regulator will also examine vital financial indicators such as Eskom's debt to equity ratio and its interest cover.

Eskom's balance sheet faces severe pressures. After many years of not investing in new generating capacity, it has now embarked on a huge capex programme to cope with power scarcities. The destruction of demand in the global financial crisis has provided unexpected, but temporary, relief to SA's strained power infrastructure.

It takes years to build new generation capacity and we cannot delay any of the investments necessary to power SA's economy in the future.

Eskom's investment requirements are gargantuan. The previous five-year estimate of R343bn will now be much higher. Eskom funds its investments partly through retained earnings and partly through capital markets, including bond issues.

The global credit crunch and the downgrading of Eskom's credit rating have made this finance more expensive. The government has sought to strengthen Eskom's balance sheet through a R60bn long-term subordinated loan (in effect equity) and debt guarantees totalling R176bn.

But it is now clear the state is approaching its limit in support for Eskom. It has other priorities, including health, education, safety and security, and social grants for poverty alleviation. Should taxpayers subsidise Eskom, or should electricity consumers pay the true cost of power? Getting this equation right is crucial for ensuring that SA has adequate power for its economy and its people. Getting it wrong would mean an unsustainable drain on the fiscus or an inexorable drift into inadequate investment and maintenance and, ultimately, more blackouts.

This is not an alarmist scenario. It has happened with depressing regularity in many developing countries whose economic potential is constrained through lack of power. We cannot afford to go down that path. We need to take the hard decisions now about economic pricing. We also need to think about other ways of raising finance for the sector. And those alternatives unavoidably involve private sector participation and market reform.

If Eskom and the government are struggling to finance much-needed investment in new generation capacity, then it is obvious that we need to reconsider possible roles for the private sector. Wholesale privatisation of Eskom, or the sale of a strategic equity stake, is probably not a good idea. It would simply entrench a private monopoly. The experience of the partial privatisation of Telkom, without confronting competition issues directly, provides a sobering example: there were few improvements in service quality or prices.

But other options could be considered. Eskom owns and operates 10 large coal-fired power stations. Some of these could be sold off and could compete in a wholesale power market or could be given competitive long-term power contracts. Or private investors could be encouraged to invest as independent power producers (IPPs) with off-take agreements with the system operator, ideally separate from Eskom.

There is no doubt that private investment and participation in the power sector is a great deal more difficult and expensive in a global credit squeeze. Yet it is still possible. IPP developers are still active in Africa. What they need is policy and regulatory clarity.

Unfortunately the latest draft regulations from the Department of Minerals and Energy, regarding the entry of IPPs, do exactly the opposite. They create additional bureaucratic hurdles that will inhibit investment. One of the challenges of the new post-April government will be to provide leadership and clarity on an appropriate market structure for the power sector.

The shock of Eskom's price increase application will focus our minds on two key challenges: we shall have to accept higher regulated prices and we shall have to encourage wider private participation in our power sector. Both ultimately will be good for SA.

If Eskom is financially sustainable it can provide reliable electricity for our economy and our people. And if private investors are encouraged (in Eskom debt, the purchase of Eskom power stations and in new IPPs), then we have a better chance of meeting future growth imperatives. Higher prices will support new investment. They have the added benefit of encouraging more efficient use of electricity.

There has been much discussion behind closed doors of these issues. Now South Africans need to confront the hard choices. Either we accept the inevitability of much higher electricity prices plus increased private finance and participation, or we become resigned to a gradually deteriorating power system with disastrous consequences for our economy and welfare. The choices are clear.

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