

## 2.5 RECURRING COST IMPACTS

### Control of surpluses.

#### 6 REDS / 7 REDS.

It is assumed that the LG tax (surpluses) will be brought down to 5% over 5 years.

In other words the total surplus as a tax surcharge will be largely depleted but some income could still be made by the LG through dividends.

We thus assume the current level of tariffs is maintained and the current level of surpluses is taken out of the EDI.

This means that LG will receive less than 30% of the total surplus taken out of the EDI because of its 30% shareholding.

This will be subject to 33% tax thus reducing it further.

The calculation thus indicates that only 25% of the current surplus will be received by LG.

This is conservative as the surpluses in the South Cape are higher than the national figures.

#### South Cape Karoo RED.

It is assumed that the current level of LG tax (surpluses) will be retained.

This is because LG will set the tax in its area of jurisdiction but there will be pressure to reduce this to the same level in the region because of the need to apply the same tariffs and to be competitive with the other LG's in the region.

In time it can be expected that this level will be reduced because of LG desire to reduce its dependency on electricity taxes.

Assume a drop of 20% from the current true ring fenced value which will take the average surplus to 15% if sales.

### Higher electricity costs for LG own use

#### 6 REDS / 7 REDS.

According to PWC the tariffs for commercial and industrial customers will increase by some 30% in real terms for RED1. See calculations at end of this section.

It is realised that about half of this increase is due to an increase in the WEPS which is believed also following an incorrect strategy which will increase costs to the ESI unnecessarily.

Own use, including public lights is some 6.15% of sales revenue in South Cape.

#### South Cape Karoo RED.

It is expected that the prices will not increase in real terms above current levels.

It is further assumed that any rises will be matched with demand side management strategies by LG.

### Streetlight lighting and own electricity maintenance.

#### 6 REDS / 7 REDS.

Under the 6 RED option LG will have to establish their own resources to provide electricity services for public lighting and for its own electricity usage and installations.

In some areas the impact will be small such as in George but for the smaller towns this could be very high. It is assumed that the cost in total will increase by 20% above the current level of cost.

South Cape Karoo RED.

The RED will continue to provide these services in close co-operation with LG.

The costs to LG can even come down as the relative costs will now be available and can be compared to provide LG with some means of negotiation.

**LG overheads to Electricity**

6 REDS / 7 REDS.

With the 6 Red's LG will be faced with the full impact of the current overhead allocation to electricity.

The full impact of the current LG administration allocation is considered a lost revenue for LG.

Analysis done for the region indicates that very little of the overheads will be reduced because of electricity not being an integral part of the LG operations.

South Cape Karoo RED.

The full impact of the legitimate administrative allocation will be considered as part of the LG tax to be levied on electricity supply.

In the negotiations about who should absorb what costs it can be expected that this burden will have to be shared somehow between the LG and the RED.

It is thus assumed that only 50% of this cost will be recovered as a LG tax on electricity.

**Credit rating impacts**

6 REDS / 7 REDS.

Because the electricity operations will not form part of the LG operations, it is expected that the credit rating will drop to such extent causing interest on borrowings to increase by say 1.5 to 2%.

South Cape Karoo RED.

The LG's share in the RED will be considered part of its finances and thus credit rating should remain the same.

**The cost implications of reduced municipal government cash flow.**

6 REDS / 7 REDS.

The reduced income as LG tax has already been taken cognisance of and this will result in higher property taxes.

Because the majority of income from the RED will be by way of dividends which will only be paid out say once or twice per year and not as a steady monthly income, the LG will have to increase its working capital.

The estimated impact is the 20% of the current level of LG income from electricity at say prime overdraft rate.

South Cape Karoo RED.

Because the payments will all be done as a surcharge paid on a monthly basis, the impact will be zero.

## LG debtor management

### 6 REDS / 7 REDS.

The independent Red's with less than 30% LG ownership will not allow electricity cut-offs for non-payment of other services.

It is difficult to assess the impact on increased non-payment of other LG charges.

Experience in the region suggest that non-payment for other LG charges will increase by at least 18% but it could be as high as 80%. A conservative 25% is assumed for the calculations.

### South Cape Karoo RED.

No impact on the LG because of joint revenue recovery strategies.

## Nett VAT payment increase

### 6 REDS / 7 REDS.

The full impact of net increase in VAT payments will be experienced for this option.

This requires extensive analysis but initial indications are that it will be close to 1% of the electricity revenue.

### South Cape Karoo RED.

This will be the same as for the 6 Red's.

## 2.6 PWC ANALYSIS ON PRICES

The table below contains the results from the PWC analysis on prices. Although there are many problems with this analysis it yields some meaningful results.

### Option A (6 RED) results

Table 1A: Option A prices (expressed in year 2000 cents/kWh)

	Electrification	Domestic	Industrial**	Commercial	Agricultural
Eskom national average prices in 2001	28.6	21.3	12	18.4	27.6
National average of local gvt. Prices in 2001	*	19.4	17.6	24	n/a
RED 1 prices in 2001/2010	30/30	26/23	16/15	20/18	24/21
RED 2 prices in 2001/ 2010	30/30	38/42	18/22	28/32	35/39
RED 3 prices in 2001/2010	30/30	33/33	17/18	25/25	31/31
RED 4 prices in 2001/2010	30/30	33/34	17/19	25/26	31/32
RED 5 prices in 2001/2010	27/26	20/20	14/14	17/16	19/19
RED 6 prices in 2001/2010	30/30	30/31	16/17	23/24	28/29

The increase in purchase costs for the South Cape Karoo RED will thus be from the current Eskom Industrial at 12 c/kWh to say 15.5 c/kWh representing an increase of 30%.

Domestic customers will see an increase from 19.4 c/kWh to 24.5 c/kWh representing an increase of 26%.

## 2.7 FINANCIAL IMPACT

The estimated financial impact with limited data of the two restructuring options are given in the table below:

LG IMPACT COMPARISON			
	6 REDS	SOUTH CAPE	DIFFERENCE
	R/y	R/y	R/y
<b>ONCE OFF IMPACTS</b>	R 0	R 0	R 0
Cost of stranded LG resources	R 0	R 0	R 0
Assets & employees transfers	R 24,140,334	R 4,828,067	R 19,312,267
Downsizing of LG services.	R 0	R 0	R 0
<b>Total Once off impact</b>	R 24,140,334	R 4,828,067	R 19,312,267
<b>RECURRENT FINANCIAL IMPACTS</b>			
Lost Control of surpluses and thus revenue	R 38,854,763	R 10,361,270	R 28,493,493
Higher electricity costs for LG own use	R 4,998,437	R 0	R 4,998,437
Streetlighting and own electricity maintenance.	R 684,160	R 0	R 684,160
Loss of administration allocation	R 11,004,113	R 5,502,056	R 5,502,056
Reduced LG cash flow impact	R 1,450,576	R 0	R 1,450,576
Increased interest due to lower credit rating	R 2,556,970	R 0	R 2,556,970
Revenue lost due to inability to cut-off	R 82,541,059	R 0	R 82,541,059
Loss of VAT reclaim	R 2,801,553	R 2,801,553	R 0
<b>Total ongoing impact</b>	R 144,891,631	R 18,664,879	R 126,226,752
Ongoing impact as % of Property taxes	116.37%	14.99%	101.38%

## 2.8 CONCLUSION

The following can be concluded from this analysis:

- o The impact on LG of the proposed 6 Red's/ 7 Red's will be dramatic leading to property tax increases of more than 100%.
- o The proposed 6 RED / 7 RED options will also see domestic tariffs increase about 15%.
- o These two effects combined is certain to cause an outcry by residents.
- o This will cause significant pressure on the LG to reduce costs.
- o The impact of the proposed South Cape Karoo RED is notable but manageable. The secondary benefits of the restructuring as proposed for the South Cape Karoo should in time be able to overshadow the initial negative effects.

The 6 Red's / 7 Red's will cause a significant amount of resources to leave the area because of municipal offices closing, staff being relocated or loosing their jobs. The 6 Red's / 7 Red's applying central buying will take away the jobs for local businesses. This will cause people to leave the area thus shrinking the socio economic activity of the total area. This will in turn reduce the tax base of municipalities thereby increasing the pressure on cost control and increased taxes.



### 3. EDI Restructuring Industry Modelling Results: 20 April 2006

#### 3.1 Differences between EDI Holdings, PWC Report and the SCKRED (PTY) LTD

The SCKRED Model is a bottom's up approach that take into account the differences between small and big municipalities and the effect that the Electricity Business have on the Total Financial ability of all the Municipalities in the DC4 and DC5.

PWC Report was a high level report into the Electricity Distribution Sector trying to satisfy all the Big Role-players like Eskom and the Metro Municipalities. It was a top down approach, trying to implement an overseas scenario into South Africa that was not implimentable.

EDI Holdings Report tried to marry the Top Down and Bottoms Up approach by engaging with Small, Medium and Metro Municipalities. Eskom was however not interested in providing their information. Their Model is user friendly and can be used to model the industry effectively. However, any model is subject to assumptions. For the Electricity Distribution Industry it is critical to know what the price of electricity is, and this is still the bone of content. Do the RED buy it at the Transmission price or the Distribution price and who owns the distribution network from the MTS – Substation downwards? Eskom alleged they do – The EDI Holding Modellers alleged the Red's do.

#### 3.2 RED Description – Scenario 4

Six Metro Red's with the adjacent Municipalities linked to the Metro (Bordering Municipalities), Sub Regional Clusters (e.g. Southern Karoo) plus balance in National RED.

**This is the Simply the Best Model for South Africa and should be implemented.**

All the other Scenario's are trying to hide inefficiencies in the 6 RED Model or the 7 RED Model. **Be Bold and tackle the PROBLEMS – DO NOT HIDE THEM**

## **4 CONCLUSION**

- 4.1 THE SOUTHERN CAPE KAROO MUNICIPALITIES HAVE CONCLUDED THAT THE ELECTRICAL DISTRIBUTION WITHIN THEIR AREAS OF SUPPLY IS FINANCIALLY VIABLE AND THE ELECTRICITY NETWORK IS IN A GOOD TECHNICAL WORKING ORDER.**
- 4.2 ESKOM HAS ONLY A 15 % SHARE OF THE ELECTRICITY BUSINESS (EXCLUDING PETROSA AS A KEY CUSTOMER).**
- 4.3 THE SOUTHERN CAPE KAROO IS A NODAL POINT FOR ELECTRICITY GENERATION AS FAR AS GAS AND RENEWABLE ENERGY RESOURCES, SUCH AS WIND AND WAVE POWER ARE CONCERNED.**
- 4.4 THE SOUTHERN CAPE KAROO WILL BECOME A METRO WITH HARTENBOS AS THE CENTRE WITHIN THE FORESEEABLE FUTURE.**
- 4.5 LOCAL GOVERNMENT WILL HAVE TO APPOINT ADDITIONAL SKILLED PERSONNEL TO TAKE OVER MAINTENANCE OF PUMPING STATIONS, STREETLIGHTING AND THE MECHANICAL WORKSHOPS WHICH WILL RESULT IN FURTHER ADDITIONAL EXPENDITURE FOR LOCAL GOVERNMENT.**

- 4.6 THE SOUTHERN CAPE KAROO WILL ALSO INCORPORATE THE POORER OR NON VIABLE RURAL AREAS WHICH AT THIS STAGE IS GETTING A POOR SERVICE FROM ESKOM.
- 4.7 THE INTEREST OF THE MUNICIPALITIES AND THEIR CUSTOMERS WILL BEST BE SERVED IN THE SOUTHERN CAPE KAROO RED MODEL OR IN SCENARIO 4 OF THE EDI HOLDINGS MODEL.
- 4.8 THE SCKRED MUNICIPALITIES CANNOT IDENTIFY ANY ADVANTAGE IN MOVING THEIR ELECTRICITY BUSINESS TO EITHER A 7<sup>TH</sup> RED OR A 6<sup>TH</sup> RED.
- 4.9 THE SCKRED MUNICIPALITIES CAN IDENTIFY A NUMBER OF THREATS TO THE WELBEING OF THEIR ELECTRICITY BUSINESS AND THEIR CUSTOMERS REGARDING A 7<sup>th</sup> RED OR A 6<sup>TH</sup> RED.
- 4.10 THE SOUTHERN CAPE KAROO MUNICIPALITIES BELIEVE THAT THEIR BUSINESS IS BASED ON SOUND BUSINESS AND FINANCIAL PRINCIPLES AND

**- WE ARE SIMPLY THE BEST-**