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ELECTRICITY

Counting the cost

By Claire Bisseker

Eskom's reduced tariff increase may result in a small interest rate cut

The 25% average annual tariff increase awarded to Eskom over the next three years has been met with relief - especially by economists, who have been falling over themselves to revise their inflation forecasts downwards.

The odds of the Reserve Bank cutting rates at the end of the month have suddenly improved.

Compared with Eskom's initial bid to obtain a 45% increase, which it subsequently lowered to 35%, the 25% seems like a victory for the 427 labour, business and civil society stakeholders who lobbied hard to get the National Energy Regulator (Nersa) to see sense.

However, for the mining sector and other exporters, the 25% increase when compounded means electricity prices will double in three years. That is negative for economic growth and jobs.

"We know Eskom needs to build power stations but we don't think the economic consequences have been fully thought through" - ROGER BAXTER

"We know Eskom needs to build power stations but we don't think the economic consequences have been fully thought through," says Chamber of Mines economist Roger Baxter.

The mining industry spent R9bn on water and electricity in 2008 - and 95% of that was on electricity. The 25% tariff increase will take that spend to around R20bn by 2012. That's a dramatic hike.

The challenge for the export sector is that domestic costs are rising too quickly, way in excess of inflation. Whether these industries can cope depends on what happens to the rand and whether they can raise their energy efficiency and productivity sufficiently.

"You will have closures of shafts and mines that can't absorb the increase, especially in ferro-alloys, gold and some parts of platinum mining," warns Baxter. "But it depends largely on what happens to the exchange rate because, in mining, the pressure relief valve is either the exchange rate or jobs."

Over the past three years the mining industry has reduced its peak demand by 400 MW by implementing energy efficiency measures. Chemical and allied industries achieved an overall improvement in energy efficiency of 13,7% for the period 2003 to 2008.

However, both industries warn that further gains are likely to require much more expensive investments.

SA needs to be far more energy efficient, but most players have yet to grasp how critical this is. SA still has a 15% duty on imports of solar equipment and compact fluorescent light bulbs, for instance.

Moreover, the Human Sciences Research Council's (HSRC) Miriam Altman points out that the department of trade & industry has introduced an incentive to buffer new, energy-intensive investments that might be compromised by rising electricity prices - when it should be helping companies become more energy efficient and helping to smooth out the 25% price increase for those most seriously affected.

Altman estimates that around 24 000 jobs could be lost as a result of the tariff increases.

According to an HSRC model, GDP would have shrunk by 0,1% had Eskom been

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Power tariffs - Not so shocking

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awarded a one-off price increase of 35%. The figure is low because electricity accounts for only 1,1% of all costs in services and manufacturing.

The HSRC found that in 72 out of 94 sectors in the economy, electricity contributes 2% or less to total costs. However, there are 10 sectors where electricity accounts for about 4% of costs or more, such as chemicals, non ferrous metals, general hardware, textiles, tyres, gold mining, and accommodation. These industries will suffer.

Many large industrial users (making up about 60% of electricity consumption in SA) are supplied directly by Eskom and will pay the full 25% increase.

But the average hike for households and small commercial users that are served by municipalities will be smaller. Nersa has issued a guideline that municipalities increase their electricity prices by about 15% in 2010/2011.

"For most industries, this should not have a major impact on costs, though it will hopefully spur energy-saving behaviour," says Altman. "However, the energy-intensive industries will be hard hit and will require adjustment support."

Though there appear to be legitimate reasons for granting Eskom large price increases that are more reflective of its actual costs, the HSRC still has serious reservations about whether the 25% hike is justified.

Eskom is a monopoly, with no competition to push it to a technological or efficiency frontier. Nor is there sufficient independent analysis to challenge Eskom's assertions.

"Could efficiency improvements reduce costs dramatically, thereby diminishing pressure on the consumer?" Altman asks. "No-one outside Eskom can say for sure. "

The court case brought by former Eskom CEO Jacob Maroga, who was fired in November and is suing the electricity utility for R85m for loss of income, is proving useful in lifting the veil.

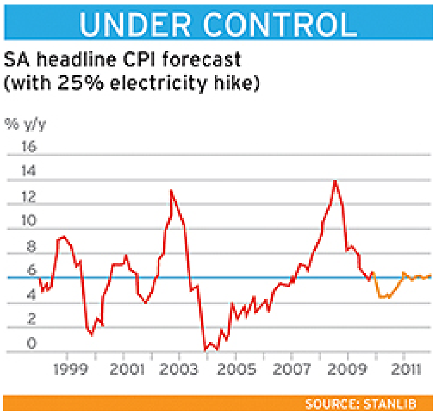
In her answering papers, public enterprises minister Barbara Hogan includes a letter by senior Eskom managers in which they warn of "continued haemorrhaging of Eskom's finances and some of its key staff" under Maroga.

"He appears unable even to make decisions in respect of simpler measures, for example, that all local travel is economy class, and other proposed operational savings, and these cannot be implemented as the entire proposal awaits Maroga's decisions for months," the managers complained last July.

The HSRC notes that about 10% of Eskom's supply goes to exports and directly to large companies. Some of these pricing arrangements are confidential and unregulated. Other consumers don't know to what extent they might be subsidising these users.

There is also limited debate regarding SA's future energy mix, either on the sources of energy or on the technologies. There could be an alternative mix of public and private provision which could reduce funding pressure on Eskom.

On a more positive note, Nersa's 24,8% increase this year is welcome from an inflation perspective. It coincides with a benign January reading of 6,2% for CPI - the fifth inflation release that has surprised on the downside.



"The market has been almost fixated with pending electricity hikes and the idea that inflation is stuck at 6% due to structural factors," says Investec's Andre Roux. "The increases granted by Nersa are also towards the low end of expectations, moderating one of the big risks to inflation. This could result in inflation coming in 0,5% lower than the market is forecasting."

Deutsche Securities is equally optimistic. It notes that the 25% hike affects only big industrial users and so feeds into PPI and not CPI.

Given that the tariff hike for residential and commercial users served by municipalities could be closer to 18% (based on Nersa's guidance of 15,3%), the impact on CPI inflation will be less than the 25% most analysts, including the Reserve Bank, have pencilled in.

WHAT IT MEANS

Electricity prices will double in three years

CPI to be impacted by less than the 25%

Deutsche is revising down its CPI forecast (which had built in a 30% price hike) by 0,2 percentage points to average only 4,1% in 2010, against the market consensus of 5,75%.

In addition, Deutsche points out that an electricity hike of this magnitude represents a tax on the consumer. With retail trade still in the doldrums, this is yet another reason for the Bank to provide additional stimulus.

But though Deutsche expects the Bank to cut rates by 50 basis points on March 25, most economists expect rates to remain on hold this year. Either way it will be a close call.