Energy Intensive Users
Group of Southern Africa
Established 1999

www.eiug.org.za @EIUGSA

ESKOM FINANCIALS SUMMARY REPORT

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1. INTRODUCTION

The following article presents a summary of analysis undertaken by The Eton Group for the Energy Intensive User Group of Southern Africa (EIUG).

The findings of an analysis of the following areas are discussed; these are identified as contributors to Eskom's current financial situation, and areas of key risk or concern for the future financial sustainability:

- Debt and Credit Worthiness
- Revenue and Sales
- Expenditure
- Sustainability

2. DEBT AND CREDIT WORTHINESS

An analysis of Eskom's recently released financial statements indicate that the utility finds itself having to service debt, but with reduced financial space to do so. Eskom may have to divert borrowing to fund operating costs, and may struggle to service its debt due to liquidity issues.

Diverting funds may also breach some loan conditions, risking a call on government guarantees and a run on cross-default clauses written into other bond and loan agreements. The 2016 credit rating downgrades by S&P and Moody's are in part due to these concerns.

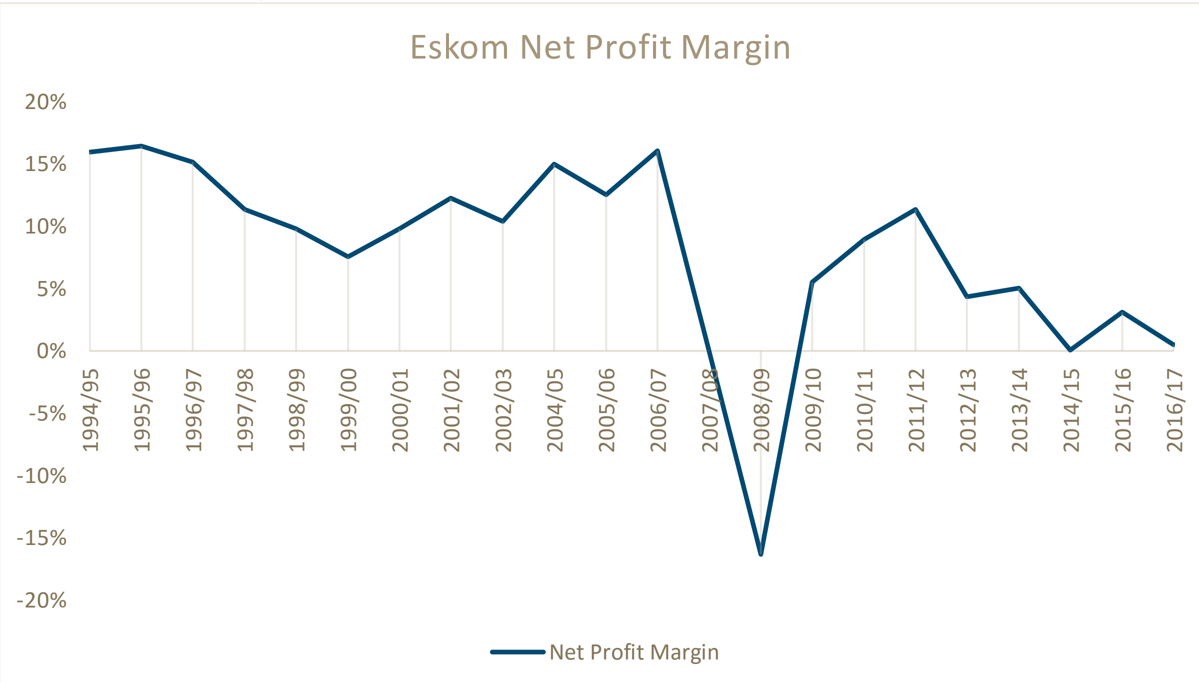
There remains the possibility that government will have to provide future equity investments into Eskom, and provide further guarantees on Eskom's debt. Statements from Eskom that it will seek to release government guarantees defy understanding of its present situation and short-to-medium term challenges.

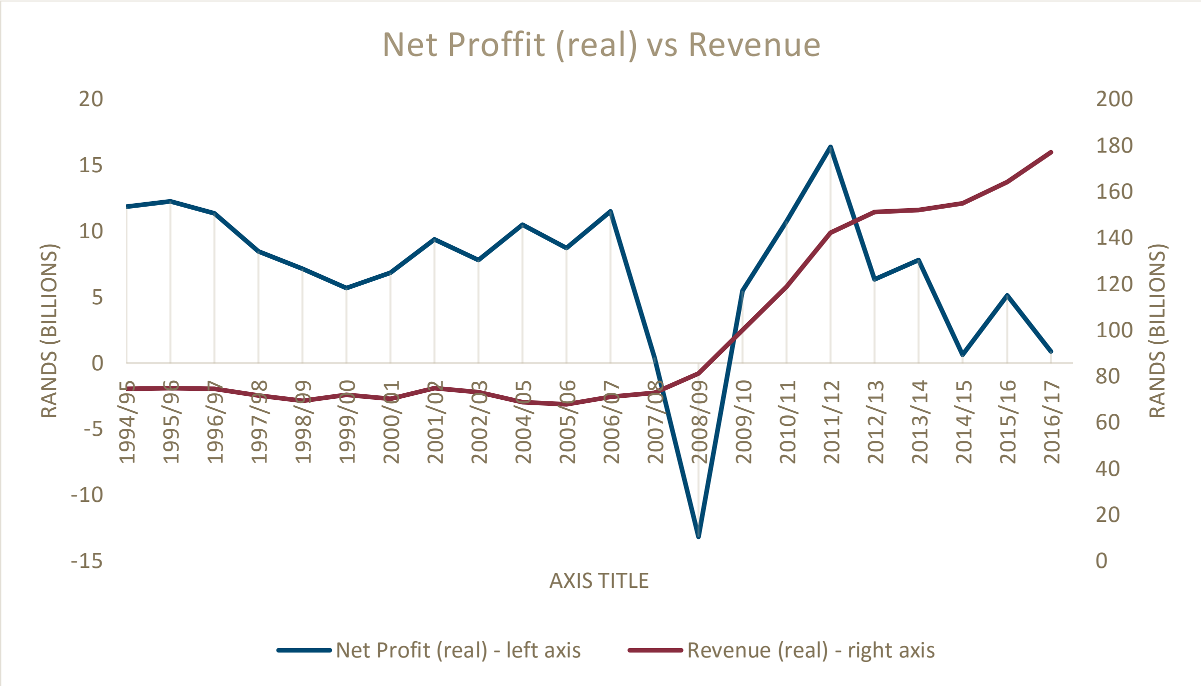
These risks require proactive monitoring and evaluation of Eskom's operational, technical and financial activities.

3. REVENUE

3.1. PROFITABILITY

Since 2007, Eskom's profits have declined, its net profit margin has averaged 4 per cent (including losses in 2007/08 and 2008/09).





The decline in Eskom's profitability since 2006/07 has occurred despite the significant and sustained increase in revenue.

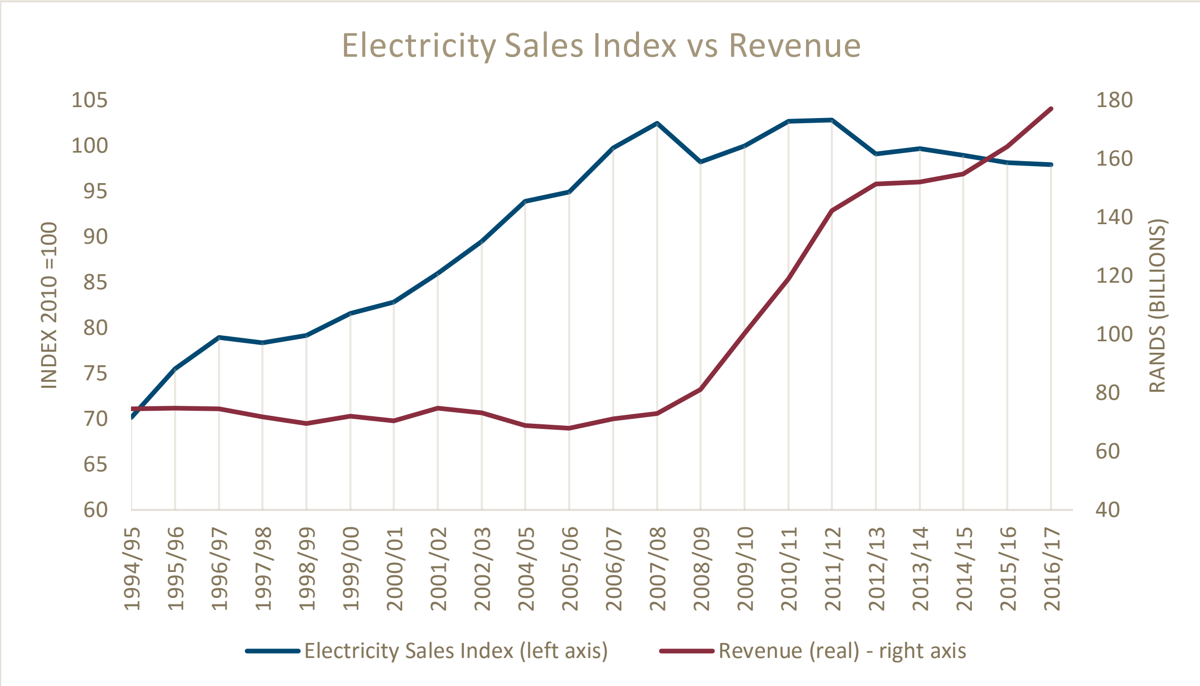
Between 2006/07 and 2016/17, Eskom's revenues grew by an annual average of 9.7 % in real terms (nominal: 16.9%), while profits fell by an annual average of 9.6% in real terms.

3.2. REVENUE AND SALES

Total electricity sales declined after 2007/08 in response to the effects of the global financial crisis, country-wide load-shedding, as well as sustained lower economic growth. Global structural changes in commodities, greater efficiencies and decreasing international electricity price competitiveness means that lost demand is unlikely to return or indeed to grow to historic levels.

Between 2007/8 and 2015/6 the industrial and mining sectors, which account for between 38 – 42% of direct Eskom sales, decreased demand by 20.4 % and 5.5 % respectively.

Between 2010 and 2012, electricity sales recovered to the 2007 levels, but have been in decline since.



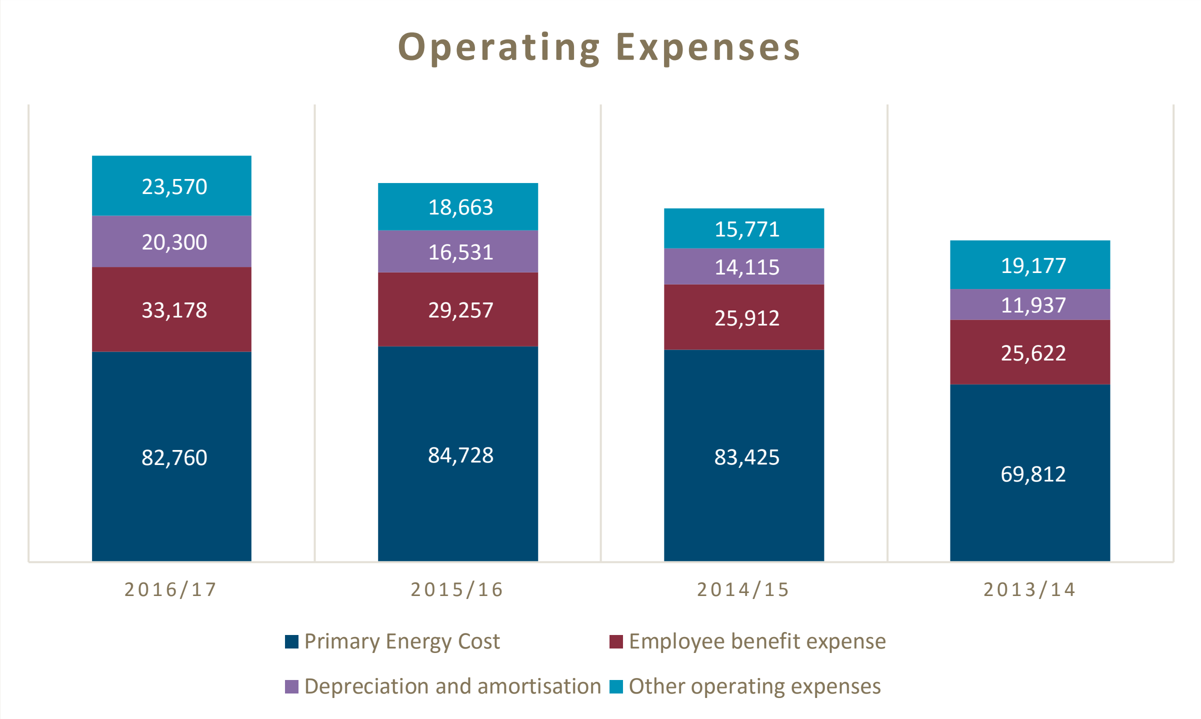
The concern over revenue and sales stems from the fact that, although Eskom was granted a 9.4% tariff increase in 2016, revenues only increase by 7.9%. Without any further analysis, this is an indication that the biggest contributors to Eskom's sales are contracting.

Short-term tariff deviations for vulnerable entities and a move to internationally competitive industrial tariffs and changes to the industry structure in the long-term may halt or slow the so-called "death spiral" phenomenon[1]. The success of such interventions depends on the characteristics of such changes, the urgency with which they are implemented, and the rate of such tariffs.

[1] Described well in Piet van Staden's article: https://www.dailymaverick.co.za/article/2017-06-29-op-ed-beyond-patronage-politics-where-is-south-africa-going-with-eskom/#.WYghFoiGO02

4. EXPENDITURE

4.1. OPERATING EXPENSES



The largest contributor to the increase in Eskom's operating expenses is attributed to "Repairs and maintenance" which increased by R 4.4 billion.

The aggregated category of "Other Operating Expenses", where the bulk of expenditure (R 1.4 billion) is ascribed to "Managerial, Technical and Other Fees", increased 140%.

Along with many irregular expenditures, this amount can be attributed to consulting fees paid to McKinsey and Trillian. These two consultancies were compensated R 900 million and R 495 million respectively for their services. The relationship and contract with McKinsey and Trillian speak to governance and compliance issues surrounding Eskom in terms of contract management, procurement and accountability.

4.2. EMPLOYEE BENEFIT EXPENSE

Employee benefits, which constitutes the 2nd largest category of operating expenses, increased by 13%.

Headcount decreased marginally (2016: 47 978 – 2017: 47 658).

The increase in employee benefit expenses can be largely credited to the R 4.2 billion set aside for annual and performance bonuses, which increased by 98% from last year. This translates to an annual and performance bonus of almost R 89 000 per employee.

4.3. PRIMARY ENERGY

Primary Energy is the largest component, contributing 52% of operating expenditure.
Expenditure on primary energy decreased 2% (2016: R 84.7 billion 2017: R 82.7 billion) almost solely due to the open-cycle gas turbines (OCGT's) no longer being used to the extent they were in the past during load-shedding.

This also speaks to the surplus in electricity generation due to new generation assets coming online and a lower demand for electricity.

If the "savings" experienced from the lack of OCGT usage are stripped out of the equation, the cost of primary energy has increase by 6.42%, which is in line with an inflationary increase, and not due to saving measures claimed by Eskom.

5. SUSTAINABILITY

The cash flow statement shows the company's cash position at the end of the year. Eskom's 2016/17 results show a negative cash flow, set out in summarised form below:

Net operational incoming cash flow	R 45.84bn
Cash used in investment activities (mainly for capital expenditure)	(R62.29bn)
Cash raised from borrowings, less borrowings repaid and interest paid	R 7.86bn
Net result	(R 8.59bn)

Source: http://www.politicsweb.co.za/opinion/digging-eskom-out-of-its-financial-hole

Eskom ended the year with a positive cash balance of R 19.9 billion, after considering the decrease in its cash of R 8.59 billion. In analysing the above calculation, note should be taken that the financing activities include new borrowing of R51 billion, a cash inflow, and a substantial interest bill of R 29 billion, a cash outflow.

Without this level of new borrowing, the net result of the cash flow statement would have been much worse. Eskom is not generating enough cash through operations and electricity sales revenue to cover the interest on its borrowings. It equates to using one credit card to pay off another. The financial consequences of poor planning and management in Eskom are now plain to see.

Unnecessary expenditure and the implementation of political agendas have caused massive inefficiencies for a company that does not have the luxury of largesse. Eskom has had 10 years to recognise the inefficiencies in its operations and to rectify them through sound cost control, good governance and forward planning. Regrettably, instead of addressing these issues, financial engineering has been used to spin a better-looking picture of an embattled company.

The 19.9% tariff application for 2018/19 is already widely contested, even before the public consultation process has started. Further uncertainty regarding 4 outstanding Regulatory Clearing Account (RCA) applications and the next Multi-Year Price Determination (MYPD) makes for nervous investors and lenders.

With the tariff increase of 2.2% for 2017/18, and optimistic growth forecasts of 2.1%, Eskom is going to be hard pressed to continue to turn a blind eye to issues that are crippling the institution.