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Our Reference: PdP/LAM

Your Reference: Mr A Kotze

Mr S. J. Njikelana
MP: PC on Energy
Parliament of the RSA
P.O. Box 15
Cape Town
8000

Dear Sir

SUBMISSION ON THE RESTRUCTURING OF THE ELECTRICITY DISTRIBUTION INDUSTRY (EDI)

The Institute of Municipal Finance Officers submits the following comments for consideration by the esteemed Parliamentary Committees on Energy and Cooperative Governance.

Rights and Responsibilities:

A municipality has executive authority in respect of, and has the right to administer, the local government matters listed in Part B of Schedule 4 of the Constitution. These matters include electricity reticulation. Reticulation is defined by Section 1 of the Electricity Regulation Act 4 of 2006 as meaning “trading or distribution of electricity and includes services associated therewith.” Looking at the other definitions Trading means “the buying or selling of electricity as a commercial activity”, while distribution means “the conveyance of electricity through a distribution power system excluding trading”. A municipality is rendered a service authority in terms of the Local Government; Municipal Systems Act, where a service authority is defined in Section 1 as ‘the power of a municipality to regulate

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the provision of a municipal service by a service provider". Thus, before any restructuring takes place, the rights and responsibilities of local government must be considered.

The Need to Restructure:

Internationally, research has shown there is not a great economy of scale above 30 000 customers in a distribution utility. Larger distribution utilities are not much better than smaller ones - based on costs to customers. Thus, the real reason for any restructuring of the distribution industry must be carefully considered and the outcome of any plan for restructuring must ensure that the main objective for the restructuring is achieved.

Structure and Funding of Universal Access:

The objective of achieving Universal Access, with whatever form of electricity distribution is in place, has been promoted for over a decade. Since the costs of Universal Access depend on the structures and funding of the activities and the utilities that take over responsibility, decisions about electricity industry structure, implementation, costs and targets are all inter-linked, despite attempts to de-link them by some.

About 25% of households are still without access to electricity. Since they are generally among the poorest households, they cannot benefit from the Free Basic Electricity policy, emphasizing the inappropriateness of its present structure and the failure of the Universal Access policy and actions.

A Rural Electrification Agency, as adopted in many countries, is unlikely to solve the problem, because it would address only the superficial elements. A suitable strategy needs to be identified first, and then a structure to support it developed.

The equitable share provided to local government cannot be relied on to fund the Free Basic Electricity (FBE). It is an unconditional grant provided to local government as that sphere's portion of nationally raised revenue. With all the funding demands on local government, the equitable share cannot be "earmarked" or made conditional for the funding of FBE. In many cases, the allocation made to local government in terms of the equitable share is not even adequate to cover all the costs of free basic services that should be provided.

Skills Loss:

The skills loss from the electricity industry is frequently blamed on the weaknesses of the small municipalities. However, it is not surprising that they are weak, since the imposed salary structures directly reduce the capability of smaller municipalities to attract good staff. Salary levels escalate with size of municipality and not with competence of the employee. Thus a loss of skills from smaller distribution utilities or smaller municipalities is entirely predictable. Restructuring that simply increases the utility size and allows higher salaries to be paid is a cumbersome way of resolving the inherent weakness of the salary systems. It is recognized, however, that there are many other factors that also contribute to skills shortages. Among these, the weaknesses of the education and training systems and structures should not be ignored.

The higher salaries paid by Eskom must also be considered in any restructuring process. The alignment of salaries in a restructured distribution industry could well push the prices of electricity up prohibitively.

Synergy of Tariffs:

The process to ensure electricity tariffs are similar across the country has been artificially adjusting expenditure in municipalities. Tariffs are largely dependent on the customer base, requirements for cross-subsidy, ability to cross-subsidise, asset replacement and maintenance needs, the cost of bulk purchases and the general operating costs. Experience has shown that economic development benefits from generally stable electricity tariff policies. Economic development is going to attract further economic benefit and it is clear that greatest growth happens in metropolitan areas. The benefit of any restructuring should at least ensure that the electricity tariff policy in one jurisdictional area is consistent. Due to Eskom and the municipality competing for distribution in a single jurisdictional area, the industry structure and the National Regulator have proved unable to achieve stable and appropriate tariffs. This has been exacerbated by the introduction of Inclining Block Tariffs (IBT). Structure needs to suit the strategies for the economy and electricity industry, but this is not evident at present.

Infrastructure Backlogs:

The implementation of new accounting standards at local government level as well as at Eskom has resulted in the revaluation of assets. This has had the consequence of inflating Rand values of refurbishing amounts. While huge amounts have been invested by National Government in infrastructure, unless it can be used for the production of income and not just the provision of free basic electricity, insufficient funds can be produced to ensure effective repairs and maintenance of the infrastructure.

Subsidies for renewable energy:

Most subsidies for renewable energy are funded by electricity customers, so the costs remain within the industry. So subsidy schemes only inflate total costs and change their distribution. Support of intermittent sources of energy incurs additional costs for base load power stations, adding to the total cost and, ultimately, to the costs for customers.

Market Structure and Public Development Responsibility

Many advisors promote increasing market-based structures, modelled on the developed economies. However, it can be argued in South Africa that the electricity utilities still have a substantial role in social and economic development, distinct from a market-based structure that is meant to promote economic efficiency and efficient allocation of resources.

This issue has not been dealt with formally in South Africa in that there are often two service providers in a municipal area where the municipality has executive authority but cannot exercise it effectively. The municipality sits with the inequity in tariffs between the municipality and Eskom, where Eskom has significant room to cross-subsidise tariffs and is often able to provide distribution services at a lower rate than a municipality due to the fact that the generation, transmission and distribution processes are so integrated that the real costs are not necessarily calculated. Further inequity is due to the fact that any levy

that can be charged by the municipality, to subsidise general municipal services from which all users benefit, cannot be charged in areas where Eskom is providing distribution services. This does not promote social or public development responsibility.

Generation and transmission

Trends towards Independent Power Producers and an independent Transmission System Operator (TSO) similarly follow the developed country models, apparently without any recognition of the very different size of industry and diversity of energy sources in South Africa. South Africa has a very small reserve margin, and this will remain so for many years, so there is little or no room for competitive bidding for generation. Artificial structures and mechanisms to try to model market forces when no real market exists simply invites disturbances similar to those that have occurred in other countries with much more developed systems (e.g. market collapse in California, and renewable energy subsidy changes in Europe).

African networks are 'weak' and extensive, unlike the much stronger and more interconnected networks in most developed countries. This practical reality has big consequences for network and generation planning and operation, affecting also the broader energy planning (such as nuclear, coal or wind/PV options). Ultimately, the electricity industry structures need to accommodate the real constraints of our geography and energy systems; not to do so will cause technical and economic inefficiency.

Conclusion:

- 1) The disruption to local government as well as the potential negative impact on income streams and service delivery must be considered when any restructuring of the electricity distribution industry is undertaken.
- 2) Any proposals to restructure must directly address the issues that are thought to be addressed through the restructuring.
- 3) There are sufficient grounds on which to restructure the electricity distribution industry, but this may only be as far as the engineering part is concerned. The potential of a wires/retail split should be further examined.
- 4) A "one-size fits all" response should not be the only option as "generalisations" have led to the belief that all electricity distribution is ineffective. This is far from the truth.
- 5) If restructuring is to be reconsidered then Eskom needs to be a willing or legislated partner of the restructuring.
- 6) If a process were to be implemented, the following legal prescripts and related requirements must be taken into account:
 - There should be no departure from the Constitutional Mandate of Local Government, which means each Municipality has and retains Executive Authority over the service and should retain such authority over service delivery in their jurisdictional area to ensure service delivery is adequately maintained;
 - If a single solution is determined through the restructuring exercise, it is recommended that the need for the Section 78 process as outlined in the Municipal Systems Act should be reconsidered in order to save costs on the process;
 - The correct service provider would probably be a Service Utility or a Multi-jurisdictional Service Utility for a particular district with Metropolitan Municipalities or High Capacity Municipalities playing a leading role. The bottom line is that any

distribution entity should be a Municipal Entity.

- Eskom Distribution and Assets should be transferred to the Service Utility at no cost except if there are outstanding borrowings. If there are still loans on the assets, new agreements should be negotiated with Lenders at the same borrowing conditions.
 - Personnel should be transferred at Current benefits into the structure of the Service Utility; Section 178 of the Labour Relations Act should be taken into account when the transfer process takes place.
 - Customers will remain with the Local Municipality and a Service Level Agreement should be signed between the Local Municipality and the Service Utility.
- 7) Any planned restructuring must take into consideration the views of the electricity services affected as well as the financial views of the municipality. IMFO would like to offer their services to assist from a municipal finance perspective if any further restructuring is being considered.
- 8) Far more can be achieved if there is a drive to standardise the distribution of electricity between Eskom and the Municipalities. This will ensure that any economies of scale available can be leveraged and will prevent duplication in some instances of distribution. Municipal Engineers should play a leading role here.

It is the hope of IMFO that our submission can provide meaningful inputs into this process.

Yours sincerely



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