IPAP 2012/15

Impact of rising input costs on manufacturing and beneficiation

November 2012

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Agenda

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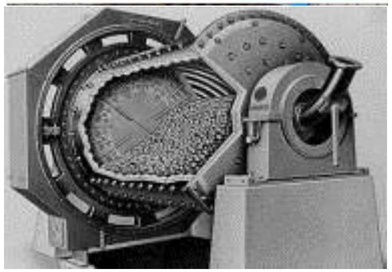
Scaw is organised along 4 main business lines producing a range of specialised high quality steel products

Grinding Media





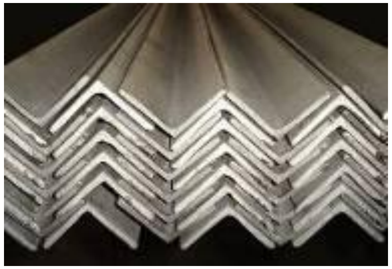
Wire Rod Products



Cast Products

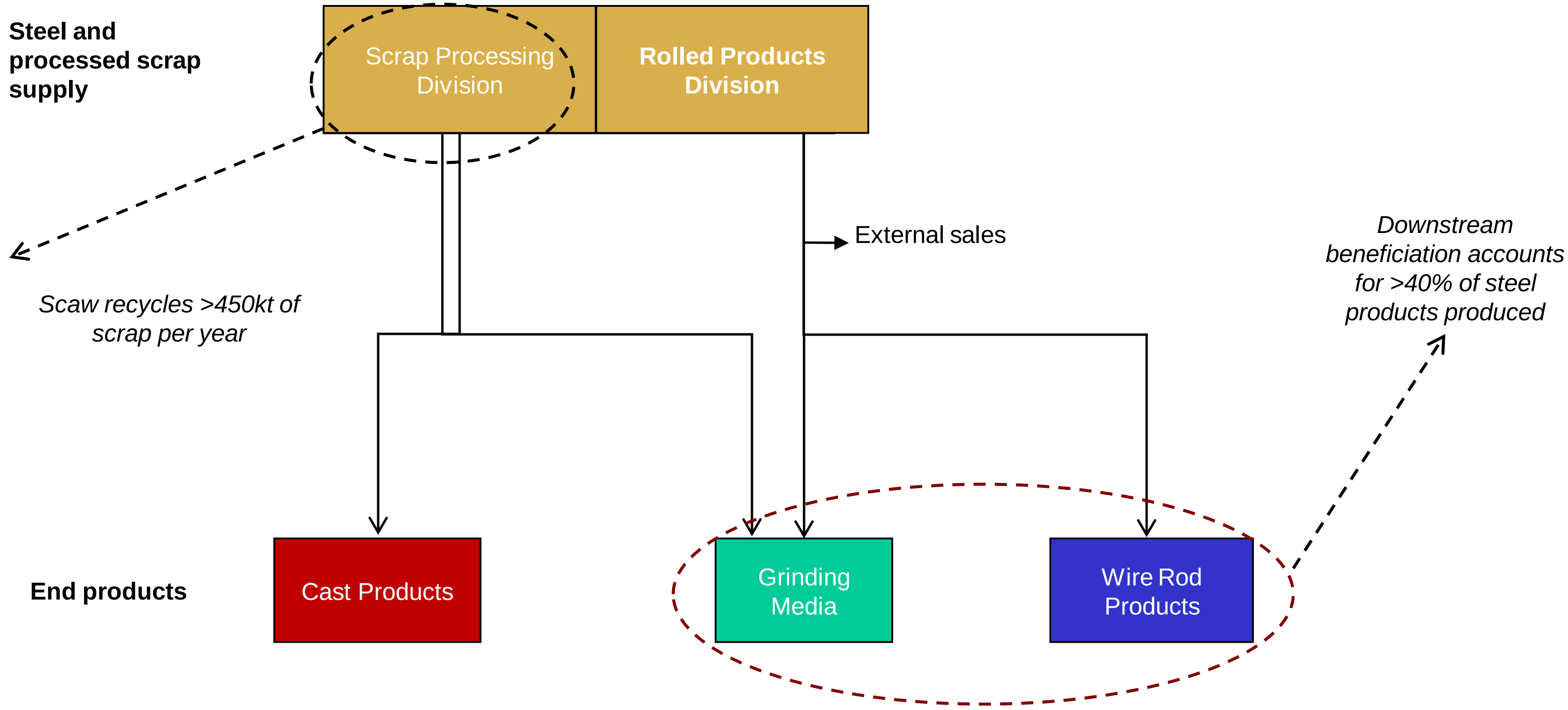


Rolled Products



Scaw has a vertically integrated supply chain and is a significant beneficiator of raw materials

Vertically integrated supply chain



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Aligned with Government policy objectives

Scaw is a success story when looking at Government's beneficiation strategies

- Government has a number of initiatives planned to further beneficiation across the manufacturing and other productive sectors of the economy which it sees as the engines of long-term sustainable growth and job creation
- This has been addressed through the number of a key Government initiatives
- Government looking at the effective use of policy tools to assist in achieving these objectives to benefit downstream industries
- Minister Rob Davies announced an enhanced support package in the mini budget on 25 October 2011

Government policy instrument	Relevant objectives	Scaw achievement
Beneficiation framework "*encourage the development of the mineral value chain to the point of final product manufacture where most of the labour-absorptive industries are located*" [1]	• Employment • Technology • Skills development • R&D intervention	✓ 6,787 permanent employees and 1,100 contractors (as of Dec-2010) ✓ 6,003 staff attended training in 2010 ✓ Metallurgical laboratory employing 53 staff for R&D ✓ Haggie R&D
IPAP2 *Industrial Policy Action Plan 2*	• Procurement legislation • Deploy trade policies more strategically • Enhance access to industrial financing	✓ R1.7bn spent on local raw materials ✓ R17.7m contribution to enterprise development beneficiaries in the value chain ✓ Large scale transport procurement of R38.4m
MPRDA *Mineral Petroleum and Resources Development Act Possible amendments to the MPRDA would make provision for the new beneficiation framework*	• Efficient use of South Africa's mineral resources • More beneficiation at source to support fabrication • Sustainable transformation and support for communities • Increased investment in R&D as a key constraint to growth	✓ Uses up to 300,000t of iron ore and beneficiates steel products from raw steel ✓ R2.2m social spend on youth, women, disabled, learners and community based projects ✓ 26% BEE equity ownership (changing to 100%) ✓ Level 4 BBBEE contributor
Steel industry task team *Set up by the Dti, EDD and DMR to ensure the viability and cost-competitiveness of the local steel industry*	• Make recommendations on appropriate policy tools to ensure the viability and cost competitiveness of the local steel industry	✓ Regular engagement with the Dti and EDD

Note:
1 Advocate Sandile Nogxina, currently a special adviser to Minerals Development Minister Susan Shabangu, 30 August 2011

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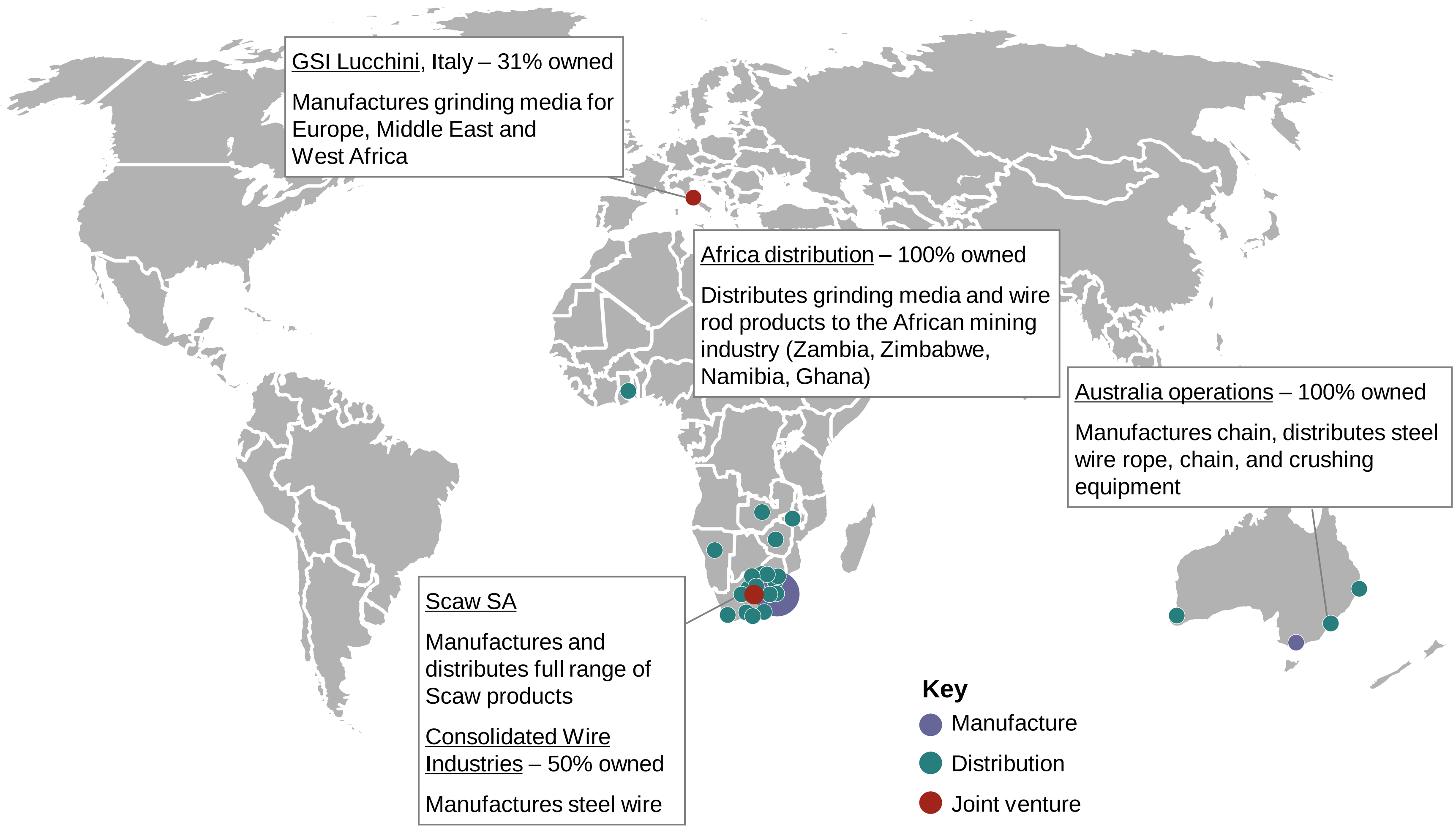
Scaw has an international footprint across a number of key mining and infrastructure geographies



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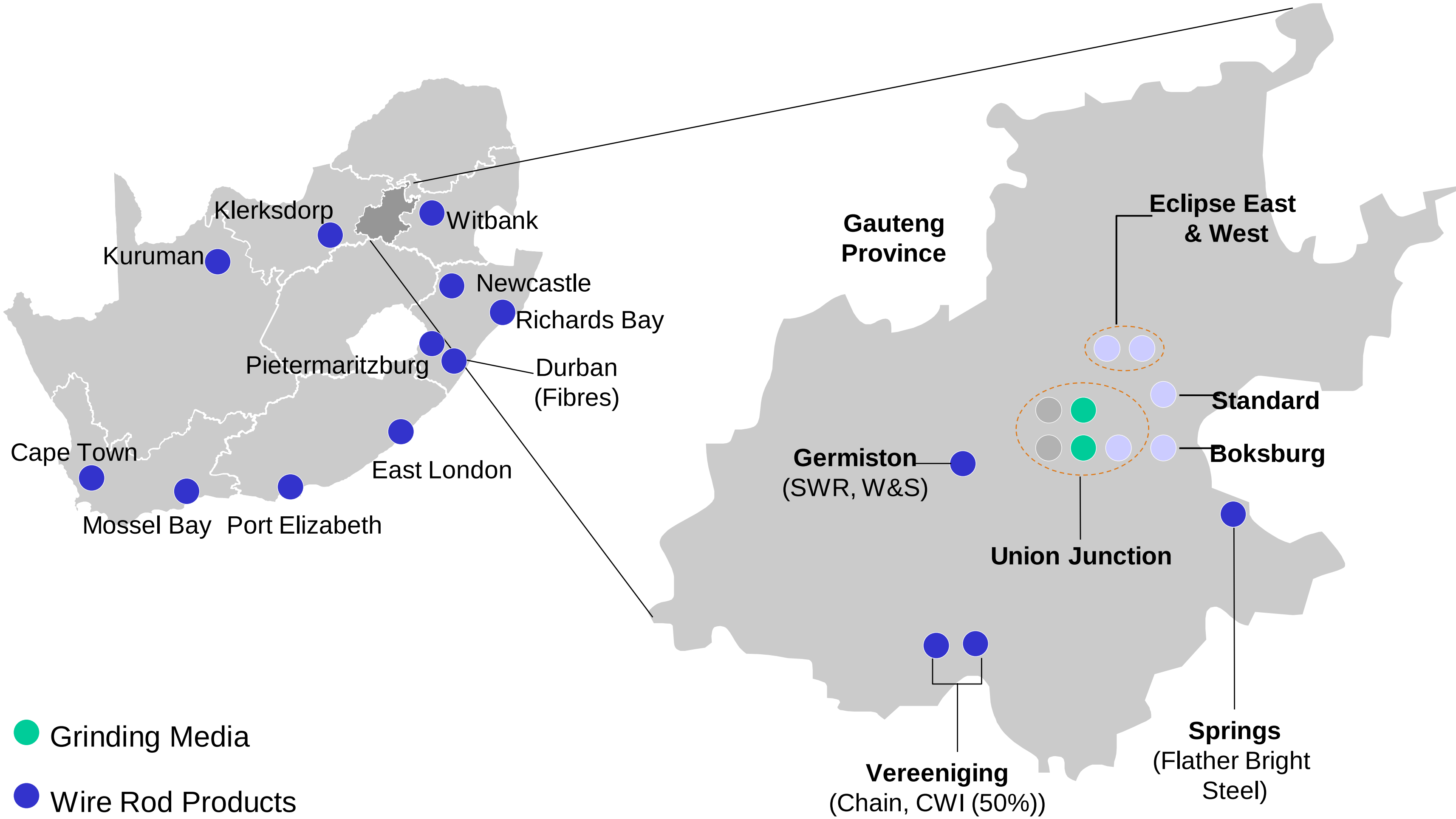
The key manufacturing facilities in Gauteng source electricity from, amongst others, municipalities



- Grinding Media
- Wire Rod Products
- Cast Products
- Rolled Products

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Industrial customers supplied by municipalities are at a significant disadvantage

Tariff	Cost per annum [R'million]	% mark up on Eskom [%]	Cost in excess of Eskom [R'million]	Unit Electrical Cost [R/kWh]	Tariff Plan	
Eskom	21.48	-	-	0.59	Eskom	Megaflex
Cape Town	26.75	24%	5.26	0.73	Cape Town	MV TOU
Durban	27.98	30%	6.49	0.77	Ethekwini	Industrial TOU
Boksburg	32.88	53%	11.40	0.90	Ekurhuleni	Tariff D
Johannesburg	38.89	**81%**	17.41	1.06	Johannesburg	Industrial MV TOU
Vereeniging	43.10	101%	21.62	1.18	Emfulweni	Megaflex

Note:
1. The above comparison is made with the 2012/13 tariff year using real factory electrical demand that has a MD of 7.2MVa and an average loading of 4.2 Mva.
2. COJ has a 4 month winter tariff period vs all other municipalities of 3 months.
3. COJ also levies a municipal levy of 2% on top of the standard tariff.

- Large municipalities in Gauteng, have the highest tariffs despite enjoying economies of scale
- This places municipal supplied manufacturing facilities at a significant disadvantage against Eskom supplied and international competitors

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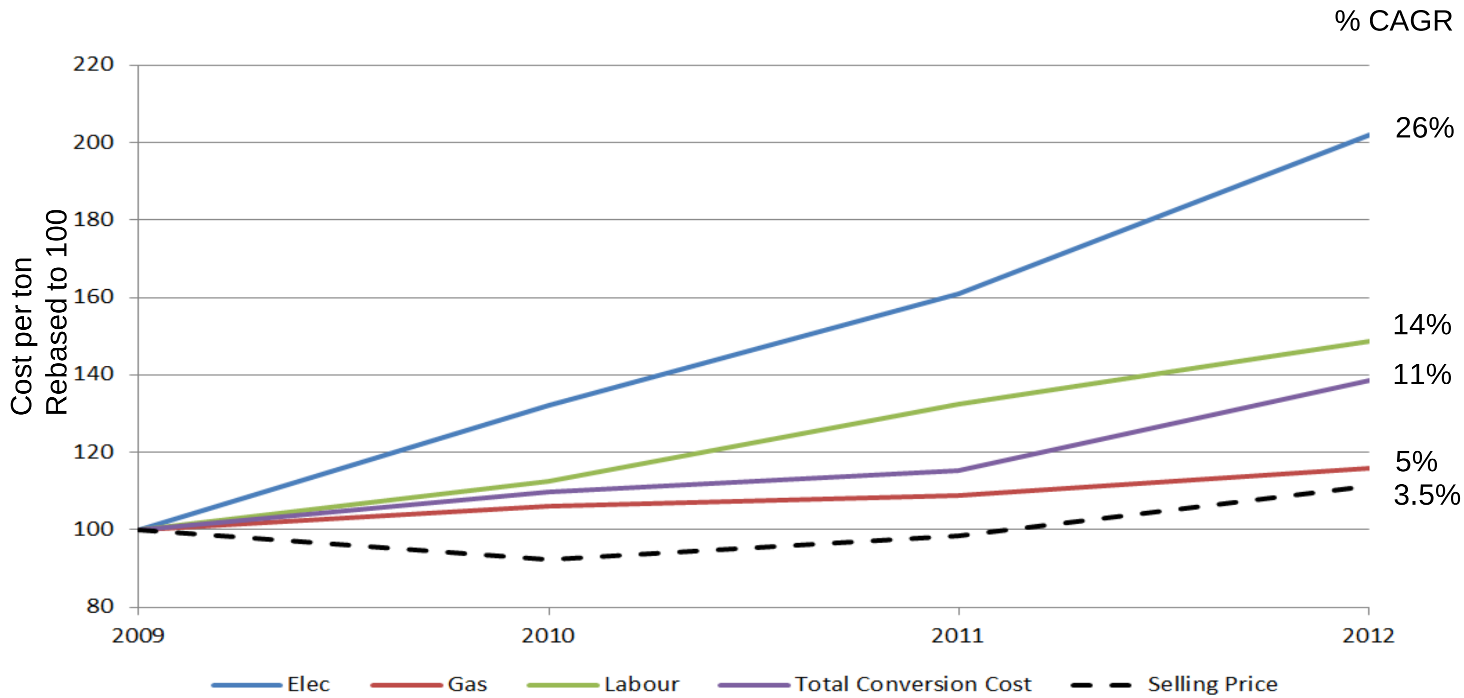
…additionally high municipal maximum-demand charges are damaging Industry

Tariff	Cost per annum [R'million]	% mark up on Eskom [%]	Demand Charges [R/kVA]	Tariff Plan	
Eskom	21.48	-	33.70	Eskom	Megaflex
Cape Town	26.75	24%	81.03	Cape Town	MV TOU
Durban	27.98	30%	90.66	Ethekwini	Industrial TOU
Boksburg	32.88	53%	68.99	Ekurhuleni	Tariff D
Johannesburg	38.89	**81%**	**133.27 to 140.76**	Johannesburg	Industrial MV TOU
Vereeniging	43.10	101%	**178.24**	Emfulweni	Megaflex

- ✗ Industry has to pay high electrical bills, even during periods of low energy consumption
- ✗ Disincentive to save energy (reduced energy consumption does not proportionally lower the electrical bill)
- ✗ Maintenance of electrical distribution infrastructure remains a concern
- ✓ Increases on Municipal Demand Charges should be capped until they are more in line with Eskom
- ✓ Revenue flowing from demand charges must be ring-fenced and used for Capital Infrastructure Refurbishment by municipalities

Example: The effect of cost increases on business profitability



- Continued cost pressure will make business unviable
- In the three year period displayed above, the cost of electricity from the municipality increased by 86%
- On low margin, high volume products doubling the electrical cost per ton over 3 years makes certain products uncompetitive.
- This has already resulted in the termination of certain products (now imported) and a loss of jobs.

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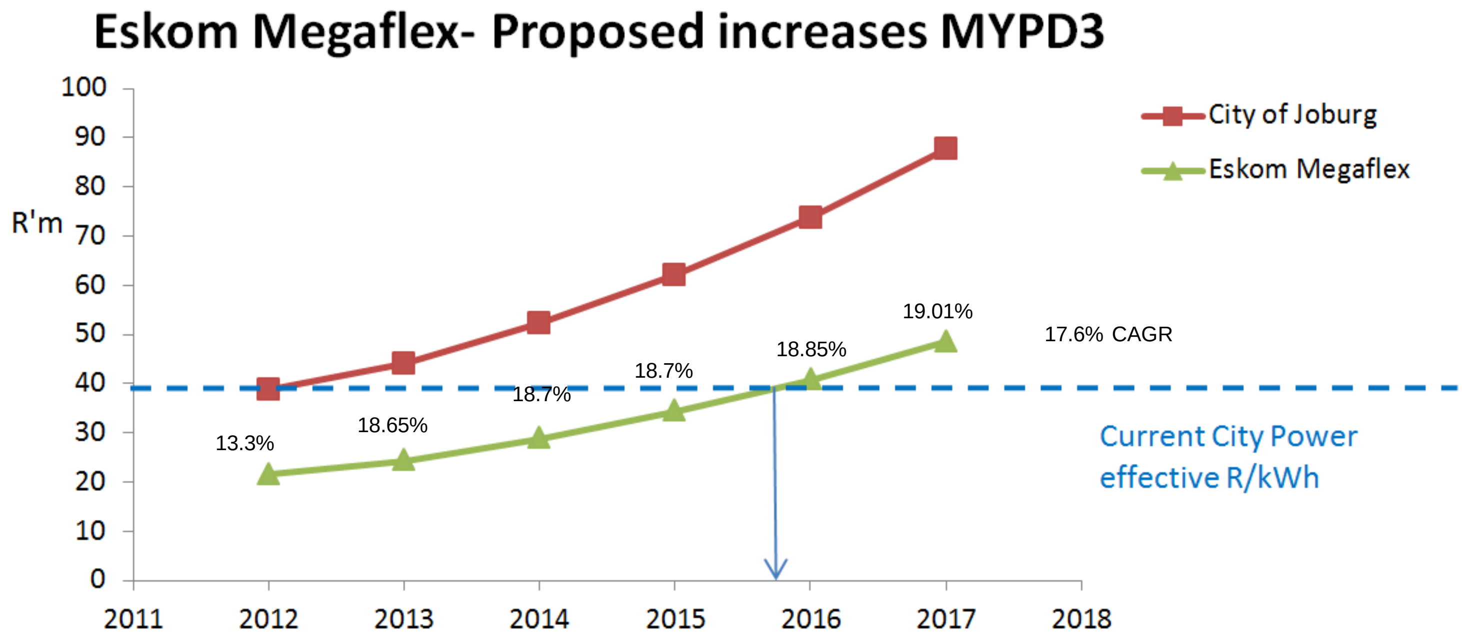
Proposed Eskom MYPD3 Increases can destroy energy-intensive industry fed by Municipalities



- The chart illustrates, as an example, that if the City Power Electrical Tariff is frozen it will take until late 2015 before the Eskom Megaflex Tariff is equal to the City Power Industrial MV TOU Tariff

- If the COJ tariff increases in step with the proposed Eskom increases, the factory in this example will pay R358m to COJ over the next 6 years versus R200m that would have been paid to Eskom (difference of R158m)

- The increase proposed by Eskom for municipalities of 13% is misleading as this is only for 2012/13. Over the 5 years the CAHR is actually 17.6%.

- This will discourage industrial investment in areas supplied electricity by municipalities

- **Municipal Tariffs need to be restructured so that they are equal to the Eskom Megaflex Tariff**

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Suggestions for bringing municipal industrial tariffs in line with Eskom Megaflex tariffs

1. Revenue Collection must be improved
    - Technical and Non-Technical Losses of 19.3% reported by CoJ in 2010/11 not sustainable
    - NERSA request for a plan on how CoJ is going to address this problem is welcomed

2. Cross-subsidisation need be addressed
    - Revenue from electricity currently to fund a significant portion of non-electricity related portion of municipal budgets
    - Revenue from electricity supply needs to be ring-fenced and used for the purposes of recapitalising ageing infrastructure
    - Treasury needs to assist Municipalities in balancing their budgets without over reliance on electrical revenue

3. Cost of supply to municipalities from Eskom needs to be lowered
    - Eskom local authority supply rates to be lowered to help bridge the gap between Eskom supplied customers and municipal customers
    - Alternatively Municipal customers must be given the option to rather purchase their electricity directly from Eskom

Alternative energy supply

If the problem of High Municipal Industrial Tariffs is not addressed there are only two alternatives for Factories to obtain electricity at a competitive price.

1. Businesses must be given the opportunity to be supplied directly by Eskom

2. Opportunities for wheeling electricity that currently exist for Eskom customers need to be made available to municipal customers
   - Though this can only work if municipalities pass the benefit on to industrial users without placing a premium on wheeling energy through their network
   - Wheeling opens up opportunities for businesses to purchase "green energy" if this is a business requirement

Neither of these solutions are short term solutions

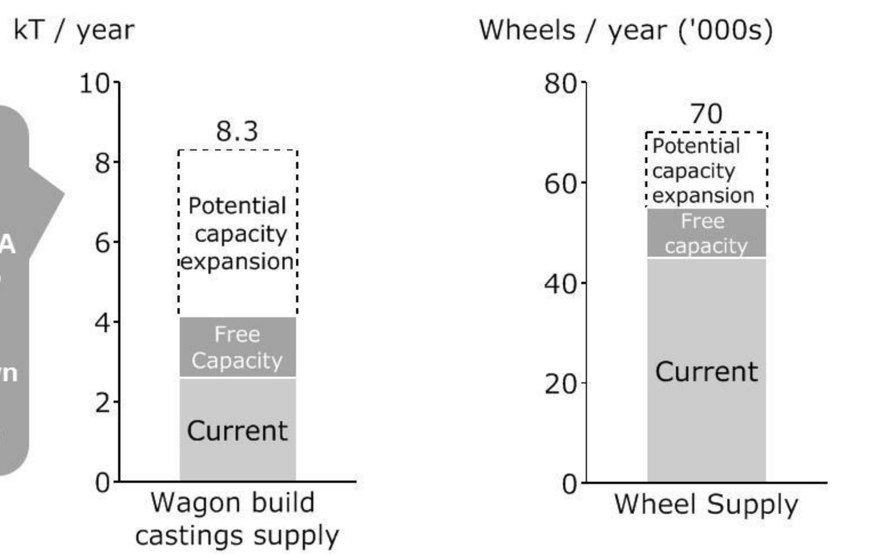
Opportunities for local sourcing

Scaw is, and will be, significantly affected by procurement efforts to leverage localisation in the following products:

1. Railway Components including:
   - Railway wheels
   - Assorted Components for Railway Bogies

In each product there is sufficient SA demand to reach capacity target shown (if imports displaced)

RAIL FRAME CASTINGS | **RAILWAY WHEELS**



Increase in employment possible through local sourcing

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Opportunities for local sourcing (continued)

2. Increased supply of strand into ACSR cables for overhead power lines
    - Long term volume commitments would assist in further investment to lower costs and increase jobs capability

3. Release of Government Infrastructure process
    - Currently supply exceeds demand, and to the extent tenders are released, Scaw can supply steel into the construction sector.

4. Continued supply of Grinding Media to Eskom for crushing and milling of coal

Cheaper local steel scrap pricing as a stimulus to the economy

- The South African Steel Industry will benefit massively from the imposition of tariffs on the export of Scrap Steel
  - Some of the best quality scrap steel is leaving the country on a massive scale unimpeded by export tariffs that many other countries have in place. This is exported to the likes of India and China for further beneficiation into steel products
  - Tariffs are not uncommon in competing countries
    China has a 40% tariff, India 15%, Argentina 20%, Zambia has a complete ban on exports
  - This steel scrap was manufactured in the past using cheap electricity. With every ton of steel exported South Africa is effectively exporting +500kWh of very cheap electricity
  - Cheaper Scrap Steel (relative to international scrap price) will make the South African Steel Sector more competitive and stimulate manufacturing growth, as the costs of raw materials for local beneficiation reduce
  - Since 2006 the export of scrap steel has grown by 22% CAGR, whilst local beneficiation has declined by 3% CAGR
  - Increased competition for scrap (local vs export) has contributed to the increase in scrap price of some 13%
  - Scaw has done research into scrap tariffs, that suggest the imposition of tariffs would not result in job losses but encourage increased local beneficiation and employment opportunities

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Recommendations

1. MUNICIPAL TARIFF NORMALISATION

- Government must in parallel with the Eskom MYPD3 proposal, establish a plan to bring the municipal industrial tariffs in line with the Eskom Mega-Flex tariff

- The three key actions needed in such a plan are:
  - To provide an Eskom wholesale tariff to Municipalities that is lower than Eskom Megaflex
  - To improve municipal revenue collection
  - To minimise cross-subsidisation of services, and to ring-fence electrical revenue surplus for use in electrical infrastructure replacement

- Consequences of Municipal Tariffs remaining at high levels of mark-up to Eskom are:
  - In the long term there will be no energy intensive businesses still fed by municipalities if this problem is not addressed
  - In the short to medium term energy intensive businesses will struggle to grow, or will shrink in size as they lose market to cheaper imports or cheaper local competitors who obtain electricity at Eskom Megaflex rates

2. LOCALISATION

- The good work already done by Government to increase localisation needs to continue which will help stabilise and then grow the South African manufacturing base

3. STEEL SCRAP EXPORT TARIFF

- Consideration to be given to steel scrap export tariffs to increase local beneficiation and manufacturing

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Questions?