

## **Why the Regional Electricity Distributors (REDs) concept is bad for Cape Town**

The City of Cape Town has asked for public input as part of the Municipal Systems Amended Act (MSA) Section 78 process investigation of the Electricity Division of the City of Cape Town Metropolitan Municipality (CoCT), to decide the most appropriate form of electricity distribution. This document details a brief outline on current activities in electricity restructuring and an argument on why the REDs option is a bad option for the City of Cape Town. The reason for the detailed background on the REDs is that the City has provided no background material or documentation to enable the public to make an informed input into the process. In addition, it has asked for public input during the Christmas recess –a tactic often used by those seeking minimum feedback and input from the public.

In 2000 The Department of Minerals and Energy (DME) appointed a consortium led by PricewaterhouseCoopers (PwC) to assist with the restructuring of the Electricity Distribution Industry (EDI). The objective of the project was to develop plans for the consolidation of the EDI into Regional Electricity Distributors (REDs), created from the distribution assets and operations currently owned by municipal local governments (Municipalities) and Eskom.<sup>1</sup> The objective of the EDI reform programme was to establish financially viable REDs.

It has long been of concern that, in the words of the Minister of Minerals and Energy, the South African EDI is in “financial crisis”. Many of the municipalities are loss-making entities as a result of inefficiencies, lack of capacity, theft, and a history of non-payment by users. Further, there is an extent of electricity cross subsidising other essential services within certain municipalities, which requires significant financial restructuring and ring fencing, prior to amalgamation with other municipalities and Eskom to form the REDs. It is reported that Eskom is suffering bad debts on its bulk supply, with municipality arrears estimated at R 100 million in July 2001. Furthermore, the haphazard development of the EDI (for historical reasons) has led to widely differing tariffs, varying levels of reliability and chaotic billing procedures.

The EDI in South Africa is two-tier and highly fragmented. Hence the urgent need to restructure the industry. Investigations and deliberations around EDI restructuring began in 1992, and as a result numerous studies have taken place since then. The studies began with the National Electrification Forum (NELF) in 1993/4, the Electricity Working Group (EWG) in 1995/6, and

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<sup>1</sup> PriceWaterhouse Coopers, Electricity Distribution Industry Restructuring Project, Department of Mineral and Energy Affairs, available at [www.dme.gov.za](http://www.dme.gov.za)

the Electricity Restructuring Interdepartmental Committee (ERIC) Report towards the end of 1996. In April 1997 the Cabinet considered the recommendations of the ERIC Report, and with regards to the restructuring of the EDI, resolved that there would be consolidation of the electricity distribution industry into the maximum number of financially viable and independent regional distributors. In June 1999 Cabinet decided to constitute an Electricity Distribution Industry Restructuring Committee (EDIRC) under the jurisdiction of the Department of Minerals and Energy (DME), to oversee the transformation of the electricity distribution industry. EDIRC appointed PricewaterhouseCoopers (PwC) as technical advisors to investigate and guide the transformation. This process culminated in six consultative workshops and an EDI Blueprint Report.

The EDI Blueprint Report proposes that RED formation begin with the separation and ring-fencing of distribution activities from the parent organisations. To this end, the Electricity Distribution Industry Restructuring Project Office (EDIRPO) developed a framework to assist with the process.

The main objectives of the EDI blueprint are:

- Ensuring that the EDI in future is best placed to meet the basic needs and requirements of electricity consumers in South Africa – specifically to provide for universal access and acceptable quality to electricity supply to all South African citizens and businesses;
- To establish a structure and financial arrangements in the sector that will support the achievement of the government's electrification programme;
- To ensure arrangements are in place in future that provide a sustainable electricity supply to low-income consumers at affordable prices;
- To ensure that the future RED's can operate on a sustained financially viable basis as independent businesses;
- To ensure that the new RED businesses are able to provide secure employment to their employees and provide the skills development and training consistent with a high technology, modern distribution business;
- To ensure that the reform process is taken forward within well planned and managed transitional arrangements; and
- To ensure that the transition to the new arrangements is done within the context of a comprehensive human resources strategy and an agreed Social Plan.

Some of the key concerns raised by Cabinet regarding the blueprint included:

- The transitional arrangements for a distribution holding company;
- The concerns over tariffs and electrification proposals;
- The effect of allowing customer choice on local government; and
- The lack of overall context of the EDI restructuring within the future ESI restructuring.

A reference group was appointed by the Minister of Minerals and Energy to review the proposals and make further recommendations. The Cabinet reviewed these revised proposals in May 2001, and agreed upon certain principles including:

- The merger of Municipal Distribution entities with Eskom's Distribution Business into six regional REDs, which will be owned, in proportion to the share of the assets contributed, by the municipalities and national government (for Eskom's share); and
- The design of each RED in an attempt to create an even balance between industrial and domestic customers. The transitional state owned EDI Holdings Company will permit cross-subsidy from stronger to weaker REDs for a period of around 5 years.
- However, there is still a need to refine key legal and operational issues which will have an impact on the financial viability of the REDs, for example:
  - The municipalities' role with respect to electricity reticulation in order to comply with the constitution;
  - The financial impact of the EDI restructuring on municipalities, and the need for a suitable compensation mechanism via levies, taxes or dividends;
  - The position of 'contestable customers', i.e., those who wish to contract directly with generators for supply, and the concept of independent retailers; and
  - Support or not of the move by certain municipalities to create legally separated Municipal Entities, rather than merely ringfenced Separated Operational Entities in preparation for the transition to the REDs.

In order to alleviate certain of these pressures, the Cooperative Agreement between central government, Eskom and SALGA was signed with an intention to bridge the gap before the formation and operation of the EDI Holdings Company.

With regards to the issue of the EDI restructuring within the overall context of the ESI restructuring, there have been meetings held between the CEO's of SALGA, EDIH and the Director Generals of the DME and the DPE where it appears that a 'contextualised' strategy for implementation is being devised.

The revised cabinet memorandum on the EDI Restructuring proposals recommended that the transition take place over a period of 3 to 4 years, to ensure that the implementation is done with minimal risk to ongoing operations, but with sufficient momentum to ensure completion as described below:

- Phase 1: Establishment of EDI Holdings (2001) and the subsequent appointment of the Board and key officials (2003);
- Phase 2: Ring-fencing of the Distribution Businesses (2002), which includes:
  - Eskom Distribution being constituted as a separate legal subsidiary of the Eskom board, i.e., the separation of Eskom Distribution from Eskom;

- The development of plans for restructuring from its present seven operating regions into the six REDs (High level plan completed mid 2003);
  - The implementation of support to the weakest municipal distributors, etc; and
  - The beginning of the task of creating the REDs and staffing their management teams; the NER should introduce WEPS in the meantime, and finalise the initial regulatory environment for the REDs (still to be completed).
- Phase 3: RED establishment (commencing with RED1 RED DAY ONE on 1 July 2005): The formation of REDs as subsidiaries of EDI Holdings, followed by the phased transfer of businesses to the REDs.

Following their establishment, the REDs would remain under the control of the EDI Holdings Company for a further 3 or more years, and weaker REDs will receive transitional financial support. All six REDs are meant to achieve financial independence well within 5 years after their establishment.

***Potential areas of concern:***

Restructuring in the electricity sector, both in the EDI and the Electricity Supply Industry (ESI) is an enormously complex business. The risks associated with the changes are very high, and as such, it is appropriate that policy decisions be taken only after due care and analysis. The need for additional generation capacity in South Africa, especially Independent Proven Producer (IPP's), by about 2007, means that investors need the confidence now that reform and restructuring of the industry is taking place timeously; hence there is little room for manoeuvre. The EDI, although being restructured first, is the last component in a complex value chain whose entirety is in need of reform. Any mishaps in the restructuring of the EDI or the ESI can have serious repercussions on the other components.

The issue of the current financial position of some of the municipalities and the future REDs has been highlighted and the phasing in the restructuring via the EDI Holdings Company is intended to ease these effects on the REDs during the transition. Other areas of concern include the introduction of free electricity services and the attendant financial impacts on the REDs, as well as the rights of local government through existing legislation.

Municipalities, as with the CoCT, face a range of competing pressures on resources for service delivery, which include managing the tensions between service quality, equity and social upliftment objectives.

Access must be extended to poor households that cannot afford basic services, at the same time that commercial and higher income consumers are demanding improved services. Municipalities must meet the needs of both constituencies in the interests of socio-political stability and improved local economic performance. Revenue streams from established consumers must not be jeopardised, and payment morality must be improved.

Budgetary constraints rule out the option of spending more to accommodate competing needs. This means that efficiencies must be realised through restructuring and modernisation of service delivery mechanisms.

Other financial pressures include:

- Transitional costs associated with amalgamation, including equalisation of salary scales; and
- Rising bulk supply costs of electricity and water.
- Duplication of services in that the COCT will still need an Electricity Department to be able to understand its electricity needs and manage its relationship with the REDs.
- The role of infrastructure in which the City has invested to build up the local Electricity Network – there is no clarity on whether these assets are transferred to the REDs without compensation, and whether such infrastructure can be used in the future for other City needs, such as communications, CCTV and traffic light management.

In addition, the PWC report clearly showed that the emphasis of continued public ownership of the industry would be that national and local government treat their investment in the REDs as any private investor would- i.e. look for return on investment rather than service delivery.

A number of local authorities that currently distribute electricity use income from this to help to fund other local government activities. The exact extent of such “subsidisation” is not known. In addition, in many local governments, the electricity distribution activity is not “ring-fenced” from other activities and therefore, to some extent, electricity departments have absorbed some costs such as street lighting and other overhead costs. As far as we are aware the REDs will not be taking over such public electrification aspects of the City –it is blatantly apparent that such activities have no income stream, as they are merely for the “public good”.

One key policy assumption, used throughout the PWC financial analysis, is that local government shall continue to receive this full electricity income per year from electricity supply (adjusted for inflation) after the formation of the REDs. However, it is envisaged that local government will collect part of this income through dividends on their shareholdings in the REDs (or income through debt instruments). This is a less than suitable arrangement as the REDs are tax paying entities and dividends are notoriously difficult to predict- especially for new entities. The history of Transnet as a public entity is littered with the vagaries of dividends. It is also envisaged that local government will be able to place a levy on the sale of electricity within their areas. In reality such a levy is already built into the income that many municipalities receive, so the PWC model may be double-counting. In their modeling of this levy PWC made the following assumptions:

- That the level of the levy would be set so that across the industry the total income to local government (ie levy plus dividend payments) should equal current income adjusted for inflation. This means that the levy has to compensate to poor performance of the REDs if dividends are low- or nonexistent!
- That the levy would not be collected from “electrification” customers or customers whose annual consumption is above 100 GWh. In case of the “electrification” customers, this refers to people who have never previously had electricity.
- That, as a result, the levy would only be collected from conventional domestic customers and from industrial, commercial and agricultural customers with the exception of those customers consuming more than 100 GWh per year (large customers). In other words, the very poor and the very rich don’t pay much- the rest get squeezed by having to subsidise these sectors. To collect the electrification revenue shortfall we have assumed that the shortfall in each RED between the long run average price to electrification customers and the price to electrification customers will need to be recovered as a levy on the price paid by all other non-electrification customers (except those customers whose demand is above 100 GWh)

In a Summary of their key findings PWC state that:

*"Our initial analysis indicates that a broadly viable distribution industry as a whole can be achieved, but that this depends crucially on ... key assumptions:*

- ***Prices: financial viability requires significant price increases (around 50%) for domestic (conventional credit) customers, in most REDs. Such tariffs would be in line with our initial estimates of the "correct" LRAIC prices for such customers.***
- ***Generally prices to commercial, agricultural and industrial customers should remain broadly at current levels (in real terms) or, in some cases, should initially decrease from the average tariffs currently charged by some municipal distributors. However, for most REDs over the period from 2001 to 2010 prices are expected to increase in real terms though only to a relatively minor extent. This is explained by the fact that for most REDs the average cost of distribution is increasing in real terms as more low consumption "electrification" customers are added.***

## Factors affecting RED financial viability

As PWC have shown, it is expected that on average there will need to be sizeable increases to the average level of some tariffs particularly to domestic and agricultural customers, to bring them up to our initial estimates of sustainable LRAIC levels. To quote *"Thereafter for some REDs there will need to be gradual increases of prices in real terms. In some cases, industrial and commercial customers can be expected to see initial price increases, but the change to these customers will be smaller than those required for other customer types. In many cases industrial and commercial customers could see price decreases. Adjustments in tariff levels of this sort will need to be introduced gradually, over a number of years. This is both to smooth the financial impact on the relevant consumers, and to prevent tariff "shocks" becoming a significant obstacle to the whole of the EDI reform process. The detrimental impact on RED finances will, to some extent, be lessened by also phasing-in any reductions in prices to some commercial and industrial customers. The net effect will, however, be to weaken the financial position of the REDs from that reported above, over the phase-in period (likely to be around 5 years). The impact of this is most likely to be felt by government in its role of equity holder. As price adjustments are phased-in over time, so will be the return on equity towards its target rate."*

## **The REDs as a precursor to electricity privatization**

The advent of the REDs, with initial municipal ownership, is in reality part of a phased approach towards privatisation of electricity distribution. Privatisation is portrayed as means of improving efficiency and bringing in funds for investment. However, governments often have to go to considerable lengths to attract investors. Such measures include assuming the debt of the enterprise, avoiding unbundling of the sector and increasing prices. Efforts in this regard are all the more intensive as so many countries are privatising at the same time<sup>2</sup>.

Despite privatisation, governments still have responsibility for the provision of stable and affordable electricity. Hence after privatisation some governments are still in a position where they are subsidising electricity prices and in some cases this has been at an unsustainable level. Alternatively, governments have insisted that enterprises restrict the prices that they charge end users. This has also been problematic as firms have been unhappy to see their profits squeezed. Whatever measures are used, private firms have been quick to start disconnecting non-payers, with presumably social implications.

In terms of performance, there is some indication that the private sector does not always deliver. One empirical study finds that there is no significant difference in efficiency between public and private electricity utilities. There are a number of examples of delivery breakdowns after privatisation.

Privatisation often means that utilities are in the hands of increasingly powerful MNCs. Despite efforts to break up monopolies, these are recreated by private firms, which buy up parallel distributors or electricity generation enterprises - undermining government efforts to introduce competition. The global nature of ownership of distributors means that enterprises may change hands frequently, reflecting a change in corporate strategy on the other side of the world or sometimes as a side issue to another deal. This also undermines the whole competitive tendering procedure.

In conclusion, while privatisation may deliver in the short term by reducing leakages and providing more effective billing, the longer-term implications are less clear. Possibly inefficient public sector enterprises may be replaced with powerful private sector concerns, accountable to shareholders with no democratic responsibility in the country where they are delivering this essential resource. This is particularly significant in poorer countries where the institutional infrastructure is such that regulation is weak. Rather than

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<sup>2</sup> Privatisation of electricity distribution: some economic, social and political perspectives, By Kate Bayliss, Research Fellow, PSIRU, University of Greenwich

blindly privatising, policy makers need to relegate privatisation to its proper place of just one of a number of policy reform options – and one that comes at a substantial cost.

In summary, the REDs should be opposed for the following reasons:

1. The City of Cape Town has a well functioning electricity department, unlike many other municipalities, and provides a good service.
2. The income from electricity is a major source of revenue for the City, and is used to cross –subsidise many other public good services.
3. The REDs will result in a new entity, which will have to invest in systems, procedures, people and a new operating model. All of these cost money and resources, which is ultimately paid for by the customers of the REDs, namely the citizens of Cape Town.
4. The ongoing revenue to the City from the RED is uncertain as it is dependent on dividends from the RED, which in turn pays tax (reducing the dividend). The RED cannot use its income for any other city services and hence tax reductions are impossible.
5. Without an details on rates, we have to use the PWC report as the basis of argument- in which it is clearly stated that domestic consumers in the middle range will be those who bear the brunt of the rates increase – which is envisaged as being considerable.
6. The City has not provided any level of detail on how the assets of the City are to be alienated and the future relationship with the RED-aside from a shareholding.
7. The RED is clearly a precursor to privatisation of the distribution of electricity- which has not been successful in many parts of the world and is likely to lead to higher costs and larger numbers of disconnections.

