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Erwin has switched us on to a timely discussion

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Minister Alec Erwin's reported statement last week that government would have to intervene, if the National Energy Regulator (NERSA) did not raise Eskom's electricity price sufficiently, raises some interesting questions.

One can see where the Minister is coming from. Current electricity prices are too low to fund new investment necessary to restore supply security. Average generation prices of around 12 c/kWh are less than half the cost of new coal-fired generation plant. The recently installed turbines, which are keeping the lights on over the Cape winter, produce power at a cost much higher than even the highest industrial tariff.

A recent international survey by NUS Consulting found that Eskom's industrial tariffs are so cheap that they are only half the level of the next cheapest country (Canada) and only 15 per cent of the most expensive country (Denmark). In other words, South Africa could more than double its electricity prices and still be competitive internationally.

How did such a situation arise? Electricity prices are low because Eskom did not have to build new electricity generation capacity in recent decades as it over-invested in the 1970s and 1980s. The capital cost of existing plant has largely been amortised. At present, electricity prices reflect mostly operating and fuel costs. But the situation has now changed and Eskom has a massive investment plan to meet growing electricity demand.

Someone has to pay for Eskom's capital expansion plan: either electricity consumers or taxpayers. Getting electricity consumers to pay for their service is clearly more efficient and desirable than using tax income that is required for education, health and other pressing needs. And if electricity consumers have to pay for new investment, then electricity prices will have to rise substantially. Failure to hike prices will place Eskom's balance sheet under severe pressure. Debt/equity and interest cover ratios will deteriorate alarmingly.

Already the credit rating agency Fitch has changed the outlook on Eskom's long-term local debt to negative with the implication that it could be downgraded in the near future, which in turn would raise the cost of Eskom's debt financing and ultimately the cost of electricity. Cost pressures are also coming from power equipment manufacturers who are struggling to meet global demand for new power sector investment.

So the Minister is right to express concern. However, his statement that government may have to intervene challenges directly the notion of independent regulation. Like many countries in the 1990s, South Africa established independent regulators in its infrastructure sectors. The logic was clear: electricity, telecommunications, water and transport are all network industries, parts of which have natural monopoly

characteristics. Consumers need protection and utilities need incentives to provide reliable and competitively priced services.

The “independent “ regulator model grants considerable decision-making discretion to regulators. The idea was to insulate price-setting and licence approvals from opportunistic political behaviour that could undermine economic efficiency as well as the attainment of social and developmental objectives.

This has been the standard model adopted around the world, including developing countries. Over half of Africa’s countries have independent electricity regulators and about three-quarters have telecommunication regulators. Even Lesotho, with barely 0.2 per cent of South Africa’s electricity generation capacity, has an independent electricity regulator.

However, what has yet to be fully grasped is that the “independent” regulator model implies two pre-conditions. First, it presumes an adequate level of regulatory commitment. In other words, governments believe in the importance of regulation and put in place robust legislation that protects their independence and stakeholders can appeal to the courts if they disagree with their decisions.

The second presumption is that regulators will be skilled, knowledgeable, experienced and competent and will make credible, fair, transparent and reliable decisions. Unfortunately, in many cases, neither precondition is in place: governments often exert pressure on regulators (overtly or subtly) and in many countries regulators face challenges in terms of skills and experience. Regulatory institutions in developing countries are also new and often fragile. Much time is therefore spent on governance, management and process issues and not enough on substantive decision-making.

Increasingly there is international recognition of some of these problems and alternative, hybrid or transitional regulatory models are being proposed that initially limit the decision-making discretion of regulators as experience and skills are built. These alternative or hybrid models incorporate regulatory contracts (that specify in detail, for example, how prices are set) or involve outsourcing of certain regulatory functions to third parties, such as expert panels.

Examples of regulatory contracts may be found in many countries. For example, electricity concession agreements in West Africa and in Latin America are in effect regulatory contracts that govern the price and quality of electricity supply. And examples of expert panels may be found in Chile and in Romania.

While there are obvious advantages in building strong, competent and experienced infrastructure regulators that make credible and reliable decisions around prices and competitive market entry, this may take time. In instances where there are either challenges in regulatory commitment or in institutional and human resource capacity, it may make sense to limit the discretion of regulators and to put in place hybrid or transitional regulatory mechanisms such as regulatory contracts and mandated use of expert panels.

Erwin's comments may be controversial, but they could also provoke a worthwhile policy debate about how infrastructure regulation could or should evolve in South Africa.

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