Why SA's power utility isn't in great financial shape

By Stephen Labson

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With news of state capture making headlines across South Africa, and the unexpected resignation of the state power utility's CEO Brian Molefe, it was easy to overlook an annexure in the finance minister's medium-term budget statement dealing with government's exposure to state-owned enterprises, and some of the finer points of Eskom's interim financial results.

A closer look suggests that South Africa's largest state-owned enterprise may not be in as strong financial shape as generally thought.

The power utility's interim results show increasing costs and a decline in profits for the first half of the year. The relatively modest level of profits that were achieved provide little comfort when looking at a set of high probability risk factors unfolding over the next few years.

These include the fact that about R40bn of under-recovered costs that had been expected to be decided by the end of this year are now unlikely to be reflected in tariffs until 2018/19, or later. It also seems highly feasible that tariff increases scheduled to start in April 2018 will be delayed in the courts, with the next major tariff increase perhaps set back to 2019/20 under this scenario.

The picture becomes more troubling when looking at the medium term. Eskom's borrowings and finance costs are set to increase significantly over the next few years. Payments to independent power producers could easily double, and further increases in revenue are unlikely to match historical trend.

With government financial exposure to the power utility at R368.5bn – and perhaps doubling over the medium term – this has implications for both Eskom and South Africa's public finances more generally.

What the numbers say

In assessing government's financial risk exposure to Eskom, National Treasury noted, as a positive factor, its recent recapitalisation programme and subsequent improvement in liquidity. Indeed, there might be reason for optimism in some of the numbers. These include a 10.5% increase in revenue as compared to the first six months of 2015/16, a 23% increase in earnings before interest, tax and depreciation and profits of R9.356bn, and various cost reductions of some R14.4bn.

But symptoms of a deeper problem emerge when unpacking these numbers.

For example, revenue gains of some R21bn were driven primarily by an increase in regulated tariffs. The problem is that Eskom has relied on significant year-on-year increases in tariffs since 2008. There is no guarantee this will continue, with flat – or decreasing – tariff and revenue scenarios more likely for the next few years.

The reason for this comes from an understanding of Eskom's regulatory environment. First, there's a huge question mark over R11bn of tariff increases allowed by the utility regulator for 2016/17. This has been set-aside by the High Court and sent back to the regulator for further review.

On top of this, the effect of the court battle is that other important regulatory decisions have been parked until the matter is resolved. This alone has already delayed other decisions on some R40bn of under-recovered costs dating back to 2014/15. Whatever the amount finally awarded to Eskom – it isn't likely to be reflected in tariffs until 2018/19, if at all.

Cost reductions not so easy to achieve

Eskom does, of course, have room to reduce costs. That said, the cost base is increasing, and in areas that are largely outside Eskom's control.

Take the long-term power supply agreements which government has placed with the power utility. The annual cost of power purchases came to some R15.1bn last year, an increase of some R5.6bn over the previous year. This cost could easily double over the next several years as government programmes in renewable power generation, gas to power projects, and coal independent power produce projects come into commercial operation.

Another way Eskom could conceivably cut costs is by substituting its own generation with supply from independent power producers. But there are two problems with this. Firstly, Eskom now has an excess of generating capacity. With weak demand and new generating units at Ingula, Medupi and Kusile in various stages of construction, it will be some time before this generating capacity can be fully utilised. Secondly, borrowings on capital invested in existing assets and those under construction must be repaid, whether used at full capacity or not.

What about savings on coal costs as Eskom outsources power generation to independent producers? There isn't a great deal of room for manoeuvre here either. The regulator has required Eskom to engage in long-term coal supply arrangements. These are generally not easy to terminate, and storage or transfer to locations where the coal might be used is costly.

A debt cliff-face looms down the line

Eskom's debt obligations were reported as R317bn, with an increase in finance costs of roughly R4bn for the six-month period. While not significant in itself, this may well be the tip of the iceberg.

For example, Eskom reported capitalised finance costs of R9 482bn. These are costs that are deferred and don't affect the reported bottom line of profits. This number wipes out the accounting profits Eskom reported of R9.356bn.

And Eskom proposes to borrow more.

To finance its capital expansion programme over the next five years the board has approved a further R327bn through to 31 March 2021. Assuming that most of the costs on those borrowings will be capitalised during construction – a common accounting practice – the full effect of finance costs will only be reflected in Eskom's bottom line profits (or losses) on completion of the current build programme.

In looking at cash flow, Eskom's interest payments on debt last year reached some R22.8bn. Considering that total borrowings are projected to roughly double by 2020/21, it is not unrealistic to anticipate annual interest payments of well over R40bn. If repayments on principal debt are added, this could reach over R50bn per year within the next five years.

So can't it cut costs? Yes. But by as much as R80bn per year to compensate for long term power purchase agreements, and borrowings? Not really.

The Eskom board has highlighted a continued focus on identifying cost savings and efficiency opportunities. But as South Africa's *de facto* electricity supplier of last resort there is not the flexibility to cut costs as might otherwise be the case.

On top of this, key cost drivers are largely determined by the government. That is not to suggest that savings can't be made. But in providing essential services and implementing government policy, Eskom isn't free to aggressively initiate cost savings as it might want to.

It would be comforting if the risks Eskom faces could be mitigated by large scale efficiency initiatives – but it is now probably too late for that alone. In managing this sea change, National Treasury may have no choice but to consider more fundamental policy responses and structural solutions to stop Eskom's finances from turning into a financial tsunami.

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