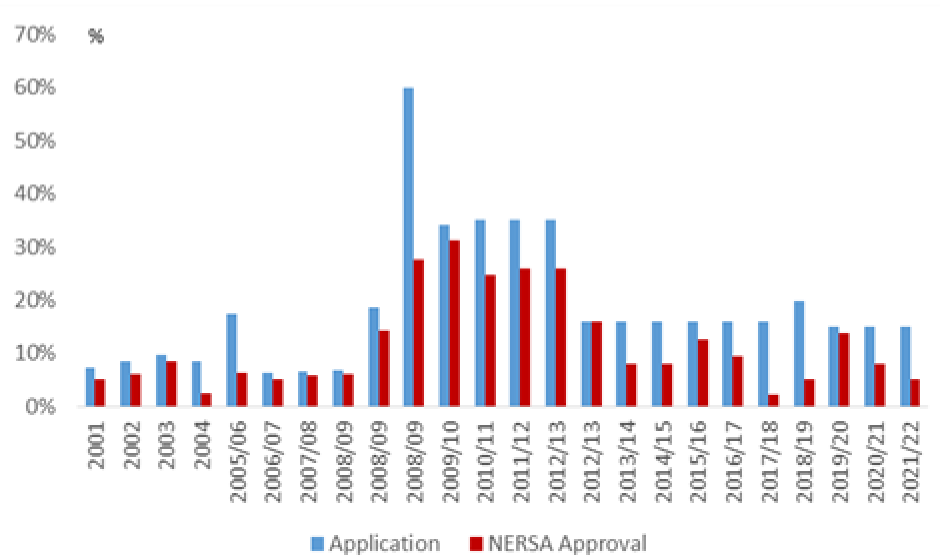
First take outs in the context of Eskom's MYPD4 revenue and F18/19 RCA application

Nersa has announced the revenue increase granted to Eskom for the MYPD4 application (F19/20, F20/21 and F21/22) and the RCA (F17/18, the fifth and final year of MYPD3). In our analysis below, we consider the implications for Eskom's net cash flow, inflation, household disposable income, credit rating and what we are watching following Nersa's announcement.

Figure 1 Eskom tariff application and NERSA approvals



Context of revenue (and tariff) increases

- Stabilising Eskom's financial position as net cash flows are negative
- Political will to implement Eskom's turnaround strategy
- Effect on households and business financial position
- South Africa's rating in the context of the government's ability to stabilise a deterioration in fiscal metrics (budget deficit, debt to GDP ratio)

Table 1:

	Eskom application (Rbn)	Nersa approval (Rbn)	Tariff increase	Revenue variance (Rbn)	RCA (Rbn)	RCA tariff increase	Total tariff increase	Shortfall vs application (Rbn)	Government assistance (Rbn)	Variance in debt service costs
F18/19	**190.3**									
F19/20	**219.5**	**206.0**	9.41%	-13.5	*8.70*	*4.40%*	*13.81%*	*-4.50*	*23.0*	*-25.2*
F20/21	*252.3*	*221.0*	8.10%	-31.3	*8.70*	*0%*	*8.10%*	*-22.30*	*23.0*	*-24.9*
F21/22	*291.5*	*233.0*	5.20%	-58.5	*8.70*	*0%*	*5.20%*	*-49.50*	*23.0*	*0.5*

What happened?

The revenue increases granted to Eskom via tariff increases to households and business should be analysed in the context of government's financial assistance announced in the 2019 Budget Review (R23bn p.a. for three years) and Eskom's three pillars and turnaround strategy.

Our starting point: (1) We analysed the effect on Eskom's cash flows using Eskom's MYPD4 revenue application submitted to NERSA. (2) We then added the RCA revenue increase of R8.7bn spread over four years starting 1 April 2019 to NERSA's revenue increases. (3) We then factored in the effect on cash flows taking into consideration government's assistance of R23bn p.a. to service debt and debt servicing costs (with strict conditions not yet announced). (See Table 1)

MYPD4 and RCA effect on Eskom's revenue projection over the next three years

F19/20: Small shortfall in net cash flow of approximately R4.8bn

F20/21: Large shortfall in net cash flow of R22.6bn

F21/22: Large shortfall in net ash flow of approximately R26.8bn.

What does this mean for Eskom's cash flows with government's financial assistance?

Our analysis suggests that the tariff increase, RCA increase and government assistance could 'nearly' stabilise Eskom's financial position in F19/20. The borrowing requirement could therefore be more or less in line with Eskom's downward revision from R72bn to around R46bn announced in the media. However, the timing of cash flows and the effect on liquidity bears scrutiny.

However, the negative cash flows in F20/21 and F21/22 underscore the importance of Eskom implementing cost savings and the turnaround strategy. A widely-expressed concern is if the financial assistance from government announced in the February 2019 Budget could be adequate. Our analysis of what the numbers mean suggests that answering this question is not yet possible.

What are we watching following Nersa's announcement?

a. **Eskom's response to NERSA's announcement:** "The Eskom Board will deliberate further before deciding on how best to address the shortfall and we keenly await the reasons for the decision as NERSA has **disallowed R102bn** of revenue over the MYPD4. NERSA allowed for a R32.0bn clawback of Eskom's RCA application of R60bn for F14/15, F15/16 and F16/17 (this translates into R8.7bn of tariff increases for the next four years). For F17/18, NERSA allowed for R3.5bn of Eskom's application of R21.0bn. Nersa is yet to announce the timing of implementation. **Eskom has appealed NERSA's decision.**

b. Nersa announced that an independent valuation of Eskom's Regulatory Asset Base (RAB) would be performed. If necessary, adjustments would be made. This holds important implications for Eskom's revenue increases and net cash flows considering debt maturities and debt service costs.

c. Implementation of Eskom's turnaround strategy.

Implication for the inflation outlook

The electricity tariff increase over the next three years could see a marginal upward revision to the Reserve Bank's new inflation forecast to be released at the MPC meeting scheduled for 28 March. The SARB's electricity tariff increase vs. NERSA's announcement was as follows:

2019: 9.7% vs 13.81%

2020: 8.8% vs 8.1% (the % change of the R8.7bn RCA increase is 0 because if the base)

2021: 6.0% vs 5.1%

We estimate that the higher tariff increases granted by NERSA relative to the SARB's forecast (including assumptions for municipality increases of 1.5% over and above Eskom's tariff increases) could add approximately 0.2 to 0.3ppt to the forecast. However, the SARB's starting point for the average CPI inflation rate for 1Q 19 of 4.6% could be revised down to 4.3% or so. This lowers the trajectory of inflation including a 74c/l increase in the fuel price in March. The SARB's 2019 average of 4.8% could be increased marginally. The SARB's 2020 forecast of 5.3% could be unchanged unless other assumptions are changed. A further issue to monitor is movements in the rand. The January CPI inflation forecast assumed a rand of 14.20/$. The news flow on Thursday caused the USDZAR to rise to 14.50 (at the time of writing) from around 14.30/$. These included dovish forward guidance from the ECB (that was EUR negative and saw the USD rise to 1.1226/EUR from around 1.132/EUR prior); SARB nationalisation (which in our view does not signal a change in the SARB's mandate); and NERSA's tariff increase (which calls for the political will to effect changes at Eskom).

Implication for household disposable income and business

The disposable income of households will again come under pressure from fiscal drag announced in February 2019, a fuel price increase (of 74c/l in March and possibility of a large increase in April), municipal tariff increases in July compounded by the electricity tariff increase. The tariff increase for business will also be difficult in view of challenging fundamentals.

Sovereign and Eskom credit rating implications

The tariff increases combined with the government's assistance is more positive for Eskom's rating (S&P CCC+). However, we are of the view that the probability of Moody's changing its outlook from stable (BBB-) to negative has increased in view of the February 2019 Budget yet again showing a deterioration of South Africa's fiscal metrics. The Budget deficit for F19/20 has been revised from 3.6% of GDP in February 2018 to 4.5% in February 2019. The debt/GDP ratio is forecast to rise above 60% of GDP in F22/23, compared with 59.6% of GDP previously.