

The Impact of Increased Electricity Prices on Municipalities



EXECUTIVE SUMMARY

Municipalities purchase bulk electricity from Eskom and resell¹ it to end users at a cost. The distribution of electricity is thus an expenditure and revenue item for municipalities. As a result of Eskom's push towards more cost-reflective tariffs, the price of bulk electricity has risen rapidly. Tariff increases affect not only end users of electricity but also municipalities. An assessment of the impact of higher electricity prices on municipalities found that these increases negatively affect municipal expenditure and revenue, jeopardising maintenance and asset renewal of electricity infrastructure. Given developments in the pipeline (for example the implementation of a carbon tax in 2016) that will effectively result in an increase in bulk electricity purchases and therefore negatively affect municipalities, the Financial and Fiscal Commission (the Commission) is calling on government to put in place a comprehensive plan to manage the risks attached to increasing bulk electricity prices.

BACKGROUND

Eskom has a monopoly on the generation and transmission of electricity, and municipalities purchase bulk electricity from Eskom in order to fulfil their constitutional mandate of electricity distribution. During the apartheid era, electricity was subsidised and Eskom tariffs kept low, declining in real terms between 1980 and 2007. This resulted in an inability to fund the development of new electricity generation capacity required to keep pace with increases in economic growth and demand for electricity, and to carry out maintenance and rehabilitation of the electricity distribution network. In 2008/09, after a R9-billion loss threatened the sustainability of the electricity sector, Eskom eventually received a government bailout. Since then, there has been a concerted shift towards tariffs that are more closely aligned to costs.² Because of the historical under-pricing, the tariff increases have been significant.

Tariff increases affect not only end users of electricity but also municipalities. The provision of electricity is a significant source of revenue (approximately one third of total municipal revenue is derived from electricity tariffs), as well as a main expenditure item for municipalities. Significant tariff increases, coupled with the poor economic environment, present a dilemma for municipalities because the electricity sector is subject to administered prices.³ Municipalities purchase bulk electricity at the given price and then resell this electricity (at a higher tariff) to end users. However, the National Energy Regulator of South Africa (NERSA) imposes regulatory restrictions that limit the extent to which tariffs can be increased. This effectively limits how much of the increased costs can be passed on to end users. This is a particularly important limitation in the context of developmental local government because revenues from electricity distribution enable municipalities to reinvest in the sector and to cross-subsidise the delivery of electricity to poor households. The Financial and Fiscal Commission (the Commission) assessed the impact of higher electricity prices on municipalities.⁴



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² In addition to costs related to 'production' of electricity, climate change concerns are also creating pressures for increasing electricity prices.

³ In addition to electricity, the telecommunications, water and transport sectors are also subject to administered prices.

⁴ For the full paper, please see Chapter 9: Administered prices: the impact of electricity price increases on municipalities. In FFC (Financial and Fiscal Commission), 2013. Submission for the Division of Revenue 2015/16. Midrand: FFC.



FINDINGS

The study found that increases in bulk electricity costs have a statistically negative impact on municipal expenditure and revenue, jeopardising maintenance and asset renewals in accordance with Section 74(2)(d) of the Municipal Systems Act (No. 32 of 2000), which envisages tariff revenues being reinvested in capital, operating, maintenance, administration and replacement-related costs associated with a service. This important provision is aimed at ensuring that the infrastructure underpinning a service is well cared for through effective spending on maintenance and asset renewal. Recent research by the Commission⁵ revealed that in 2011/12 municipalities (taken together) under-budgeted by R5-billion and under-spent by nearly R10-billion on general maintenance. The current asset renewal backlog within the electricity distribution industry is between R8-billion and R41-billion.

Furthermore, major developments within the energy sector (e.g. the completion of two coal-fired power stations at Medupi and Kusile) and new rules and regulations to ensure environmental sustainability will also affect municipalities. For example, the compliance costs related to the implementation of a carbon tax (postponed to 2016), the National Environmental Management Air Quality Act of 2004 and the 2012 National Framework for Air Quality Management will be transferred to end users, either directly from Eskom or via municipal distributors. In the case of municipal distributors, these increased costs are likely to be transferred via higher prices for bulk electricity purchases.

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⁵ See Chapter 12 (entitled Challenges, Constraints and Best Practices in Maintaining and Rehabilitating Water and Electricity Distribution Infrastructure) of the FFC's 2014/15 Submission for the Division of Revenue. This document can be accessed at: www.ffc.co.za.



CONCLUSION

The historical subsidisation of electricity prices, which kept tariffs low, resulted in a lack of funding for developing new electricity generation capacity. Since 2008/09 the shift towards tariffs that are more closely aligned to costs has led to significant price increases, affecting both end users and municipalities. The negative impact of increasing bulk electricity costs on municipal expenditure and revenue are of concern, while the growing priority attached to environmental sustainability is likely to increase costs, which will probably be passed on to municipal electricity distributors. This will endanger the sustainability of the sector and the ability of municipalities to invest in basic service delivery infrastructure (including asset maintenance and renewal) and/or to cross-subsidise general municipal expenditure. The Commission therefore recommends that government puts in place a plan to manage the risks associated with increases in the price of bulk electricity purchases. Such a plan should:

- Consider the implications of increases in bulk costs on municipal expenditure (through crowding out expenditure on other items) and revenue (by eroding revenue needed to fund maintenance or cross-subsidise poorer households).
- Be explicit regarding the different impacts that bulk purchase price increases will have on different categories of municipalities.

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