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If users don't foot Eskom's bill, the state will have to

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OVER the next few months, the government, the ruling party and its alliance partners will face one of their most challenging economic tests. Decisions will have to be made around electricity price increases that will have far-reaching implications, not only for the financial viability of Eskom, but for the security of power supplies and consequent effects on economic development and growth.

The magnitude of price increases will also have a direct effect on the rating, and hence cost, of Eskom's debt and whether there will be a requirement for sovereign guarantees and/or further national treasury transfers to Eskom, and hence fewer resources for other social programmes.

The decision around Eskom's price increase is not simply "business as usual". Gone are the days of price increases below or just above inflation. Even the step change in electricity prices of 27,5% this year, and the envisaged 20% in each of the next three years, will be insufficient to pay for required new generation capacity or to keep Eskom solvent.

Eskom's price increase application last year of 60% provoked a heated national debate and led to a national energy summit, at which the government, business and civil society became directly involved in policy discussions on a desirable future price path for electricity. Eventually a compromise was proposed that would smooth price increases over the next few years.

But costs have continued to escalate. A rule-of-thumb estimate for the costs of coal-fired power stations used to be about $1000 a kilowatt (kW) of installed capacity. With escalations in input costs, a global scarcity of engineering skills and tight equipment supply markets, those costs have escalated to more than $2500/kW. Nuclear costs have escalated even more: a recent report by Moody's suggests that all-in capital costs could exceed $7000/kW.

Primary energy costs are also rising. Eskom has been paying about a tenth of global coal prices, mainly due to favourable long-term contracts with mines adjacent to its power stations.

But as it expands power production, it will increasingly be exposed to coal prices that will escalate at a rate very much higher than inflation. Eskom financing will also become more expensive after the downgrading of its debt.

Eskom's investment requirements are gargantuan. The previous five-year estimate of R343bn will most likely be revised to above R400bn and could even rise to R500bn, with the fall in the rand and higher costs. Historically, this is the largest investment by a single enterprise in SA. Eskom had hoped to fund its capacity expansion programme partially through retained earnings and partially through local and international private capital markets. But with the global credit crunch, the latter option becomes more difficult and expensive and Eskom has recently cancelled a proposed bond issue.

Eskom also faces serious challenges in funding required investments through retained earnings. For the first time in decades, Eskom will sustain a loss in this financial year. It may also record a loss next year, depending on what price increase is agreed on. Its interest cover will be negative and its debt-to-equity ratio will rocket from close to zero to a figure of nearly four within a few years.

Eskom's finances are under severe strain. It may have to negotiate a World Bank loan, provided the government is prepared to offer a sovereign guarantee. This will be the first significant loan from the World Bank to SA after years of keeping the institution, and its policy prescriptions, at bay.

Electricity price increases at least double this year's record increase will be necessary in each of the next three years. Current regulated prices are clearly sub-economic. Eskom's average electricity price in the 2007-08 financial year was 19,45c a kilowatt hour (kWh), among the cheapest in the world. The generation component accounted for 13c/kWh (the rest consisted of transmission and distribution costs).

Yet the cost of new coal-fired power generation is now approaching 60c/kWh and nuclear energy will be higher than 90c/kWh and perhaps even more than R1. It is obvious that prices need to rise sharply.

But electricity prices are not set in the market. The electricity sector is entirely government-owned and prices are regulated by the National Energy Regulator of SA.

The system of independent regulation has worked well in country contexts where governments have been prepared to delegate responsibility for price-setting, where competent and experienced regulatory institutions have developed, and where price determinations are either below inflation or, at worse, not much higher. Not all of these conditions prevail in SA and it is likely that the regulator will come under intense political pressure over the next months.

There is thus an urgent requirement to reach a political consensus on a future electricity price path. This consensus cannot simply be based on a crude negotiation in which Eskom asks for a certain price increase, which is then negotiated downwards to a level acceptable by the different social partners. The basis for the price increase has to be the revenue requirement calculation by the regulator supplemented by an analysis of Eskom's financial viability and financing requirements. Ultimately, this is a political decision that has to be based on robust financial modelling.

Political arguments against sharp electricity price increases will mostly revolve around affordability issues for poor households. But it should be remembered that poor households comprise only a tiny fraction of total electricity demand and that there is much scope for targeted cross-subsidies from other customer categories.

Mines, industries and businesses may not like the fact of higher electricity prices, but they understand the need for these increases to pay for new capacity. Their primary concern is security of supply and many are prepared to pay more to guarantee their supply.

If the government, the African National Congress and its alliance partners do not rise to this challenge the consequences are clear: Eskom will not earn sufficient revenue to pay for new generation capacity, it will have to borrow more at higher cost, or (more likely) it will require further cash injections from the government, which will mean less money for other priority social programmes.

And remember the numbers: Eskom has to invest R400bn-R500bn over five years. Do we really want the government to spend nearly as much on Eskom as it spends on education or health or safety and security?

The worst scenario is if the decision on much higher electricity prices is ducked and the government refuses, or is unable, to inject further cash into Eskom. Then Eskom will be unable to build sufficient new generation capacity. The lights certainly will go out, with devastating consequences for economic development and growth.

But if brave and informed decisions are made to raise prices to adequate levels, not only will we be able to fund investments in new generation capacity, there will be the added benefit of reducing electricity demand through accelerated investments in energy-efficient equipment. It will take time for new power stations to be built and commissioned. But energy savings can be made now and will be essential if SA is to survive this period of power scarcity.

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