APPENDIX A

Electricity Distribution Industry Restructuring Blueprint Report

Compiled by the

Department of Minerals and Energy

Reform of the Electricity Distribution Industry (EDI) in South Africa: Strategy and Blueprint

February 2001

EDIRC membership:

Department of Minerals and Energy (DME) (Convenor)
Eskom
South African Local Government Association (SALGA)
National Electricity Regulator (NER)
Department of Provincial and Local Government (DPLG)
Department of Public Enterprises (DPE)
Department of Finance (DoF)
Department of Trade and Industry (DTI)
Department of Labour (DoL)
Technical MINMEC (Provincial and Local Government)
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I Introduction and summary

1.1 This report provides recommendations on the future structure, ownership, commercial, regulatory and financial arrangements in the Electricity Distribution Industry (EDI). This first section describes the background to the proposed reform of the EDI, why such reform is necessary, the main objectives and priorities that the reform seeks to meet, and a brief summary of the main recommendations contained in the remainder of the report.

Background

1.2 The future of the electricity distribution industry has been the subject of considerable debate over recent years. Numerous studies have been undertaken, culminating in:

- Cabinet approval, in 1997, of the Electricity Industry Interim Committee (ERIC) report, which recommended the restructuring of the EDI into a number of Regional Electricity Distributors (REDs); and
- Cabinet approval, in 1999, of a transitional process to move the industry to the RED structure.

1.3 Since October 1999, the electricity distribution industry restructuring committee (EDIRC) or (‘the committee”) has met, with the objective of developing proposals and recommendations to implement these key Cabinet resolutions. These recommendations are set out in this report. A consortium led by PricewaterhouseCoopers (“the consortium”) was appointed in April 2000 by the Department of Minerals and Energy to advise on the reform of the South African Electricity Distribution Industry (EDI).

1.4 The consortium presented its draft Stage I Blueprint report to the EDIRC in July 2000, and their final blueprint report in August 2000. The report contained their recommendations on the overall “blueprint” for the future EDI, and the recommended basis on which work to plan for and implement the reforms in the sector should proceed.

1.5 Using the consortium’s report and recommendations as a basis, the EDIRC have deliberated, and this report presents DME’s official recommendations on the framework for reforming the electricity distribution industry in South Africa. The report is based on the work and final comprehensive (“main report”) of the consortium as well as the deliberations by the EDIRC. It also reflects comments made by the joint meeting of the Cabinet Committees for the Economic Sector and the Social Sector on an earlier version of this report dated November 2000.

1.6 This Stage I Blueprint Report represents broad principles and a “road-map” of the best way forward in the EDI restructuring project. Many of the finer details will now be worked up in subsequent stages of the project. Changes to the key elements of the “Blueprint” presented here will only be contemplated if a compelling case for doing so is found during the subsequent detailed stages of the work.

1.7 The EDIRC has endeavoured to reach consensus during its deliberations on the main recommendations of the consortium’s blueprint report. In Sections II to XIII of this report, all main recommendations are shown in bold inside boxes. Any additional and/or differing
minority views from some members of the EDIRC are shown in bold italics in the boxes below those of the recommendations.

The need for change

1.8 Electricity is currently supplied to end users in South Africa by Eskom and approximately 378 municipalities. Eskom supplies electricity to approximately 40% of consumers by number, which represents about 60% of sales by volume. The municipalities collectively sell to about 60% of consumers by number, amounting to about 40% of sales by volume. The municipal distribution sector is not homogeneous. It is characterised by a small number of very large distributors and a large number of very small distributors. The 12 largest municipalities account for about 75% of all electricity sales in the municipal sector.

1.9 Municipalities in South Africa have constitutional and other legislative rights to supply electricity within their local boundaries. Eskom has legislative rights to supply throughout South Africa where municipalities, or other licensees, are not supplying.

1.10 The electricity distribution industry is an important element of the South African economy, and has a key role to play in the government’s economic and social development plans. The EDI has five key objectives:

- to provide low cost electricity to all consumers, with equitable tariffs for each customer segment;
- to provide a reliable and high quality supply and service to all customers, in support of the government’s economic and social development plans;
- to meet the country’s electrification targets in the most cost-effective manner, and so ensure that electrification is contributing to social and economic development;
- to meet the legitimate employment, economic and social interests of all employees in the sector, and ensure their safety; and
- to operate in a financially sound and efficient manner, in order to provide a reliable and sustainable future for both consumers and employees.

1.11 There is now urgent need for significant reform of the EDI if the industry is to meet any of these critical objectives in the future. The need for reform is widely recognised by all stakeholders in the sector. Current problems in the sector are many and serious, and can be summarised as follows:

1.12 Financial viability: The EDI is currently in financial crisis. Many municipal distribution businesses in recent years have suffered financial collapse and many others are now close to bankruptcy – facing severe debt problems, including a backlog of non-payment for bulk supplies to Eskom. Over the past few years a “quick fix” approach has been taken where municipal distributors have collapsed. In some cases this has taken the form of Eskom distribution, another municipality or Provincial Government conducting the distribution operation on behalf of the municipality in question. This “restructuring by default” is not
sustainable and does not represent a permanent solution that is consistent with the government social and economic development objectives. The financial crisis facing many distribution businesses has very real and severe consequences – for example:

- **investment** in the distribution networks is falling significantly short of that required to maintain the assets and to extend the network to meet growing demand. As a result the government’s objective of secure and reliable electricity for all is under increasing threat;

- the ability of many distributors to meet the financial demands of the **electrification** programme in future is under serious threat – both the initial installation costs and the ongoing financial support to low-income households;

- failure of many municipal distributors to pay debts to Eskom, if continued under the current structure, will ultimately threaten the **viability of the whole electricity supply industry**. The financial viability of the whole sector depends critically on distributors being able to collect revenue from customers and meet their financial commitments to Eskom for generation purchases; and

- many of the financially weak distribution businesses do not represent secure **employment prospects** for their labour force. This in turn is creating both pressure on many skilled staff to leave the industry for more secure employment elsewhere, and significant uncertainty and concern among other members of the current labour force.

1.13 **Inequitable treatment of consumers:** The current arrangements in the EDI are the result of the historic development of the sector and form no coherent pattern. As a result, consumers face significantly different levels of tariffs, standards of supply reliability and service across the country. The result is widespread inequity among consumers. This is inconsistent with government objectives of promoting economic and social development throughout the country. In particular:

- wide disparities exist in the **tariff structures** caused by the high level of fragmentation of the industry (domestic tariffs supplied by municipalities range from 16 – 60 c/kWh). These tariff differences bear little or no relationship to the quality of service provided, the costs of supply or consumers’ ability to pay;

- reliability of supply and the ability of distributors to offer a basic and secure supply to **low income households** differs markedly across the country;

- **unfair discrepancies** exist between Eskom Distribution and Municipal Distribution purchasing tariffs from Eskom Transmission – to the benefit of some large customers, but the detriment of the majority of domestic and low-income consumers;

- **electrification** needs are not evenly distributed across regions, with some of the poorer regions having the greatest need. Under the current EDI structure, the burden of financial support to newly connected rural and low income
Urban customers will fall randomly on some consumers and not others in an entirely unplanned and uncontrolled manner; and

- the threat of financial collapse is most acute for a number of municipal distributors in certain low income rural, urban and industrialised areas in South Africa.

1.14 **Inefficiencies:** The EDI is currently highly fragmented, with some 400 distribution businesses. These businesses are extremely small by international standards. As a result, many of the basic economies of scale in the sector are being lost. Administration and technical functions are duplicated across adjacent distributors in rural, urban and industrial areas. Costs and prices in the sector are, in consequence, unnecessarily high, and will remain so until the number of businesses is reduced radically, in line with earlier Cabinet resolutions. The highly fragmented nature of the sector also means that:

- the EDI is currently very difficult to regulate and monitor effectively;
- it is extremely difficult to attract and retain high quality management teams for such a large number of separate businesses; and
- many of the businesses are too small to be able to invest in the specialist skills development and training required of a modern distribution business.

1.15 In summary, the current arrangements in the EDI are unsustainable, from a financial, efficiency and equity point of view. The need for reform is urgent, if the problems in the current EDI are not to present a significant obstacle to the government’s social and economic development programme. Such is the scale and urgency of the problem that distributors are starting to restructure the EDI on a micro-regional basis and in an uncontrolled manner. These restructuring exercises are being paid for by a small number of consumers, and the result will be an industry structure that is consistent neither with government’s social and economic priorities, nor with the long-term interests of the South African electricity consumer or employee in the sector. A single, co-ordinated programme of reform is now required.

**Objectives and priorities**

1.16 The recommendations set out in this report have been developed to fulfil the resolutions of Cabinet with respect to the reform of the EDI, and to do so in a way which meets the following key objectives:

- **basic needs:** to ensure 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 to electricity supply to all South African citizens and businesses, regardless of location or income; to ensure acceptable and sustainable levels of supply security and quality; and to provide for high levels of customer service to all users. These basic needs must be fulfilled by the new arrangements on a consistent basis throughout the country, and not be subject, as now, to radical differences for consumers because of the historic development of the sector or location;
• **electrification**: to establish a structure and financial arrangements in the sector that will support the achievement of the government’s electrification programme;

• **protection of low-income consumers**: to ensure arrangements are in place in future that provide a sustainable electricity supply to low-income consumers, regardless of location, at affordable prices, and within a planned and well-regulated structure that ensures that the burden of financial support to such households is provided for on an equitable and long-term basis;

• **financial viability**: to ensure that the future REDs can operate on a sustained financially viable basis as independent businesses, as required by Cabinet resolution, within the context of providing high and sustained levels of service and investment in the sector;

• **development of labour**: to ensure that the new RED businesses are able to provide secure employment to their employees, provide the skills development and training consistent with a high technology, modern distribution business, and operate within nationally agreed terms and conditions of employment;

• **planned & managed transition**: to ensure that the reform process is taken forward within well planned and managed transitional arrangements, consistent with the Cabinet resolution for a national holding company to oversee this transition in the interests of all electricity consumers nationwide; and

• **human resources strategy**: 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, so that the interests of all individuals affected by the reform programme are protected, and the arrangements are consistent with government policies towards skills development and social protection.

**Criteria for success**

1.17 If the transformation is to be successful and command the support of both employees and customers it must:

• harness the skills and depth of expertise which already exists within the industry;

• acknowledge, preserve and develop centres of excellence within Eskom and the municipalities; and

• be executed in a manner which ensures that day to day service delivery does not suffer; and

• be communicated in a clear and unambiguous manner.
Role of Eskom

1.18 As the largest and only national operator within the EDI, Eskom Distribution will play a central role in the restructuring process. The plans developed must ensure that the Eskom’s skills and capabilities are used to the full, before, during and after the transition to the REDs. In contrast to many of the municipal distributors, which rely heavily on other departments within their respective councils for many of their non-engineering requirements, Eskom operates as self supporting integrated business and its experience in both core EDI and non-core support activities will provide the essential foundation on which the REDs will be built.

1.19 Key areas of Eskom’s experience that will be harnessed include:

- human resources management and development, an area where many municipalities lack appropriate skills;
- operations and planing, with experience of operating on a regional as opposed to a purely local basis;
- systems development and integration, for finance, operations and customer management;
- electrification, especially in rural areas; and
- integration, where the transformation process will draw on the experience of assimilating both individual municipalities and larger scale regional networks.

1.20 The plans developed for the restructuring will need to ensure that Eskom’s existing skills’ base is preserved and that key centres of excellence do not lose critical mass. This could be achieved by transferring all members of a particular team to one RED, or establishing a organisation, owned collectively, to provide expert services to the industry.

Summary of key recommendations

1.21 A comprehensive set of recommendations has been developed to address all aspects of EDI restructuring. These are described in the remaining Sections of this report, and summarised briefly below:

Establishment of EDI Holdings

1.22 We recommend the establishment of a holding company (EDI Holdings), as the first step in the restructuring process. EDI Holdings would be established as a 100% national government owned company. EDI Holdings would initially, through special voting shares, have control over the REDs and be able to exercise most of the powers of a sole shareholder. The Board of Directors would be appointed by the Minister of Minerals & Energy. Its overall purpose would be to ensure the successful implementation of government policy towards the EDI, and hence oversee and direct the reforms described in this report. EDI Holdings would initially be established for a period of six years, at the end of which a full review would be undertaken to determine whether it continues to be required, and if so, to fulfil which residual roles, and for how long. This review would be undertaken against a pre-agreed set of criteria,
primarily relating to the ability of the REDs to operate on a fully independent basis from that
date onwards.

1.23 Prior to the establishment of the REDs, the role of EDI Holdings will be:

- to assume responsibility for planning and co-ordination of the national **electrification** programme. This will involve the transfer of staff involved in this activity to EDI Holdings upon establishment and balanced planning of grid and non-grid supplies;

- to assume responsibility for securing short-term support to those **municipal distributors currently under greatest financial and operational strain**. This is likely to involve planned and agreed arrangements between those distributors and Eskom and/or a metropolitan distributor to provide the required financial and operational support. It would be done under the co-ordination and oversight of EDI Holdings, and could also involve the formal transfer of title to the relevant business to EDI Holdings, as an early step towards consolidation of ownership arrangements; and

- to establish a number of task teams, made up of industry secondees and advisors, to **plan and prepare for the implementation of the REDs**. This would encompass all legal, financial and operational preparation work. As noted below in relation to the transition, it is proposed that, prior to RED implementation, Eskom Distribution should be separated out within Eskom and re-organised in line with the new proposed RED boundaries. It is also proposed that this period is used by the municipalities to “ring-fence” their electricity distribution activities, in preparation for transfer to the REDs. EDI Holdings would plan, co-ordinate and oversee both of these streams of activity.

1.24 It is proposed that the REDs be created initially as subsidiary companies of EDI Holdings, into which the businesses of the existing distributors would then be transferred on a phased basis. During this period of phased RED creation, EDI Holdings will retain effective control of the REDs, through special voting shares that will expire once the REDs are fully established and operational. During this period, EDI Holdings will:

- hold a veto over key RED management decisions;

- approve the appointment of Directors and management teams of the REDs;

- monitor and oversee the process of RED establishment; and

- retain the option, in extreme circumstances, of reallocating staff, assets or financial resource among the REDs.
Establishment of the REDs

1.25 We recommend that six REDs should be created, with the boundaries indicated in the map in the main body of this document. The recommended RED boundaries are subject to detailed refinement prior to implementation.

1.26 A large number of alternative RED models have been examined. The proposed 6 RED model best meets the objective of the maximum number of independent financially viable REDs. Fewer REDs would be unmanageably large businesses. Options with a larger number of REDs would all require future electricity prices to be higher than under the proposed 6 RED option if they were to be financially viable, and would also involve significantly greater differences in future electricity prices across the country. Financial viability should not, in our view, be achieved through long term financial dependence of one RED on cash transfers from another. Nor should it be achieved at the expenses of higher prices to the final customer than necessary. We believe that the proposed 6 RED model best achieves these objectives.

1.27 REDs will be constituted under the Companies Act from the distribution network assets and liabilities of Eskom and the Municipalities. They will be managed by competence (as opposed to stakeholder) based boards appointed by the shareholders, and include the staff and systems currently devoted to electricity distribution and retail. Generation assets will be transferred to the REDs only in exceptional circumstances.

1.28 Compensation to current owners will be in the form of shares (except for some smaller contributors who would be compensated through cash or fixed interest bearing debt instruments). During the transition period when the REDs are being established and stabilised, the shares issued to current owners would carry limited rights. These would include the right to receive dividends, but would not give shareholders the right to make key decisions affecting the structure of the business. These rights would be retained by EDI Holdings through its special voting shares. When EDI Holdings is dissolved the limited voting shares would be converted to ordinary shares. National government would hold a “golden share” to restrict changes in ownership or the capital structure for a period of five years. Shares attributable to Eskom’s distribution assets will be held by national government.

1.29 We recommend that assets should be valued upon transfer to the REDs on the basis of relative depreciated replacement costs (DRC) or discounted cash flow (DCF) depending on what is deemed appropriate for the industry. Where asset data is deficient, proxy methods will be used to ensure that existing owners receive fair compensation. In order to facilitate the transfer of assets and liabilities to the REDs, current distribution undertakings need to be well defined, ring-fenced and audited. National legislation should provide the basis for the transfer of assets and liabilities.

Human resource planning

1.30 Effective human resource planning and the need to communicate clearly the implications of change are at the heart of the EDI restructuring project. Experience from other restructurings in South Africa has confirmed the need not to underestimate the scale of the human resource issues to be faced. EDI Holdings and the REDs will all be created within the framework of a comprehensive human resources strategy covering:
the organisational structure for each RED;

• the basis on which staff should be transferred from Eskom and municipalities into the RED;

• detailed planning for the key tasks, including: the negotiation of terms and conditions, organisation design, preserving expertise, skills’ audits and a training strategy;

• a change management and communications strategy; and

• a comprehensive Social Plan.

1.31 This framework will ensure that priority is given to the achievement of critical social development objectives. Specifically:

• all existing labour rights will be protected upon transfer of staff to their new employer;

• new harmonised terms and conditions of employment will be developed through an agreed process of centralised collective labour bargaining, established by EDI Holdings; and

• the whole of the restructuring will be undertaken within the context of an agreed Social Plan which will: govern the transfer of staff to the REDs, provide for skills development and training, specify support for staff redeployment, and address all aspects of community support required throughout the reform process. Preliminary estimates of the impact of restructuring indicate that, on balance, the industry is more likely to be characterised by skills shortages than surpluses and the need for retrenchment will be limited.

Support for low-income users

1.32 The interests of low-income households will also be given high priority in the reforms. All low-income households will have access to tariffs capped at affordable levels, in the form of “electricity basic services support tariffs” agreed with both government and NER. These rights will be enshrined in the form of regulatory obligations on the new REDs and EDI Holdings, and it will be an explicit responsibility of EDI Holdings to oversee the effective implementation of these tariff protections for low-income households during the transition period.

1.33 The REDs and EDI Holdings will also have regulatory obligations to provide connections to all users in their respective geographical areas, and obligations to provide supply and customer service to a quality and standard defined by the regulatory arrangements. These will be expressed explicitly to oblige the provision of universal access to electricity supply, and ensure that the REDs must, in future, meet the legitimate basic needs of all electricity users, with particular regard to the rights of low-income and disadvantaged households.
Commercial and regulatory arrangements

1.34 Prior to the establishment of the wholesale electricity market, REDs should purchase energy and transmission by means of a regulated Wholesale Electricity Pricing System (WEPS), and thereafter purchase energy from the market and transmission service according to regulated arrangements.

1.35 International experience has shown that competition in electricity retail can deliver benefits to consumers, and it is proposed that competition to sell electricity be introduced in South Africa – on a carefully controlled and phased basis. Under such arrangements the consumer would still be charged the WEPS price for the wholesale element of consumption and a regulated price to its host RED for use of the distribution network but would be free to chose a retailer to provide billing, metering and customer service activities. Any organisation that wishes to become a retailer will have to obtain a licence from NER.

1.36 Strict rules will be applied through the regulatory system to ensure that this competition does not impact in any way on the financial viability of the REDs. In particular, a RED’s financial viability will in future depend almost entirely on the revenue earned from use of its distribution network. Some large customer use little or none of this network, and so would not, in any case, have contributed to the RED’s financial position. For those who do use the RED network, exactly the same charges will still need to be paid to the RED for use of the network, regardless of whether the customer is sold its electricity by the local RED or by another supplier. This arrangement has operated successfully in many countries internationally for many years and has brought significant benefit, without impacting adversely on the RED financial position. It can offer benefits to consumers by encouraging improved levels of customer service and better tailoring of price structure to the requirements of the individual customer. It is something which large industrial consumers in South Africa are eager to see.

1.37 Initially, retail competition should be limited to those customers with annual consumption exceeding 100GWh per year at a single site. The NER will determine the timing of the initial tranche of retail competition, and of any subsequent tranches, taking into account the prevailing circumstances and skills in the electricity industry. NER will be required to give reasonable notice of any extension of the contestable market.

1.38 Existing special deals should continue with Eskom Generation providing bulk supplies at an adjusted WEPS price to REDs to meet the requirements of these customers, thus ensuring that the RED is not disadvantaged. Neither the introduction of retail competition, nor the continuation of special deals will have a significant impact on the financial viability of the REDs.

1.39 The NER and the Municipalities will both have a role in the regulation of the EDI:

- NER will issue licences to cover the REDs obligations on monopoly distribution activities and retail to customers who are outside the competitive market. It will then use an incentive based approach to ensure continued improvements in operating efficiency and customer service; and
• Municipalities will discharge their service authority responsibility relating to electricity distribution through a Service Delivery Agreement (SDA) with their host RED.

1.40 In line with the priority given to supply security and the provision of consumers’ basic needs, the REDs will each have a regulatory obligation to connect and supply consumers within its designated area, including provisions to ensure an appropriate balance between grid and non-grid supplies.

1.41 Temporary regulatory arrangements should be contained in a temporary license issued to each RED for a two year period from establishment.

1.42 An incentive-based regulatory system should be set, initially, for a three year period and, thereafter, for five-year periods.

**Tariffs**

1.43 The recommendations regarding tariffs and levies are made so as to be consistent with the key objectives outlined above. Specifically, they are designed to ensure that low-income consumers are guaranteed a basic supply of electricity at affordable prices; that the electrification programme can be fully funded and supported; and that the current inequities among consumers (according to location or the historic development of the sector) are removed. These will be replaced with a fair and equitable system of tariffs and levies that reflect the key principles of cost-reflectivity, equity, affordability and transparency.

1.44 The vast majority of the EDI is currently in financial crisis. Very significant tariff increases, to domestic customers, would be needed to ensure that the current 400 distribution business were financially viable. This is clearly unacceptable. Reform of the sector, based on the proposed move to 6 REDs will reduce very significantly the scale of any future required tariff increases. Some price increases will still be required to some classes of consumers, but this will be introduced in a phased and controlled manner over several years. Prices to industrial customers, by contrast, are likely to fall with EDI reform. Specific provisions will be made, and enshrined in regulations, to shield low-income households from such tariff adjustments and so ensure that they have secure access to electricity at low and affordable prices. The costs of offering low-tariffs to low-income customers will be met through a transparent cross-subsidy charged to all other consumers.

1.45 Wherever possible within the constraints of the above-mentioned tariffs for low-income households, tariffs will move over time to ones that more accurately reflect the costs of supply. This will ensure that consumers are faced with the most efficient price signals possible, and so make decisions about electricity consumption that reflect the costs incurred to meet their needs. This will encourage efficient resource allocation, to the long-term benefit of the South African economy as a whole.

1.46 EDI Holdings will be able to make recommendations to NER regarding measures that could be taken to mitigate the required increases in tariffs including: targeting higher levels of operational performance improvement, accepting a lower return on the asset base and reviewing investment requirements. These measures could substantially reduce the increases in tariffs which will affect households and allow prices to industrial customers to fall substantially.
Electrification

1.47 Delivery of the government’s electrification programme will be a central objective of the new arrangements – in line with the priority placed by government on the electrification objective. EDI Holdings and the REDs will be under explicit obligations to deliver the programme to a specified schedule over the next ten years. Staff involved in the overall planning and scheduling of the electrification programme will be transferred to EDI Holdings to fulfil this obligation, and this responsibility will pass to a National Electrification Agency after the dissolution of EDI Holdings. Each RED will be responsible for implementation of the electrification schemes themselves and will be obliged to consider a balance of grid and non-grid supplies.

1.48 It is proposed that most or all of electrification capital costs should be funded through the fiscus. The financial structures of the REDs will be set up to enable them, in future, to fund the operating costs associated with new electrification schemes from their own resources. Tariffs to newly electrified customers will be capped at agreed affordable levels.

1.49 These arrangements will provide for more effective implementation of the electrification programme and ensure that newly connected customers have access to levels of customer service enjoyed by existing customers.

Local government funding

1.50 Explicit arrangements are proposed to protect Local Government from the effects of the proposed creation of the REDs. Many municipalities currently receive income from their electricity distribution activities, which contributes to other Local Government services. It is proposed that Local Government should not suffer financially from the creation of the REDs. Under the proposed new arrangements, current levels of financial transfers from electricity to Local Government will be maintained, through a combination of an explicit levy on electricity tariffs and any dividends to Local Government as shareholders in the new REDs.

1.51 These arrangements will leave Local Government unaffected financially be the new arrangements, and have the benefit of making the financial transfer from electricity consumers to other Local Government services more transparent.

Transitional arrangements

1.52 A significant programme of work is required to move from the current EDI structure to those now proposed, based on the establishment of six REDs. It will be important that the transition to the new arrangements is implemented in a very carefully planned and controlled manner. It was for these reasons that Cabinet endorsed the use of a Holding Company (EDI Holdings) for a transitional period, to oversee the restructuring and ensure that it is implemented successfully.

1.53 It is proposed that the EDI move to the new arrangements, as summarised above, in three broad phases. Each phase will be carefully monitored to ensure that implementation is done with minimal risk to the on-going operations of the sector, but also with sufficient momentum to ensure that it is seen through to completion. The three proposed phases are as follows:
1.54 Phase 1: Establishment of EDI Holdings (February 2001 to June 2001). EDI Holdings would be established by April 2001 as a limited company, 100% owned by national government with a Board of Directors appointed by the Minister of Minerals and Energy. The initial work of EDI Holdings will be to establish:

- a national electrification planning and co-ordination team;
- a team to monitor and manage the support required to those municipal distributors in greatest financial and operation crisis (see below);
- additional teams to manage the development of an electricity basic services support tariff and the industry wide social plan; and
- a number of dedicated task teams to develop all of the specific detailed plans and arrangements required to implement the proposals for creation of the REDs as set out in this report. EDI Holdings will take explicit responsibility for creation of the REDs according to the “Blueprint” design in this report.

1.55 Phase 2: Ring-fencing of distribution businesses (July 2001 to December 2002). The industry has expressed concern that the restructuring process must be done in a well-structured and orderly manner – there should be no “big bang”. It is proposed therefore that the process of RED formation should begin with an 18-month period during which all existing distribution activities are separated and ring-fenced from their current parent organisations. This should be done under the overall management and supervision of EDI Holdings. Specifically, it is proposed that:

- **Eskom Distribution** should be separated fully from the rest of Eskom and that it should then be corporatised as a separate company. This new Eskom distribution company would, during this phase, remain as a subsidiary of Eskom. During this phase, Eskom should also re-organise its distribution activities into the proposed six RED areas, in preparation for formation of the REDs.

- **Municipality distribution activities** should, in this phase, be explicitly identified (assets, liabilities and staff) in preparation for separation from Local Government.

1.56 Phase 3: RED establishment (January 2003 to December 2004). The formation of the REDs as operating entities will happen in a phased manner over this 2-year period. EDI Holdings will first form six wholly owned subsidiary companies, into which the assets and liabilities of the distribution activities will gradually be transferred over the 2-year period. The legal formation of the subsidiaries and the recruitment of RED management teams will begin from mid. It is currently envisaged that the REDs will first receive the distribution businesses of Eskom and one or two of the major municipalities or Metros in the RED area, followed by a phased absorption of other municipalities over the period. The precise phasing and order of absorption will be determined by EDI Holdings, and can be controlled by EDI Holdings during this period to ensure a smooth transition. RED management will be responsible for integrating their endowments into stand-alone businesses, and could call upon EDI Holdings for support as required.
1.57 EDI Holdings will be constituted under the Companies Act with a competence-based board of directors. It will comprise a small number of full time employees and will establish a number of workgroups to address all of the issues relevant to the EDI reform process. Workgroups will be formed largely from industry experts as secondees, with additional outside support as required.

1.58 During the period of RED creation, EDI Holdings will retain special voting rights in the REDs to ensure that it retains sufficient control over the implementation programme to enforce the adoption of government policy with respect to the reform process. These special voting arrangements will fall away once EDI Holdings is satisfied that the REDs are fully established and operating. These special voting rights will give EDI Holdings effective veto over all RED management appointments and key operational / financial decisions of the REDs, and back-stop rights, in extreme circumstances, to re-allocate staff, assets and financial resources among the REDs during the transition period.

**Restructuring support provided by EDI Holdings**

1.59 EDI Holdings will establish a number of workgroups to support and undertake the planning work required for RED implementation, including the collection and validation of necessary data. EDI Holdings will draw extensively on the expertise and capacity of Eskom to support this planning work. EDI Holdings will also provide assistance to municipalities to support the ring-fencing of their EDI businesses, drawing on external support where the skills cannot be provided from within the industry.

**Transitional support to the weakest municipal distributors**

1.60 The phased approach to RED formation outlined above has been developed in the light of concerns that a more rapid implementation programme may be unduly risky and difficult to manage. Within such a phased approach, transitional arrangements will be required to provide support to those municipal distributors that are in greatest financial and operational difficulty, before they can be absorbed into a RED.

1.61 To date, such distributors have been brought under the umbrella of either Eskom or one of the larger and stronger municipal businesses. Until the REDs are formed, this will need to continue to be the case. It is proposed, however, that this process of “rescue” of the weaker municipal businesses now be done under the control and co-ordination of EDI Holdings. Specifically, it is proposed that:

- a dedicated team be established within EDI Holdings as a matter of top priority, to take direct responsibility for this issue; and
- this team will identify and monitor the position of the weakest distributors, in most urgent need of potential support, and take responsibility for identifying and negotiating new operational and financial support arrangements with Eskom and/or a stronger municipal business (as appropriate) for each such business, in priority order. These arrangements should be developed in a way that is consistent with the end-position as defined in this Blueprint, and hence on a more planned basis than hitherto.
1.62 These arrangements will continue to require the goodwill of Eskom and other municipalities, as EDI Holdings will be unable to enforce any revised arrangements, prior to legislation. The priority task will be to secure interim operational and financial support to these distributors, prior to absorption into a RED. This interim solution need not involve formal transfer of the assets of the weak business to Eskom or a stronger municipal business. Indeed to avoid the need for a double transfer, the EDI Holdings team should seek, wherever possible, either to leave formal asset ownership with the current owner, or effect a direct transfer to EDI Holdings itself in anticipation of their transfer to a RED.

RED accountability

1.63 During the proposed transition period, the REDs will be directly accountable to, and controlled by, EDI Holdings. Beyond this transition period, the REDs will be subject to a system of accountability in line with best international practice for the sector – specifically:

- the REDs will be accountable for their financial performance to their direct shareholders, namely central and local government, in line with their respective shareholdings in the business;
- the REDs will be responsible to their regulatory bodies (NER and MMSDs) for the fulfilment of all regulatory obligations, with respect to tariffs, supply security, service standards etc; and
- in addition, it is proposed that central government will hold a “Golden Share” in the REDs for a period, through which central government will retain residual rights of control over the REDs in respect of certain key issues, most notably ownership.

Implications of EDI reform for key stakeholders

**Eskom**

- Distribution assets, liabilities, staff and systems will be transferred to the REDs
- Contribution of shares to the REDs to be held by national government
- Bulk sales to REDs initially at WEPS; later at wholesale market price
- Use of Eskom skills and resources to restructure Eskom Distribution to the boundaries of the six REDs and thereafter to manage the integration with the municipalities

**Municipalities**

- Distribution assets, liabilities, staff and systems to be transferred to the REDs;
- Audited levels of current income from electricity sales to be continued in the form of a levy and dividends;
- Obligation to supply electricity to be in the form of a Service Authority / Service Provider arrangements exercised through a Service Delivery Agreement (SDA) with the REDs. It would be preferable if Municipalities
formed Multi-jurisdictional Municipal Service Districts in order to enter into these SDA’s.

- Use of Eskom Distribution skills and resources to assist with ring-fencing and restructuring

**Large customers**

- Participation in the competitive retail market if over 100GWh per year
- Pay WEPS for energy and regulated charges for use of the network;
- Special deals will continue (as a variation to the WEPS price only);
- Neither competition nor special deals will impact on RED viability;

**Low income customers and electrification**

- Obligation on REDs to provide for basic needs, including obligation to connect and provide supply
- Electricity basic services support tariff available to low income customers at subsidised price;
- Cross-subsidy made from other customers within the RED;
- Electrification capital costs met from National Electrification Fund through the fiscus;
- Implementation and management of the electrification programme by REDs with access provided to grid and non-grid supplies

**Labour**

- Reform programme to be implemented within the framework of a comprehensive human resources strategy including an agreed Social Plan.
- Continuity and security of employment;
- Transfer of Eskom and Municipality staff to REDs according to their existing terms and conditions;
- Harmonised terms and conditions to be offered to new employees.
- Centralised bargaining forum to be established to deal with the terms and conditions which need to be determined in advance of RED creation.

**Structure of this report**

1.64 The remainder of this report is organised into three parts, as follows:

- **Part A – The REDs.** A summary of our key recommendations on the proposed regional electricity distributors (REDs) focusing on the end state that will reached at the end of the transition process;

- **Part B – Transition.** A summary of our proposals for EDI Holdings, the role it would play in the industry and the overall transition plan; and

- **Part C – Implementation.** A summary of our proposed approach to implementation of the new arrangements.
Part A – The REDs

In this part we describe in turn our main recommendations on the proposed REDs. We discuss in turn:

- **Section II:** the number and boundaries of the proposed REDs;
- **Section III:** the ownership, governance and legal status of the REDs;
- **Section IV:** the arrangements for valuation and transfer of assets and liabilities to the REDs;
- **Section V:** the commercial and regulatory arrangements within which the REDs will operate;
- **Section VI:** our proposals on tariffs and levies to RED customers;
- **Section VII:** our assessment of future RED financial viability and transition;
- **Section VIII:** RED organisation and human resource strategy;
- **Section IX:** RED systems and processes;
II Number and boundaries of REDs

2.1 EDIRC first considered the appropriate number and boundaries of the new REDs taking into account the White Paper’s objectives for reform and the key criteria by which RED configurations should be assessed. It concluded that six REDs should be established.

Objectives

2.2 The objective set by the Energy White Paper is to create the “…maximum number of financially viable REDs…” This objective itself requires some consideration. Almost any number of REDs could be financially viable, if the costs involved were to be accepted and if prices to the final customer were allowed to reflect those costs in full. We need, therefore, a more precise definition of financial viability to ensure that the future EDI is one that can deliver the best possible quality and cost of service to final customers. In our view, financial viability should be judged against four key parameters:

- **size** – the REDs must be of a sufficient size to capture the main economies of scale in the EDI, but also avoid risk of any loss of economies through the creation of businesses that are unmanageably large. These size criteria aim to ensure that the REDs have the potential to operate at an efficient overall cost level, for the benefit of future customers;

- **balance** – the REDs must be as comparable as possible, in order to ensure that they are all able to perform effectively within the regulatory and competitive environment in the future South African electricity industry. Regulation in future (see below) will operate on an incentive basis, within which the REDs will be encouraged to improve efficiency on a continual basis – including through the use of benchmark comparisons among the REDs, to reward the most efficient and penalise the least. Similarly, competition to retail electricity to final customers will be introduced over time. In our experience, the REDs will be best placed to operate in an environment of regulatory and retail competition, if they are as comparable as possible at the outset, and hence are as broadly balanced as possible in terms of their initial customer bases and underlying cost drivers and hence tariff levels;

- **implementation costs** – excessive and unnecessary implementation costs, which would place a strain on the initial financial position of the REDs, should be avoided. In particular, the RED boundaries should conform as far as possible with the electrical configuration of the existing or planned transmission and distribution network, and significant costs associated with relocation of control centres, call centres, work management centres, etc, should be avoided where possible; and

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1 Here and elsewhere in the text we distinguish between distribution activity (which comprises construction, operation and maintenance of the network) and retail activity (which comprises the bulk purchase of generation, transmission and distribution services and their resale to final customers, including the customer service activities of metering, billing, cash collection and customer handling).
• **financial independence** – the REDs should be capable of medium term financial independence. In particular, reliance of any one RED on financial transfers from other, financially stronger REDs should, in our view, be avoided, except for the possibility of limited financial support during the establishment phase. To build a system in which some REDs are financially strong and others weak would be a critical mistake, and against the long-term interests of final customers. Any scheme of inter-RED financial transfers would quickly come under pressure, and be the cause of difficulty and tension from the outset. A desire by the stronger REDs to avoid/minimise the cash transfer is inevitable, the effect of which would be to place the weaker RED under financial strain – to the ultimate detriment of the final customer.

### Boundaries

**Recommendation 1:** Six REDs should be created, with the boundaries indicated in the attached map, subject to further refinement of the boundaries prior to implementation taking into consideration amongst others, implementation costs.

**Eskom and SALGA’s comments:**

Although the consortium has argued that it has achieved an overall balance between the REDs, it is evident that this still appears not to have been realised in the area of current low income and future low income users. These differing low income customer numbers would result in differences in costs and in tariffs across the REDs both initially and in the future. However, if cross-subsidies to low income users are dealt with on a national basis, then it could be argued that a higher number of REDs might be viable.

2.3 The key reasons for this recommendation are discussed in the following paragraphs, by considering each of the above four elements of financial viability in turn.

### Rationale

**Size**

2.4 The EDIRC’s analysis of RED size indicated a range of possible REDs between five and fifteen at the very most. Fewer than five REDs would be undesirable for three key reasons:

- each RED would, by the end of the electrification programme, serve some two million customers or more. These would be very large businesses by international standards, and may prove to be beyond the management capabilities, at least in the short term;

- competition in the competitive retail market would be weaker with only a very small number of REDs. Competition among at least five REDs, plus new entrant retailers, is in our view, the minimum desirable level to ensure the emergence of an active market in which there is genuine competition and choice for the customer; and
• comparison among fewer than five REDs would be a less effective element of the future regulatory regime – in which efficiency benchmarking among the REDs may play a role.

2.5 Similarly, REDs in excess of around fifteen would:

• risk the loss of some of the basic economies of scale in distribution and retail. The consortium’s analysis of scale economies indicated that the fixed costs, in terms of headquarters, finance and IT, would outweigh the benefits to be gained from more effective benchmarking. Furthermore, as the number of REDs increases, their characteristics become more dissimilar making benchmarking harder and slowing performance improvement;

• risk an imbalance in any future competitive wholesale electricity market in South Africa between generators and REDs. A very large number of small REDs would be disadvantaged, in terms of financial strength, negotiating position and purchasing power, against a potentially smaller number of large generators. A reasonable balance of position in the wholesale market will be in the best long-term interests of the final customer, and minimise the need for heavy regulatory intervention in this market; and

• result in REDs which are insufficiently balanced in other key parameters.

Balance

2.6 Within the five to fifteen range of REDs, a very large number of possible RED configurations were analysed by the committee. Balance across the REDs had proved very difficult to achieve, because of the geographic distribution of the electrical network and customer base across the country. The preferred six RED option appears to give the best achievable balance across a range of criteria:

• **urban/rural balance** – each RED would have a balance of urban and rural customers, with significant urban load centres and a sizeable rural area in each. Each RED as been “anchored” on at least one significant urban load centre. RED 3 is anchored on two metros (Durban and Port Elizabeth), the others as follows: RED 1 - Cape Town, RED2 - East Rand, RED 4 – Johannesburg, RED 5 – Pietermaritzburg, Nelspruit and/or other major towns, and RED 6 – Pretoria;

• **rural electrification** – currently only 46% of rural households are supplied with electricity. Each RED would therefore have a significant future rural electrification programme to undertake. The distribution of this burden varies between RED 3, where customer numbers would increase by around 74%, to RED 1, where numbers would rise by 25%. While the financial burden of new electrification may be very largely borne by the general taxpayer through the fiscus, the management burden of new electrification will be significant and should be shared across the REDs as far as possible;
• **customer numbers** – the REDs would have a range of customer numbers between 700,000 (RED 4) and 1.4m (RED 3) at the outset, rising to between 1.1m (REDS 1 and 4) and 2.4m (RED 3) by 2010 at the end of the electrification programme;

• **load mix** – *domestic* load, a key driver of customer service costs, is broadly balanced across the REDs (in the range 3TWh (RED 5) to 7TWh (REDS 2 and 6)). There is a wider dispersion of *industrial* load (from 10TWh (RED 1) to 34TWh (RED 5). The range of industrial loads reflects industrial concentration with RED 5 containing a small number of sites connected at high voltages which will not have a significant impact on the RED cost base;

• **assets employed** - there would be broad equivalence in the assets employed (line length and transformer capacity per customer) across the REDs with line length (m/customer) in the range 60m to 80m, excluding RED 3, and transformer capacity (kVA/per customer) in the range 14kVA to 29kVA;

• **load density** - varies in line with industrial concentration, with overall load density from 70MWh/km (RED 1) to 650MWh/km (RED 5), while load factor would be balanced in the range 70% to 82%; and

• **income per household** would be balanced across the REDs with an average of R31,000 per year and a range of between R22,000 (RED 5) to R47,000 (RED 1).

2.7 While these parameters show a considerable range across the REDs in a number of cases, the preferred six RED option does nonetheless provide the best overall balance of the options which have been examined. The six REDs do, we believe, have an adequate mix of these key physical parameters to provide the basis for future viability, and the basis for both an acceptable level of regulatory benchmarking and vigorous retail competition. Significantly smaller REDs would contain concentrations of individual parameters (for example electrification requirements or industrial load) that would be impossible to balance within the constraints of financial viability that we have established.

**Implementation costs**

2.8 We have sought to minimise the initial implementation costs of the move to the new REDs by ensuring, as far as possible consistent with the objective of long term sustained viability, that the proposed REDs:

• do not violate any major network configuration requirements, and in particular do not require significant spending on network reconfiguration. We believe this to be the case for the six REDs proposed, although some new metering at the proposed boundaries will need to be installed, and some modest distribution network reconfiguration may be required. Options with a significantly higher number of REDs typically require existing metropolitan area businesses to be split to keep broadly comparable sized and balanced REDs. Indications are that such options would be costly to implement, and
most stakeholders have indicated that this would be undesirable on political and practical grounds also;

- contain at least one existing distribution control centre. Again this is the case for the proposed six RED option. Some consolidation of control centres will be required in this and most other options examined;

- contain at least one work management centre, one call centre and a reasonable distribution of local stores and depots. Under our preferred option each RED would contain at least one major call centre and all except RED 4 would contain one of Eskom’s existing work management centres; and

- do not violate significant geographical boundaries or features. In this regard, we have proposed a boundary between REDs 2 and 5 and REDs 5 and 6 consistent with the local geography, and sought also to limit the geographic distances within a RED as much as possible. RED 1 covers a large geographic area, but the most distant parts of the Northern Cape have very low population densities.

2.9 There is recognition that the headquarter anchor points are sometimes located on the periphery of the relevant RED but we consider that effective regional offices and management will mitigate any potential cost impact of the head quarters location and help to ensure that management remains in touch with customers and responsive to local needs.

Financial independence

2.10 The future financial position of the preferred six RED option, and a number of other options, have been projected over a ten year period, in order to confirm that they are capable of independent financial viability – both in the long term and during the first few years of transition. The key findings from the consortium’s financial analysis as it impacts on the choice of REDs are as follows:

- the preferred six RED option appears to offer the prospect of strong, financially robust REDs in the longer term, reflecting the balance of underlying physical attributes discussed above. As discussed later, all six can, in the longer term, fund their on-going operations, fund required new capital expenditure, service debt to a gearing level of up to 70% and earn a reasonable return on the equity in the business – at prices which reflect efficient levels of underlying supply costs;

- the preferred six REDs also appear capable of independent financial operation over the initial years of transition – i.e. no cash transfers across the REDs appear to be required even in these early years. They can be established, on the boundaries shown, with a broadly comparable initial financial position, and can achieve full financial viability over a broadly comparable period (around five years);

- options with larger numbers of REDs appear less attractive financially. The underlying costs to serve different customer classes differ, according to a wide
range of factors. In particular in the domestic sector, low income and rural customers represent a significant cost burden on a RED, due to the need to subsidise prices at affordable levels for low-income customers and due to the low load density (and hence higher average costs) in rural areas. As the number of REDs increases (and hence their size falls) these high cost customers become more and more concentrated in particular REDs. The financial analysis indicated that, as a result, either prices in these REDs have to rise, thus widening the range of tariff differentials among the REDs, or financial transfers are required among the REDs to hold the range of tariff differentials to an acceptable level. Specifically, the consortium’s financial analysis of a range of RED options indicated that:

- the extent of price increase to domestic customers will be least with the preferred six RED option, and significantly higher for options with ten or more REDs (reflecting both the higher total overheads in the EDI and the more concentrated distribution of rural and low income customers which require some of the smaller REDs to drive prices high to achieve financial viability); and

- the range of tariff will be significantly broader in options with either a large number of REDs or with significantly imbalanced REDs. For example, the range of cross-subsidy on RED prices to cover the cost of subsidised low-income tariffs is over three times greater in a ten RED option than in the preferred six RED option.

2.11 We have undertaken our financial analysis against a background of the creation of each RED on a single day. As we explain in Section XII, we propose a phased approach to the establishment of each RED. While it will inevitably take longer to reap the benefits of performance improvement which we expect to follow consolidation we are confident that this process will not compromise the medium term assessment of financial viability.

2.12 During the transition period, over which the REDs are fully established, it may, however, be appropriate for the Holding Company to make limited financial transfers between REDs to maintain the financial equilibrium of the industry. This should be at the discretion of the Holding Company carrying out its duty to support the financial position of the industry. Additionally the Holding Company will have the power to make adjustments to the REDs’ initial debts position to allocate the debt service burden on a more equitable basis.

2.13 In summary, the proposed six RED option, in our view, best meets the White Paper objective of “...the maximum number of financially viable REDs...” in both the short and longer term. We are of the opinion that the potential full financial viability of the REDs in the longer term, and their ability to operate independently of each other financially from the outset. We are of the opinion that greater numbers of REDs require either wider tariff differentials among the REDs or some form of cash transfers among them. More fundamentally, the six REDs proposed appear to be the option with businesses most broadly balanced across a range of underlying physical characteristics and cost drivers – which in our view will enable them all to operate effectively within the future regulatory and competitive market environment envisaged in the sector in future – at the lowest prices for customers.
Other definitional issues

**Recommendation 2:** The boundary between transmission and distribution should be based on voltage, with some specific exceptions as described below. In addition to voltage, the purpose/use of the network (irrespective of voltage), particularly if it has clear distribution function, should also be considered in determining the separation.

2.14 There are a number of issues relating to the design of the REDs that need also to be addressed. These are summarised below:

2.15 The boundary between transmission and distribution should, in our view, be based as far as possible on a simple voltage definition. Attempts in other countries to use functional distinction (ie to define assets to be either transmission or distribution according to their function) have been fraught with difficulties – not least because the function of pieces of the network can change over time. We propose that distribution be defined as all electrical networks at 132kV and lower voltages, and associated equipment, with the following limited exceptions:

- 132kV circuits that are international interconnectors;
- short lengths of 132kV circuits linking transmission facilities;
- 132kV bus-bars at transmission substations which provide dedicated connections to generation;
- dedicated generation connections; and
- high voltage circuits which have a clear distribution function and in particular those currently being used by the municipalities and Eskom.

2.16 We propose that the new REDs should own and operate all distribution assets within their geographic boundaries other than:

- system assets owned by parties other than Eskom and the municipalities (including isolated systems, such as photovoltaic systems, and interconnected systems); and
- traction circuits.

**Recommendation 3:** Embedded generation above 50MW should remain with its existing owner, but where generation is an integral part of Distribution, it may be transferred as a Distribution asset; embedded generation between 50MW and 1MW which, for system reasons, cannot readily be separated may transfer to the RED; embedded generation less than 1MW may transfer to the RED.
III Ownership, governance and legal status of the REDs

3.1 The proposed REDs will be made up from assets and liabilities contributed by Eskom and a large number of individual municipalities. We need, therefore, to consider how these REDs will be owned and governed, and the legal form that the REDs should take.

Ownership of the REDs

**Recommendation 4: All contributors of assets to the RED should be compensated.**

3.2 All contributors of assets to the REDs should, in our view and as a matter of law be compensated in some form. Cash compensation is not a practical option. The asset contributors will need to receive their compensation in the form of some legal instrument, payments under which are linked in some way to the financial performance and ability to pay of the REDs. Two options present themselves:

- to compensate the asset contributors in the form of ordinary shares (or “equity”) in the relevant RED. This would tie the financial return to the asset contributor directly to the financial performance of the RED, and give each contributor voting rights within the governance arrangements for that RED; or
- to compensate local government through debt instruments, and lodge all equity in the hands of national government. This would provide either the same form of financial compensation for local government (if payments under the debt instruments were linked directly to the profit of the RED) or could be made more stable (if debt payments were fixed, in part or whole). In either case, all voting stock would be held by national government.

**Recommendation 5: Compensation should be in the form of ordinary shares in the RED, except for some smaller contributors which could be compensated through cash or fixed interest bearing debt instruments.**

**Eskom’s comment**

*Final recommendations in this regard are highly dependent on the outcomes of a fundamental assessment of investors’ opinion.*

3.3 The options are finely balanced, in our view. Debt instruments have the attractions that they allow a simpler future ownership structure for the REDs, have the potential to provide local government with a more stable income stream, and place control over both the process of RED establishment and future RED ownership solely in the hands of national government.

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2 Not only is this normal corporate and commercial practice, but also it would avoid difficulties arising under the Constitution.
government. We recommend compensation in the form of ordinary shares\(^3\), however, for two key reasons:

- it is more reflective of normal company capital structures, than the more artificial device of debt instruments which effectively carry equity-type financial risk associated with the performance of the business. (The REDs could not, in reality, carry significant amounts of any debt secured by instruments with fixed payments on their balance sheets without significantly exceeding prudent gearing levels); and

- it does not create concerns over national government influence in the REDs which can be better addressed by means of a “golden” share.

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<tr>
<th>Recommendation 6: A “golden share” in each RED should be held by national government giving certain rights described below.</th>
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**SALGA’s Comment:**

The concept of a veto over certain limited decisions for the first five years is accepted and that veto must be exercised by the principals of each of the shareholders of the company i.e. Cabinet, Metro Council, District Council and/or Local Council.

3.4 Under the recommended option, we propose also to issue an additional “golden” share to national government. This share will give national government a right of veto over certain limited decisions among RED shareholders, which may be exercised following inter-ministerial\(^4\) consultations. We propose that this “golden” share should:

- be in place for five years;
- give national government a right of veto over the sale or disposal of shares by any shareholder;
- enable national government to prevent concentration of ownership interests by limiting shareholdings to a maximum of 25% (other than in the holdings arising from the initial allocation of shares);
- give national government a right of veto over the issue of new shares or quasi-equity in the REDs, or other significant change in RED capital structure;
- give national government the right to require a shareholders’ meeting to approve takeovers or propose an increase in share capital; and

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\(^3\) In the case of some small contributors, it may be appropriate to make a cash payment or give a debt instrument bearing fixed interest to simplify the shareholdings in the REDs.

\(^4\) Relevant ministries could include the Department of Minerals and Energy, the Department of Provincial and Municipal Government, the Department of Public Enterprises and the Department of Finance.
3.5 In our view, the combination of mixed national and local government shareholding, and national government rights of veto via a “golden” share over key ownership and capital structure issues, represents the most balanced and effective option for the future ownership of the REDs.

**Recommendation 7: National government should hold shares in respect of Eskom’s contribution to the REDs, provided that this has no significant impact on Eskom’s credit rating.**

**Eskom’s comment:**

Eskom as a legal entity, needs to be compensated through ordinary shares as this is the only practical compensation option. This will assist in addressing current and future investor requirements. The benefit of investor confidence, and industry stability outweigh any potential conflict of interest. There is a real risk of significant credit rating impact should this matter not be dealt with the necessary sensitivity. Furthermore, as the industry opens for competition, any potential conflict of interests due to the common stake of Eskom in Distribution and Generation, will decrease.

**SALGA’s comment:**

SALGA is of the view that those Municipalities whose citizens were previously supplied by Eskom should hold shares in respect of Eskom assets that fall within their areas of jurisdiction.

3.6 The question arises as to how the shares attributable to Eskom’s contribution of assets to the REDs should be held. Our preference is for these shares to be held by national government rather than by Eskom itself, for three key reasons:

- because of the proposed governance arrangements for the REDs (see below) there is no intermediary role which Eskom might play which could not be played directly by national government;
- whether or not it is restructured, Eskom will be the transmission company and owner of generation in the sector, from which the REDs will in future purchase power and transmission access. Eskom’s involvement in a RED as shareholder would create a perceived conflict of interest in this regard; and
- similarly, we would expect that Eskom Generation may wish to establish a licensed retail business, to compete with the REDs for the business of large customers in the competitive retail market. Again, perceptions of conflicts of interest may arise if Eskom is also a shareholder in the REDs.

3.7 Under our proposed transition plan we raise the possibility that ownership of Eskom Distribution, following enactment of the Eskom Conversion Bill, could be transferred to the Holding Company. In this case the interest in the REDs deriving from Eskom Distribution’s assets would be retained by the Holding Company (effectively national government).
3.8 However, this matter needs to be dealt with sensitively, and this preference may be amended if discussions with lenders to Eskom show that the proposal is likely to have a significant adverse affect on Eskom’s credit rating. Equally it may be necessary to review the proposals for the ownership of Eskom Distribution during the transition period, prior to RED establishment if they are likely to restrict the ability of the remaining Eskom Generation and Transmission businesses to provide essential support to Eskom Distribution.

**Governance of the REDs**

**Recommendation 8: Each RED should be controlled by its own Board of Directors with the competence and skills to manage the business.**

3.9 We have considered whether the REDs should be controlled by competence-based or stakeholder representative Boards of Directors. International experience of stakeholder boards suggests that these are often ineffective decision-making bodies, and discussions in South Africa has confirmed the initial view that these should not be adopted for the REDs. Indeed there appears little enthusiasm for such boards among the EDI stakeholders themselves.

3.10 We recommend, therefore, that each RED should be controlled by its own Board of Directors, consisting of executive members, with the competencies and skills to manage the business. These should be complemented by non-executive directors, to oversee and challenge the executive management team on behalf of shareholders.

**Recommendation 9: RED board members should be appointed by shareholders.**

3.11 RED board members should be appointed by the shareholders (national government and municipalities), although we envisage that Holding Company would determine the initial appointments to be in place during the transition period until all assets have been vested in the REDs. NER should not be represented on the Boards of the REDs (even as an observer) as this may compromise its perceived independence.

**Recommendation 10: RED decision making should be through normal majority voting**

3.12 We propose that RED decision-making should be through normal majority voting, although, as we set out in Section XII, we envisage some restriction to this principal during the transition period, to ensure that the interests of minority shareholders and municipalities yet to be incorporated are not prejudiced.

**Legal status of the REDs**

**Recommendation 11: Each RED should be established as a company under the terms of the Companies Act**

3.13 We recommend that the REDs should be established as companies incorporated under the terms of the Companies Act, initially as wholly owned subsidiaries of the Holding Company. We believe it to be in the best long term interests of the electricity customer in
South Africa that the REDs are managed as far as possible as normal commercial entities, with strong commercial and regulatory incentives to bring down costs.

3.14 The main alternative approach would be to establish the REDs as statutory corporations under primary legislation. Any changes to the REDs’ constitution would also require legislation. A concern has been expressed, however, that this will make for potentially slow and ineffective decision making, to the ultimate detriment of the REDs, their customers and all their stakeholders.

**Accountability of REDs**

3.15 The REDs will be subject to a system of accountability in line with best international practice for the sector – specifically:

- the REDs will be accountable for their financial performance to their direct shareholders, namely central and local government, in line with their respective shareholdings in the business;

- the REDs will be responsible to their regulatory bodies (NER and MMSDs) for the fulfilment of all regulatory obligations, with respect to tariffs, supply security, service standards etc; and

- in addition, it is proposed that national government will hold a “Golden Share” in the REDs for a period, through which national government will retain residual rights of control over the REDs in respect of certain key issues, most notably ownership.

3.16 During the transition period, when the industry will operate under the direction of the Holding Company, the REDs will be accountable to the Board of the Holding Company.
### IV Asset valuation and transfer

4.1 If the REDs are to be owned by national and local government according to the assets and liabilities contributed, we need next to consider how those assets and liabilities are to be valued. Indeed, such valuations are required for four distinct purposes:

- to determine the fair compensation due to the current owners, in the form of shareholdings in the REDs;
- for the purposes of financial reporting, management accounting and internal control;
- for regulatory purposes, as an input to the setting of allowed revenues and hence tariffs; and
- for determining income tax allowances.

4.2 The recommendations on asset valuation methodology, treatment of liabilities (notably debt), and the arrangements for transfer of assets and liabilities to the REDs are as follows:

**Asset valuation**

| Recommendation 12: Assets should be valued upon transfer to the REDs on the basis of relative depreciated replacement costs (DRC) or discounted cash flow (DCF) depending on what is appropriate for the industry. |

4.3 The consortium has recommended that the assets of both Eskom and the municipalities should be valued, upon transfer to the REDs, on the basis of the relative depreciated replacement cost (DRC) of those assets. It will be for the Holding Company to determine whether this or an alternative valuation methodology, based on discounted cash flow (DCF) represents the more equitable and efficient way in which to value the industry.

4.4 DRC is an estimate of what the asset would cost to replace at today’s prices and technology, adjusted for the age of the asset and hence reflecting its remaining useful life. The consortium recommends this approach for two main reasons:

- under the proposed regulatory approach, it is equivalent to the theoretically correct approach. The correct approach to value any asset is always to do so on the basis of its future earning potential. This is most usually done through a “discounted cash flow” (DCF) method, which measures directly the difference between the future revenues and costs associated with an asset, to derive its present value. Under the regulatory approach proposed for electricity distribution, it can be shown that the DCF that a business will be allowed to earn under the regulatory controls will (on average, over time) be equal to the depreciated replacement cost of the assets that it employs. This is simply because the REDs will in future, be allowed to earn a total revenue that includes an allowance for its direct costs (energy purchases, transmission costs, etc.)
charges plus its own operating costs) plus an allowance to cover the depreciation on the replacement cost of its assets and a reasonable rate of return on those assets. The DCF of the RED’s cash flow will, therefore, be equal to the depreciated replacement cost of its assets at the outset; and

- it is the most practical option available. The proposed approach depends much less heavily on potentially controversial future forecasts of RED revenue and costs than does a DCF methodology. Indeed, given the above explanation of how a RED’s regulated revenue will in future be determined, a DCF approach will in any case require replacement cost asset values to be derived. The proposed approach will, nevertheless, be very data intensive and difficult to apply, but is in our view the easiest and most practical option open to us.

4.5 Two issues with respect to the application of “depreciated replacement costs” warrant brief summary here.

4.6 First, concerns may be raised that the proposed approach takes no account of future growth in the businesses of the respective asset contributors. The consortium believes that this is the correct approach in valuing the assets at the outset, for two reasons:

- if there is future load growth served by the existing assets, this will not result in an increase in the RED’s allowed revenue (other than to cover any incremental operating costs). The regulator will still only allow the RED to earn sufficient revenue to cover the replacement cost of the asset and a reasonable return on the assets. The prospect of future growth served by existing assets should not, therefore, alter the asset values of the asset contributors upon establishment of the REDs; and

- similarly, future growth served by the construction of new assets should have no effect on the valuation of existing assets contributed to the REDs. Under the proposed regulatory system, a RED will, when it constructs a new asset, be allowed additional revenue to cover the replacement cost of that asset, plus a return. When discounted back to today, that additional revenue will exactly equal the construction cost of the asset. Put simply, assets not yet constructed have zero value.

4.7 Second, consideration need to be given to how assets constructed to serve low-income customers, for whom prices will not rise to the full cost of supply, will be valued. As is discussed in the section of this report dealing with tariffs this is a key matter of policy. Our current understanding is that new electrification assets will, in large part, be funded from the Fiscus by the general tax payer. These assets would not, therefore, be allowed into the regulatory asset base of the RED, on which the RED’s allowed revenue would be derived. Such assets will be assigned a zero (or very low) regulatory value. It is for consideration whether existing electrification assets, constructed by Eskom and the municipalities to serve low income customers, should be similarly valued at the outset, or whether instead they should be treated as normal revenue generating assets. The consortium’s financial modelling has, to date, assumed the latter.
Recommendation 13: For businesses with good asset registers, depreciated replacement costs should be extracted directly from the registers; for other businesses, depreciated replacement costs should be estimated by proxy approaches. Current distribution undertakings need to be well defined, ring-fenced and audited to facilitate the transfer of assets and liabilities to the REDs.

4.8 As noted above, even the proposed “depreciated replacement cost” methodology will be data intensive and difficult to apply, in practice, to all of the assets of all of the current electricity undertakings in the EDI. If EDI restructuring is to proceed quickly and smoothly, a pragmatic approach will be required, involving some approximations and estimates of relative values. Work to derive the specific values and hence relative shareholdings of the parties under this approach will be undertaken as part of the implementation programme. Our recommendations are:

- for Eskom and municipalities with good asset registers, we propose that the depreciated replacement costs are extracted directly from the registers;

- for other (smaller) municipalities, we propose use of a proxy approach to ensure that they receive equitable compensation for they assets they contribute in circumstances where, for historic reasons, comprehensive asset registers have not been maintained. We recommend a proxy approach based:
  
  - on valuation and aggregation of individual network components using asset register information for most such cases. Under this approach standard equipment schedules, lifetimes and values would be developed and applied to the items in the asset register to determine the overall valuation; and

  - on a simple proxy indicator for other cases, especially for the smaller distributors, where asset register data is lacking. Under this approach a simple proxy value indicator would be derived (as simple as Rand/MWh), based on full asset valuation exercise on a sample of distribution businesses, and would be applied to determine the overall valuation. The principals of the proxy method should be acceptable by the affected distributors.

4.9 We recognise that this approach will inevitably be approximate, and will require support and flexibility from all parties if it is to be accepted as a pragmatic way forward. We have given some initial thought to what the simple proxy indicators might be – although the preferred method will need to be decided from the actual valuation exercises undertaken during implementation.

Treatment of liabilities

4.10 The principal liabilities that are likely to be transferred to the REDs by existing electricity undertakings are existing debts. Such debts could be transferred to the REDs in a number of different ways, including:
full transfer – the loan is assigned and transferred to the RED, with the full consent of the lender;

back-to-back arrangement – the loans are not transferred, but mirror debt instruments are issued by the RED to the municipality/Eskom that match the original loans, both in terms of cash flow and security against the assets of the business; and

refinancing/new debt – the existing debt is redeemed rather than transferred to the RED. The asset contributor is compensated with an equivalent amount of cash raised by the RED through new debt.

**Recommendation 14: Back-to-back loan arrangements in respect of existing loans should be the preferred outcome of discussions with existing lenders. The extent to which this may be implemented is highly dependent on the outcomes of a fundamental assessment of investor requirements.**

4.11 Any or all of these options can be employed, and all have the same ultimate effect – namely to transfer the debt service and repayment obligation to the RED. Discussions with lenders will be required during implementation to settle on the preferred approach. The second of the above three options would, in many ways be the simplest and easiest option to put in place, and is the approach which we recommend is taken to lenders for discussion. Lenders, in this case, would need to accept that a cash flow from the RED to the original borrower, and corresponding calls on the assets themselves in the case of default, represents adequate security (i.e. security equivalent to that which they currently enjoy). Some lenders may, however, insist on full repayment in the event of transfer of the underlying assets, in which case the third of the above options may need to be used to some extent.

**Recommendation 15: Liabilities transferred should be valued on the basis of book value or net present value.**

4.12 Other liabilities such as trade creditors and employee-associated liabilities are also to be transferred. In such event either the book value of the liability, or in the event of payments that are due only at some future time, the net present value of such liability, will form the basis for valuing these liabilities.

4.13 Whichever transfer route is chosen, asset contributors who also transfer liabilities/debt to the REDs will see a corresponding reduction in their shareholding (or “equity stake”) in the RED. The respective shareholding in a RED will be determined according to the relative net assets contributed by each of the existing undertakings in the sector. Respective shareholdings will therefore be derived by:

- calculating the depreciated replacement cost values of the assets contributed by each party;

- subtracting from that the value of the liabilities/debt transferred to the RED by each contributor, to derive each party’s relative net asset contribution; and
• calculating the total net asset value contributed, and expressing each party’s net asset contribution as a percentage of the total net asset value.

Transfer method

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<th>Recommendation 16: National legislation should provide the basis for the transfer of assets and liabilities.</th>
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4.14 There are two basic transfer methods that could be employed in transferring assets and liabilities to the REDs:

- a contractual approach, under which the RED would contract with each asset contributor for the assets and liabilities that it will acquire; and
- a legislative approach, under which national legislation would be passed to provide for the legal transfer of all assets and liabilities.

4.15 We recommend the legislative approach, as it is by far the more practical approach and is significantly quicker, simpler and less burdensome. It is the only realistic approach when networks are transferred: otherwise, thousands of landowners would have to consent to, or be given notice of, the transfer of wayleaves and servitudes. The legislative arrangements required to implement the proposed reform of the EDI are summarised in Part C of this Blueprint Report.
V Commercial and regulatory arrangements

5.1 We consider next the commercial and regulatory arrangements within which the proposed REDs will operate. The commercial arrangements relate primarily to the retail activities of the RED, while the regulatory arrangements relate to both their distribution network and retail activities.

Bulk electricity purchases

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<th>Recommendation 17: Prior to establishment of the wholesale market, municipalities and REDs should purchase energy and transmission by means of a regulated Wholesale Electricity Pricing System.</th>
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5.2 The arrangements for the bulk purchase of electricity must be clearly established at the outset, and apply to all REDs equally. In the initial years of the REDs’ lives there may not yet be a fully developed wholesale market established. During this initial period, therefore, it is proposed that the REDs would purchase energy and transmission by means of a regulated Wholesale Electricity Pricing System (WEPS). The WEPS contains separate energy and transmission components, should be controlled and regulated by NER, would be published, and would be transparent as to its derivation and composition. Any energy purchases made from embedded generation would be charged to customers at a cap equal to the regulated energy component of the WEPS.

5.3 The introduction of revised arrangements for the purchase of bulk electricity by municipalities and Eskom Distribution is not dependent on the establishment of the REDs, although the process would be easier, and we recommend that NER introduces the WEPS as soon as is practically possible.

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<tr>
<th>Recommendation 18: After establishment of the wholesale market, REDs should purchase energy from the market and should purchase transmission service according to the regulated arrangements.</th>
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5.4 In the longer term, it is envisaged that a wholesale electricity market will be established, comprising both some form of short term market in which REDs can purchase energy at short notice or on the day, and one or more longer term markets in which REDs can purchase under contract from a generator. Once such arrangements have been established, it is proposed that:

- the REDs will purchase their electricity from any or all of these markets as they wish;
- the REDs will purchase connection to, and use of, the transmission system from the transmission business, according to a regulated and published set of tariffs or other regulated arrangements;
- the REDs will be subject to a direct regulatory requirement to purchase their electricity efficiently, and hence have no absolute guarantee of being allowed to recover excessively high purchase costs from their customers; and
there would be controls in place, at least for a number of years, to limit cross-
ownership between generation and the REDs, at least until fully effective 
wholesale and retail markets are in operation.

Retail competition

**Recommendation 19:** Retail competition should be introduced as soon as is practically possible taking into consideration, amongst others, the skills and systems required to participate in such a market.

5.5 International experience has shown that competition in electricity retail can deliver benefits to consumers, and it is proposed that competition to sell electricity be introduced in South Africa – on a carefully controlled and phased basis. Typically competition is introduced first for a group of the largest customers, for whom energy purchases represent a relatively large proportion of costs. Retailers, distributors and consumers must all invest in appropriate metering and settlement systems and a phased approach allows the competitive arrangements to bed down before the market is expanded. Once experience has been gained with this group it may then be appropriate to extend the competitive market to a wider group of consumers.

5.6 Under such competitive retail arrangements the consumer would still be charged the WEPS price for the wholesale element of consumption and a regulated price to its host RED for use of the distribution network but would be free to chose a retailer to provide billing, metering and customer service activities.

5.7 The majority of a RED’s net income will be derived from the operation of the distribution network, with only a small proportion coming from the retail market, especially the market for the largest customers. In our view competition can therefore be introduced in this way, without threatening the financial position of the REDs. It can offer benefits to consumers by encouraging improved levels of customer service and better tailoring of price structure to the requirements of the individual customer. It is something which large industrial consumers in South Africa are eager to see.

5.8 We propose that competition for the retail of electricity to some final customers be introduced as soon as is practically possible after creation of the REDs taking into consideration, amongst others, the skills and systems required to participate in such a market, and that competition to retail electricity to all other customers in South Africa be phased-in subsequently. In our view, retail competition provides the best guarantee that the interests of the final customer are protected, that the quality and price experienced by final customers are the best achievable, and that the retail activities of the REDs are as efficient and customer-oriented as possible.

5.9 We recognise, however, that the REDs will not be in a position to compete effectively for a large part of their customer base for some considerable time. The consortium has indicated that internationally, the systems and processes required to operate in a fully competitive electricity market are complex and costly to set up. Equally, the call on management time is significant. Competition will, therefore, need to be limited initially to a small number of major customers, and the phase-in of competition to other customer groups will need to take place over an extended period.
Recommendation 20: Initially, retail competition should be limited to those customers with annual consumption exceeding 100GWh at a single site.

5.10 We recommend that, as soon as possible after establishment of the REDs, all customers with an annual consumption of 100GWh or more should be eligible to choose their retailer. This limit should be defined as a site-specific limit (i.e. customers cannot qualify by aggregation of consumption across several sites), and with respect to evidence provided to NER of consumption levels in the immediately preceding 12 months. We understand that this proposed limit, which has been recommended taking into account the capacity of the industry and consumers to undertake the necessary investment and develop rapidly the appropriate operating arrangements, will qualify some 150 customers for the initial competitive retail market. We propose that the timing of the introduction of competition to this initial tranche of large customers be determined by the Holding Company so as not to place an undue burden on the REDs immediately following establishment, when their focus will be on integrating their endowments.

Recommendation 21: Regulatory rules and obligation should be established to operate the competitive retail market as summarised below.

5.11 A number of important regulatory rules and obligations will need to be established in order to operate this competitive retail market. Most importantly:

- any retailer wishing to sell to these contestable customers will need to apply to NER and be granted a contestable market retail licence. We propose that all REDs be granted such a licence at the outset, and that the only businesses that would be disallowed from holding such a licence would be the Holding Company and, once it is created as a separate company, Eskom Transmission. We note that a large consumer can itself apply for a licence to supply itself, and that Eskom Generation can also apply for a licence, to be held by a separate Eskom retail business, operating at arms length from the generation business; and

- any retailer would be required by licence to purchase bulk energy at the WEPS, to pay transmission charges (if separate from the WEPS) and, critically, to pay a regulated distribution charge to the host RED of the customer being supplied, in respect of the connection to, and use of, the local distribution system by that customer.

Recommendation 22: Existing contracts with special terms should be fully honoured through arrangements summarised below which will not place REDs at a disadvantage.

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5 As explained later, the financial viability of the REDs is protected as REDs receive payments for use of their distribution system regardless of which retailer is chosen.

6 There should be a right of appeal to NER, which may consider aggregation in certain exceptional cases (e.g. Spoornet).
5.12 A number of the largest electricity customers in South Africa are currently supplied under contracts that contain specially negotiated terms. This applies to customers both above and below the proposed 100GWh threshold. It is important, in our view, that these arrangements are fully honoured within the context of the EDI reforms. We are also keen, however, that these arrangements do not hinder or prevent the emergence of a competitive market for the over 100GWh customers. We propose, therefore, that:

- customers with such special terms below 100GWh should be supplied by their host RED on precisely those agreed terms, and that RED should in turn have a contract in place with Eskom Generation which provides back-to-back arrangements with respect to that customer; and

- customers with such special terms over 100GWh should be free to select their retailer, but the selected retailer will be guaranteed a back-to-back contract with Eskom Generation that provides supply to that retailer on the same terms as currently agreed with the customer in question. It will, of course, be for competing retailers to offer any further enhancements to those terms that they wish, as part of the normal competitive process.

5.13 We have not, at this stage, sought to advise on the appropriate timetable for the competitive retail market. As noted above, we consider that the first tranche of retail competition to some 150 contestable customers can be introduced as soon as possible after RED establishment at a time to be determined by the NER. However, we are concerned that a significant increase in the number of contestable customers will impose a large systems and process change burden on the REDs that they will be unable to manage until the REDs have been firmly established as integrated operating businesses. Our preference, therefore, is to leave the decision on further retail market opening to NER, who should make an assessment of the readiness of the REDs to establish and compete in such a market at the time. We recommend that NER should be required to report on the next tranche of retail competition within three years of RED creation (and annually thereafter), and should give the industry reasonable notice of any extension of the market.

Recommendation 23: The NER should determine the timing of the initial tranche of retail competition and the timing of any subsequent tranches, giving reasonable notice of any extension of the contestable market.

Regulatory framework

Recommendation 24: The future regulation of the EDI should be through a combination of local and national arrangements: the municipalities should exercise their constitutional role through a service delivery agreement (SDA) with the RED; the NER should exercise its role through licences issued to the REDs based on applicable national legislation.

5.14 The future regulation of the EDI will be founded on a complementary set of rights, obligations and controls, applied through a combination of local and national government arrangements. This will be designed to balance both the constitutional role of local government in local electricity supply, and the requirement for overall consistent regulation of the sector by NER at a national level. We propose that:
it would be preferable that, through the vehicle of Multi-jurisdictional Municipal Services Districts (MMSDs), municipalities should enter into a Service Delivery Agreement (SDA) with the RED in their area. In this arrangement, the SDA will require the RED to prepare and submit the following documents annually for approval by the governing body of the MMSD in their area:

- an electricity distribution development plan (including an operating and an investment plan). The RED will be required to ensure that these plans are consistent with the integrated development plans for the area and to facilitate co-ordination with the municipal planning process. The SDA will also require that these plans are consistent with the technical requirements for operating and planning distribution systems specified in the RED’s licence;

- policies in the area of credit control, debt collection and customer management. In preparing these policies the RED will need to comply with the generic provisions set out in the Municipal Systems Bill and to ensure consistency with any licence conditions and national standards;

- tariff policies and electricity tariffs. These will have to be prepared in accordance with the licence conditions (see below), and any national policies or national legislation in this regard. To the extent that the RED has flexibility in the level of tariffs which it sets, it will be required to address specific local requirements; and

- performance indicators and targets. Key performance indicators will have to be consistent with the RED’s licence conditions, and any national standards or national legislation in this regard. The RED will be required to monitor and report to the MMSD in respect of these indicators;

NER will regulate the REDs through licences, issued to the RED for specific activities over which NER will exert control on a consistent basis. Specifically, the following licences will be issued by NER to the REDs:

- a distribution licence, to regulate the REDs’ monopoly distribution network activities and prices;

- a captive market retail licence, to regulate the REDs’ monopoly retail activities and prices with respect to customers who are unable to select their preferred retailer; and

- a contestable market retail licence, to place a limited set of controls on the activities of a RED and any other retailer with respect to customers in the competitive retail market.

5.15 The regulatory roles of Local Government and the NER must be clearly defined to avoid overlap or conflict.
Longer term regulatory controls

Recommendation 25: NER should exercise its control of the monopoly activities of distribution and captive market retail through the issue of licences which place significant obligations on the REDs, as summarised below.

5.16 The key proposed features of the above three licences are as follows:

- the distribution licence will control the prices charged and services provided by the RED’s distribution business. Specifically:
  - universal service obligation – the licence will contain an explicit obligation on the REDs to provide, over time and to an agreed programme, universal service of connection and electricity supply to all users in its designated area. This will include an explicit obligation to provide for the basic needs of all users in the area and to offer access to grid and non-grid supplies;
  - low-income households – the licence will contain specific provisions with respect to the protection of low-income households, including obligations to develop and implement poverty tariffs in accordance with government policy;
  - total revenues will be controlled through an incentive regulatory regime which will specify an allowed revenue to which the RED must adhere. This allowed revenue will be fixed for a regulatory period initially of three years and thereafter of five years. The allowed revenue will be set to recover the NER’s view of the operating costs which the RED should incur, operating efficiently over the regulatory periods, plus an allowance for depreciation on the gross book value of the regulatory asset base (RAB) and a reasonable rate of return on the net book value of the RAB of the distribution business. Accordingly, during each regulatory period the RED will have strong incentives to control costs and to retain any resulting additional profit;
  - the price structure (i.e. the way in which total allowed revenues are recovered from different customer groups) will be controlled by requiring licence holders to comply with NER’s tariff methodology when setting distribution use of system charges;
  - distribution access and connection terms will be regulated by the NER approving standard Distribution Connection Agreements (DCAs) and Distribution Use of System Agreements (DUOSAs). REDs will be required to enter into these agreements with any third party connected to their systems. Amongst other conditions, these agreements will require REDs to provide non-discriminatory access to their distribution systems. NER would have power to determine in disputes over the terms of the agreements; and
supply and service quality will be controlled through a specified list of service standards to be achieved by the RED over the period, supported by financial penalties, at least some of which will be paid by the RED to its customers directly in the event of failure by the RED to meet those standards. We would expect these standards to be set with regard to the stage of development of the REDs, and hence to become progressively more demanding over time until satisfactory levels of performance are achieved;

the captive market retail licence will control prices and service quality in the retail of electricity to customers outside the competitive market. Specifically:

the total revenue recovered from such customers will be controlled to equal the total costs incurred by the RED retail business in the purchase of generation for these customers, in the purchase of transmission and distribution services from Eskom Transmission and the RED’s own distribution business respectively, and an allowance for the retail business’ own costs (for metering, billing, customer service, etc). These businesses will be allowed to earn a small margin over their operating costs;

the price structure (i.e. the way in which total allowed revenues are recovered from different customer groups) will be controlled by requiring licence holders to comply with NER’s tariff methodology when setting final tariffs for captive customers; and

supply and service quality will again be controlled by a small list of specified service standards, supported by financial penalties for non-compliance;

Recommendation 26: NER should exercise its limited control of the competitive activity of contestable market retail through the issue of licences which place minimum obligations on the licensee, as summarised below.

the contestable market retail licence will place a minimal list of obligations on the RED, which will be precisely the same as all other retailers in this market, with one exception. Specifically:

the licence will apply no price controls on customers in this market;

the licence will require the holder to purchase electricity and transmission at the WEPS;

the licence will require the holder to pay the host RED a distribution charge for use of the distribution network;

the licence will require the holder to enter into Contestable Market Retail Agreements (CMRAs) with its contestable customers and to
comply with the Contestable Market Retail Code approved by the NER; and

– the RED’s licence (but no other) will require the RED to be the “retailer of last resort” for contestable customers in its geographic area.

Transitional regulatory controls

**Recommendation 27: Temporary regulatory arrangements, as described below, should be contained in a temporary licence issued to each RED for which would expire no later than two years after the end of the transition period.**

5.17 The long term regulatory arrangements outlined above, in our view, cannot be implemented at the outset. Upon creation, neither the REDs nor NER will have available data of sufficient reliability to set allowed revenue controls of the sort envisaged above. Equally, the REDs will not have in place the expertise, financial systems and management processes to enable them to operate within an incentive based regulatory system of this sort. It is unlikely that they will have, at the outset, the means to ensure adherence to any agreed overall allowed revenue limit or to attain a consistent standard of service across the area served by the RED. Some transitional regulatory arrangements will therefore be required.

5.18 We propose a very simple form of regulatory control over the monopoly elements of the REDs for an initial period covering the transition phase of RED establishment and extending for up to two years thereafter. This will be contained in a transitional licence which will be issued to each RED on creation and will be coterminous with that for each of the other RED. The transitional licences will terminate on a date to be determined by the NER, which should be no later than two years after the establishment of the final RED. During this transitional period:

- the REDs will be required to account separately for any contestable market retail activity. REDs will not be required to account separately for distribution and captive market retail activities but the licence will require them to formulate and implement a plan for establishing the “end state” separate accounting requirements;

- technical and customer service regulation will focus upon ensuring that the quality of service does not deteriorate during the transitional period. REDs will be required (as at present) to report on standards achieved in each area currently served under a separate licence and will face fines for a drop in supply or service quality;

- tariff regulation will be applied by direct control of annual changes to tariffs inherited by the REDs. Regulation will focus upon providing a simplified form of control which allows REDs to earn revenues. Specifically:
  - tariffs will be adjusted annually for changes in the CPI, changes in the WEPS and in line with annual adjustments required by the financial transition strategy; and
– REDs will be allowed to rebalance tariffs subject to demonstrating to the NER that rebalancing leaves the RED revenue neutral, is a step towards meeting the “end state” tariff methodology and meets any constraints set by the NER regarding the annual real increase in any individual tariff.

**Recommendation 28: The incentive-based regulatory system should be set, initially, for a three year period and, thereafter, for five year periods.**

5.19 We propose that these arrangements remain in place for a transitional period, during which time NER and the REDs can prepare their data, systems, processes and develop expertise for the longer term regulatory regime. Furthermore, we recommend that the incentive-based regulatory system introduced at the end of this initial period is itself set only for a three year period, in order for both the NER and the REDs to learn how to operate in such a system. A full five year regulatory period can then be started no later than five years after the establishment of the REDs.
VI Tariffs and levies

Principles

Recommendation 29: Tariff and levy recommendations should be consistent with three important principles: cost-reflection; affordability; and transparency, as summarised below.

6.1 Our recommendations on tariffs and levies have been prepared on the basis of three important principles that, if followed, will be in the long-term interests of the electricity customer in South Africa. Specifically:

- electricity tariffs should, in the long-term, reflect as closely as possible the underlying costs of supply for the majority of customers. This will ensure that customers make rational decisions on electricity consumption, and that the correct levels of resources are, over time, dedicated to electricity supply in South Africa. This is consistent with the Energy White Paper;

- considerations of affordability of electricity should be taken into account, in both the short and longer-terms. Any required tariff adjustments should be introduced in a phased manner, in order to give customers the opportunity to respond and adjust behaviour accordingly. Equally, electricity supply to very low-income households will need to be held below full cost-reflective levels in the medium/long-term, for social development reasons. This is a critical element of government policy, and the REDs will be placed under an explicit regulatory obligation to offer “electricity basic services support tariffs” to poor households; and

- any levies or cross-subsidies should be made explicit and transparent. Customers should see the effect of any such levies on their bills and should understand their purpose. Similarly, the REDs should be required to account for all levy payments separately, and NER should ensure compliance with these transparency requirements.

6.2 Adopting a policy of introducing cost reflective tariffs ensures that consumers are charged directly for the resources they consume and that the industry has the financial resources to maintain and develop the network. Where tariffs are set below cost reflective levels consumers may consume wastefully. In addition the balance of costs must be met from other sources: either other groups of consumers or the general taxpayer. The former approach will require prices to exceed costs for some consumer groups and, if this cross-subsidy is borne by industrial customers, it will compromise their ability to compete internationally and restrict the flow of foreign direct investment into South Africa, to the detriment of economic development.

6.3 If the shortfall is of tariff income is funded from general taxation, either local or national, the ability of the industry to maintain its network and invest to meet the objectives of government social development policy will be dependent on continued external support. This support may be withdrawn according to the state of government finances and this will
make the EDI less attractive for investors, thus making it harder for the industry to raise the funds it requires for development.

6.4 For these reasons we recommend that cost reflectivity be adopted as the basis for determining tariffs in the EDI, although, for social development reasons, cross-subsidies will be required to support the basic needs of poor customers who are unable to afford the full price.

**Tariffs**

6.5 We have undertaken a brief review of current tariff levels in the sector, in order to understand the extent to which they reflect the underlying costs of supply. Unless they do, on average, the REDs will not face the prospect of long-term future financial viability. There are two main components to the cost of supply:

(a) a **generation and transmission** component covering the production and transport of bulk electricity – if bulk supply charges, and retail prices, do not cover this cost there is the danger that generators and transmission operators will not be able to fund the capacity necessary to replace old assets and meet the requirements of load growth, leading to system instability and, ultimately, to demand exceeding supply; and

(b) a **distribution and retail** component representing the revenue required by the RED to maintain its asset base, meet its operating costs and earn a reasonable rate of return on its assets – if retail tariffs do not allow recovery of this revenue the network, quality of supply and the standard of customer service will all decline and, additionally, the sector will not be seen as attractive to investors and lenders.

6.6 To assess the generation and transmission component of the cost of supply we have used estimations of the WEPS price provided by Eskom, and accepted by the NER. To assess the distribution and retail component we have assessed the revenue requirements of the RED taking account of operating costs, current cost depreciation and a commercial return on the asset base. This is the standard approach used internationally within an incentive based regulatory regime, and mimics the approach which we recommend that NER adopts in setting distribution and retail prices within the reformed EDI.

6.7 The findings from the EDIRC’s assessment of tariff levels can be summarised as follows:

- **domestic tariffs** appear currently to fall significantly short of our initial estimates of their fully cost-reflective levels. Our assessment indicates that this may be by as much as 50% or more, when assessed against current cost levels in the sector;

- **commercial tariffs**, using the same criteria, on average, appear to fall short of cost-reflective levels by some 15%.
• **industrial tariffs**, using the same criteria, on average, appear currently to exceed cost-reflective levels by some 5%; and

• **agricultural tariffs**, using the same criteria, on average, appear to fall short of current estimates of the full supply cost on average by around 15%.

6.8 The EDIRC’s findings on current tariff levels are a critical element in the proposed reform of the sector, and should be fully understood. Their analysis shows that, at current levels of cost and efficiency, domestic tariffs fall short of fully cost reflective levels by over 50%, attributable to both the generation / transmission and the distribution / retail components of the price. Without EDI reform, therefore, there is a requirement for tariffs to be increased and rebalanced if the industry is to be placed on a firm financial footing that will allow it to fund its ongoing development without resorting to external fiscal support. This underlines the point that the current financial state of the EDI is unsustainable and that structural reform is necessary to avoid further deterioration of services. By contrast the fact that industrial tariffs currently exceed cost reflective levels indicates that some businesses in South Africa may be being put at a competitive disadvantage by being charged prices which are higher than they need be.

6.9 Costs of service in the sector will fall over the next 10 years as load growth (and hence load density) improves, but the consortium estimate that domestic prices would still need to be around 40% higher (in real terms) by 2010 than they are now, in the absence of EDI reform.

6.10 Creation of REDs, as part of the reform of the EDI, can serve to lessen significantly the extent of this required tariff adjustment. Once established, the REDs have the capacity (and will be incentivised) to achieve significant improvements in cost efficiency, loss reduction, improvements in revenue collection, and achieve growth in total load served in an efficient manner. There is doubt whether such improvements can be achieved within the EDI as it is currently structured. We estimate that, by the end of the first ten years of the REDs’ lives, the required extent of domestic tariff increases will have been reduced from 40% to some 22% or less under our preferred six RED option.

6.11 It is important to realise, therefore, that the process of EDI reform is not a direct cause of the tariff increases that will be required to ensure the industry is placed in a sustainable financially viable position: it only accounts for part of the increase. On the contrary, the reforms will allow the exploitation of economies of scale and efficiency improvements which will substantially mitigate the increase in tariffs which would otherwise be required. Equally it should also be borne in mind that tariffs for industrial customers are expected to fall by around 16% as a consequence of EDI reform so aiding industrial development and international competitiveness.

6.12 Any such tariff adjustments will, of course, need to be phased over a number of years, consistent with the second of the above principles. The specific proposals, on the phasing of the required tariff adjustments are summarised in the next section of this report.

6.13 Our initial financial analysis of the proposed REDs has also been undertaken on the basis of the following policy assumptions;
Recommendation 30: Prices to poor income residential customers should be subsidised to levels below the fully cost reflective level and be affordable to the targeted customers.

Comment:

*There is a difference of opinion on the issue of effecting this subsidy. One view being that there should be a cross subsidy within a RED, and the other being through a national allocation (“equitable share”). Alternatively this subsidy could be carried by the total industry.*

- poor income residential customers should continue to enjoy subsidised prices for the foreseeable future.
- all negotiated special arrangements on tariffs for a number of larger industrial and commercial customers should be honoured in full until their expiry.

6.14 Reform of the EDI must take place in a way which places the needs of poor consumers at its heart and supports rural development. For this reason the Holding Company will establish a task team to make recommendations to the Department of Minerals and Energy as to precisely how the basic needs of poor customers will be met, insofar as they relate to electricity. Two broad options exist:

- a cross-subsidy to poor customers, both those connected to the grid and off-grid supplies, funded by other electricity consumers; and
- a direct contribution to the finances of the REDs by way of an allocation from equitable share which is paid to municipalities to support the cost of provision across a range of services to poor families.

6.15 The working group will need to consider the options around the level of the basic service to be provided and its proposed recipients. Initial proposals have included the allowance of 50kWh per month for all families. It will also need to consider the options for funding the basic allowance, including the fiscus and cross subsidy from other consumers within a RED. It will then carry out a pilot exercise before making final recommendations as to how the scheme should be introduced on a national basis, and will manage the implementation of the social support tariff thereafter.

6.16 The recommendation to subsidise prices to low income residential customers will need to be operational in a way which, as best as possible, ensures that all low income households benefit, but that the subsidy is not made readily available to other customer groups. Options for doing this are discussed in Volume VI of the consortium’s main report. They recommend the following mechanism:

- for residential supplies below 40A, only a single-rate tariff structure should be available. Subsidised single rate tariffs should be calculated for each amperage option. The charge for each option should be set so that the price for the lowest amperage supply option is subsidised, and the price should increase (and hence the subsidy decrease) progressively as the amperage of the supply increases; and
• all residential customers whose service is rated above 40A should be offered two tariff structure choices: a subsidised single-rate tariff or a two-part tariff. Although subsidised, the single-rate charge will be higher than the variable charge of the two-part tariff so that above a single level of monthly consumption, the two-part tariff will be more economical than the single-rate tariff. No customer should be allowed to switch between tariffs more than once per 12 month period.

6.17 Customers who wish to upgrade their supply to a higher amperage should be required to pay the full incremental cost of doing so.

**Levies and subsidies**

6.18 We propose a mechanism to deal with tariff support to low-income residential customers and the maintenance of a levy on electricity sales to ensure that the finances of local government are not compromised by the EDI restructuring process.

6.19 **Low income residential cross-subsidy.** The cross-subsidy will be used to provide tariff support to low-income residential customers that will be funded by charging a premium on all customers within a RED region. Elements of this cross-subsidy will remain even if some portion is funded from external sources under the proposals to be developed by the Holding Company. The need for this cross-subsidy arises from three related issues:

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<tr>
<th>Recommendation 31: Geographical differentiation of tariffs within REDs will be subject to regulation via the SDA’s and the NER; it being recognised that the existing geographic initial differentiation will have to be balanced or standardised over a period of time.</th>
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• **differences in supply costs within customer categories:** there are inevitable differences in the costs of serving customers within any definition of a customer category, according to their geographic location, load characteristics, etc. This is most marked in the domestic sector in South Africa, where differences in average supply costs to urban and rural domestic customers differ significantly. We recommend that, for the foreseeable future, this difference in underlying cost (primarily distribution related) should not be reflected in the tariff structures of a RED. We recommend that the REDs should move to a single domestic tariff for all but the low-income customers – with the effect that customers in rural areas are subsidised in part by urban customers. To do otherwise would place further financial strain on rural customers, many of who will anyway qualify for the electricity basic services support tariff relief; and

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<th>Recommendation 32: Most or all of electrification capital costs should be funded through the fiscus.</th>
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• **electrification:** significant new electrification remains yet to be done in South Africa. It is estimated that a programme of some 2.5 million households will need to be connected over the next 10 years or so – at a total capital cost of around R1 billion per year. Work is currently underway within Government
to establish the National Electrification Fund (NEF), as the mechanism to implement Government policy to fund most or all of the new electrification capital costs from the general taxpayer. We fully support this approach, but recommend that the REDs be provided with a pre-fixed sum from the fiscus for each new connection, in order to give REDs an incentive to implement the programme at least cost and efficiently. The level of support should be determined taking into account the balance between the numbers of lower cost urban and higher cost rural connections which will need to be made. Any planned shortfall between the allowance from the fiscus and the expected costs of electrification would be covered as part of the tariff support to the electrified customers. The essential planning for the electrification programme will be undertaken under the direction of the Holding Company with specialist resources transferred to it from Eskom and the Municipalities. The programme of new connections will be managed by the REDs and operating costs will be met by tariffs to new customers, with any shortfall being covered by the subsidy mechanism provided for above;

- **subsidies to poor customers:** as noted above, it is proposed that poor customers should benefit from subsidised prices, and that rural customers should also be shielded from very high distribution system costs in remote rural areas. As more electrification is undertaken, the number of customers benefiting from these policies will rise, and hence the financial shortfall to the REDs will also rise.

### Local government levy

6.20 The local government levy will be used to recover funds for local government, in recognition that the electricity sector currently represents a significant source of cash with which many other local government services are funded in part. The initial estimate of the size of these cash transfers is some Rand 2.4 billion per year. Data is not readily available due to the fact that electricity businesses of municipal distributors are not ringfenced entities. This is based on an estimate prepared in 1996 by NER (of some Rand 1.4 billion), which the consortium have adjusted for general inflation (to give some Rand 2 billion) and added a further 20% contingency allowance.

6.21 It is argued that more funds are required to cover the “stranded costs” associated with local government overheads currently shared by the electricity sector within a municipality. These costs will, however, be fully funded by the estimated R2.4 billion (it is for the municipalities to decide whether to spend that cash on maintaining existing overheads as they do now, or release the funds for other uses), and so no further funds are required. In this regard, the R2.4 billion may be an overestimate of the sum required.

6.22 We should also stress that the proposed levy may not be set to recover the full R2.4 billion. To the extent that local government receives income in the form of dividends as shareholders in a RED, this should reduce directly the sum to be raised from the proposed levy. It should, however, be stressed that the consortium has not carried out a detailed review of the precise transfers between local government and the EDI but has developed its recommendations so as to ensure that municipal finances are not affected by the EDI restructuring.
Recommendation 33: Local government income from electricity, consisting of income from a levy and dividends, should continue at current audited levels. Any variation in this income will be subject to any legislation that determines otherwise.

6.23 Our recommendation of a levy as the means to maintain a flow of funds to local government is in line with the Energy White Paper. It should not, however, remain in place indefinitely in our view. Local government should ultimately seek to place their financial position on a sound footing. A levy on electricity consumption is an inefficient means of raising tax revenue, as it will serve to distort electricity consumption, and promote an inefficient allocation of resources in the energy sector – to the ultimate detriment of customers and taxpayers alike.

6.24 Our preference is for local government income from the levy to be capped at current audited levels for the first five years of the lives of the REDs and any further levy from electricity sales should be reviewed after this period. This is done on the basis that the value of local government income from both the levy and any dividend income is capped at Rand 2.4 billion (and indexed for general inflation) during the first five years. We also see some merit in the alternative option involving capping the value at a percentage of the electricity price and phasing local governments’ levies to this percentage level and recommend that the Holding Company consider this alternative before finalising the approach.

Recommendation 34: The local government levy or charge on electricity should be applied as a percentage of all customers’ bills. Any exemption or offset of this levy for certain categories of customers will be subject to policy considerations.

6.25 We recommend that the local government levy or charge be applied as a percentage of electricity bills. In general, the levy or charge should be applied to all customers except poor households. The majority of large customers do not currently contribute to local government funding. It is a matter for government policy decision whether any such exemption should continue to apply and for how long. One approach, which we would favour, would be to phase-in a contribution to local government funding from such large customers, possibly in association with the introduction of competition to retail to such customers.

6.26 We recognise, however, that matters relating to the scope and level of the local government levy, including those customers to whom it should be applied, are matters to be determined by the Department of Provincial and Local Government, and are, as such outside the scope of the blueprint report. The consortium has made these recommendations to demonstrate that the restructuring of the EDI can take place without prejudicing the finances of local government and to present, for consideration, methods of funding local government which will not prolong unnecessary distortions to the operation of the EDI.
VII RED financial transition

7.1 We have prepared ten year financial projections for the proposed REDs, in order both to assess their potential future viability, and to derive the main elements of a transition strategy to move the businesses from their initial financial position to full viability in the future. The financial criteria, methodology, the underpinning assumptions, including data sources, and the projections themselves are described in the consortium’s main report, and summarised below.

Financial viability criteria

| Recommendation 35: To be financially viable and independent, a RED should be able to meet each of the financial criteria summarised below, while charging prices which reflect the long run costs of supply under reasonably efficient operation. |

7.2 We need first to understand the criteria by which a RED will in future be judged as to its financial viability. In our view, for a RED to be financially viable and independent on a sustained and long-term basis, it would need to meet each of the following criteria while charging prices in line with the long run cost of supply under reasonably efficient operation. The RED should:

- generate sufficient cash to meet all efficiently incurred operating costs;
- undertake sufficient capital expenditure to meet load growth and replace existing assets (approximately equivalent to investing each year the amount of the depreciation charge on current cost assets);
- meet all debt service and tax obligations in full;
- yield a return on equity invested commensurate with the risks in the business; and
- maintain gearing at levels acceptable to lenders (we estimate gearing should not exceed 70%), and maintain an acceptable interest cover ratio (we estimate the cover ratio should exceed 2).

Methodology

7.3 The consortium’s financial projections have been prepared using a financial model of the REDs which has been built for this purpose. The model takes financial data collected for each existing distribution undertaking in the country, and aggregates those data for any chosen RED configuration, to provide an estimate of the initial financial position of each RED. Projections of the financial position can then be derived, reflecting a range of input assumptions as to future system customer and financial parameters. These financial projections are produced in the form of a full suite of projected financial statements for a 10-year period.
Key assumptions

Recommendation 36: The key assumptions used to project financial performance of the REDs should be as summarised below. Importantly, tariffs should be assumed to move to cost-reflection following paths summarised below.

7.4 The full range of input assumptions that underpin the financial projections are described in Volume VI of the consortium’s main report. The assumptions of greatest importance is the rate of assumed tariff transition. A number of options are outlined in the cited volume. As already noted, with no reform of the EDI domestic tariffs would need to increase by over 50% immediately, or by 40% by 2010. The benefits of reform over the next 10 years could, however, reduce this required rise to just 22% or less. We anticipate, by contrast, that prices for industrial customers will fall by around 16% over the same period. Rather than an immediate increase in tariffs followed by large and real reductions thereafter, our preference is to smooth the tariff adjustments. Our financial projections have been prepared on the basis that the tariff adjustment over the next ten years for domestic customers is achieved through a combination of:

- average real price increase to domestic customers of some 8% in each of the first five years; followed by
- average real price reductions of some 3% in each of the subsequent five years.

7.5 We highlight our other key assumptions below:

- **poor household prices**: prices to poor households are assumed to be subsidised;

- **electrification funding**: national government is assumed to provide the majority of the funds to meet the capital costs of an electrification programme of some 350,000 new connections per annum over a period of 10 years to eradicate the current backlog of 3.2 million connections and the 1.7% household growth per annum over this period;

- **local government funding**: all customers (with the exception of those over 100GWh and poor households) are assumed to pay a levy or charge for local government, to raise R2.4bn per year (in year 2000 prices);

- **operating costs**: each RED is assumed to incur restructuring costs of some R80 million in each of the first five years (i.e. total of R400million). Underlying operating costs are assumed to fall at a cumulative real rate of 2% in each year from 2002 to 2005, and 3% per annum thereafter; and

- **cost of capital**: it is assumed that the REDs can raise additional debt (up to a gearing of 70%) at a cost of 1.5 percentage points above the rate on government long bonds. It is also assumed that the REDs should target to yield a return on equity employed in the business of 4 percentage points above the cost of its debt.
Financial projections

7.6 The financial projections show a transition to financial viability for each of the REDs by around the end of year five, on the basis of simultaneous establishment of each RED.

7.7 Over the first five years of their lives, however, each of the REDs falls short of the financial viability criteria in a number of important respects. While each RED is projected throughout this five year transition period to generate sufficient funds to meet the costs of restructuring, to fund on-going operation, and to meet debt service obligations:

- dividend payments to shareholders are zero or very low initially, and only begin to rise towards target levels for most REDs by years four and five;
- few of the REDs are able to meet their full target capital expenditure programme (as defined above) in the early years; and
- all of the REDs require new debt funds to meet the rising capital expenditure over the first five years. For most REDs, this involves an increase in gearing from initial inherited levels of between 40% and 50%, to levels between 60% and 70% by year five. No RED, however, exceeds the ceiling 70% gearing.

7.8 Our projections assume the simultaneous creation of all the REDs by way of a single transfer, rather than the phased establishment process, described in more detail in Section XI. We believe that, since the majority of the assets will be transferred into the REDs from the outset that our medium term assessment of financial viability remains valid, although the Holding Company will need to carry out detailed financial analysis to determine the preferred phasing of RED creation during the transition period.

Transition options

7.9 The consortium has carried out its tariff and financial analysis with a view to establishing the set of measures that will bring the EDI swiftly to independent financial viability and ensure that REDs have the resources to meet their WEPS charges in full. The target measures of financial viability have been derived to ensure that the REDs are able to deliver high (and improving) levels of reliability and customer service while at the same time being attractive to investors and lenders. The initial analysis indicated that domestic tariffs are currently significantly below the levels needed to meet those objectives and that, within the current structure of the EDI, many distributors are neither able to meet their capital investment requirements nor earn any real return on their assets.

7.10 The RED financial projections are founded on the need to move to cost reflective tariffs and the consortium has proposed a range of measures to ensure that this can be done without the need to resort to external assistance. Some increases in tariffs, especially for domestic customers are likely to be necessary, but these could, potentially, be mitigated by compromising on some of the financial viability criteria set out above. In addition some additional measures could be considered as a way to smooth the path to financial viability and to ensure that the REDs are more financially balanced. We set out below some of the further measures which may be considered, and some of their implications.
7.11 The distribution and retail component of the price is driven by a number of factors including: the extent of annual improvements in operating efficiency, and, in terms of the asset base, the rate of return earned on it, its life, the extent to which it is maintained. The pace with which electrification is carried out will also affect both the operating costs of RED and the extent of the required cross-subsidy from other consumers (in the event that this model is adopted to address the implications of capped tariffs for poor customers).

7.12 Further implications for the RED cost structure are derived from its opening balance sheet net debt position and its dividend policy.

7.13 The main mitigating measures against tariff increases which could be contemplated include:

(a) **raising the target for operating cost improvements.** We have assumed a relatively conservative (by international standards) operating cost improvement rate of between 2 and 3%. Operating costs represent around 33% of the cost reflective domestic tariff in 2001: if the rate improvement was raised by around 1% per year the cumulative impact (around 10.5%) might reduce the end state tariff increase for domestic customers by up to 4% (ie. an overall increase of 18% instead of 22%);

(b) **adjusting the allowed rate of return on current cost assets.** We have estimated the commercial return that shareholders would seek for investments in the EDI as giving a weighted average cost of capital of around 7% in real terms. If this were to be reduced by 3% then the reduced revenue requirement that this would entail could reduce the required end state tariff increase by around 6% (ie an increase of 12% instead of 18%);

(c) **reviewing required capital replacement requirements.** We have assumed an asset life of around 25 years (across all assets) if this could be raised by around to 31 years, eg. by reviewing the asset lives of substation and line assets, the depreciation charge could be reduced by around a third. This could equate to around 4% of the end state tariff (ie. an increase of 8% instead of 12%);

(d) **economising on capital replacement.** A similar effect to that shown above could be obtained by reducing capital expenditure below replacement levels. The implication of this would be that the RED would be letting its network deteriorate, implicitly trading off customer service against tariff increases. This would also feed through to a lower return on current cost assets. We do not believe that this approach should be used except in extreme circumstances;

(e) **restricting the roll out of the electrification programme**: The electrification programme is at the heart of the EDI and has rightly been given prominence in the consortium’s work. It does, however, impose a burden on other consumers through the cross-subsidy required to maintain tariffs to poor customers at affordable levels. Limiting the roll out of the programme would therefore reduce the burden borne by richer domestic customers. Essentially this is a trade off of access for new consumers against price increases for existing consumers.
7.14 The above mentioned measures, or some combination thereof, could help to reduce the required tariff increases for domestic customers to around 6%, and bring about further reductions in tariffs for industrial and commercial customers, but their implications should be understood. For example:

- the industry is currently cautious over its ability to meet the efficiency improvements we have discussed;
- in reducing the allowed rate of return government will be accepting a return which would not fully compensate future potential commercial investors for the risks of the industry; and
- raising asset lives is not consistent with recent experience in South Africa.

7.15 International precedent does, however, exist for these measures in the context of distribution industry restructuring.

7.16 In addition, while the measures detailed above will help to reduce the burden of tariff increases felt by domestic customers (and increase the price savings to industrial customers) they do not directly support the viability of the REDs which will be influenced by:

- the speed at which cost reflective tariffs are introduced;
- the ability to exceed the cost efficiency targets set by the NER; and
- the debt service burden in relation to the operating cashflows.

7.17 We have, pragmatically, assumed that cost reflective tariffs are introduced over a period of five years and it will be a task of RED management to meet the NER’s targets. The consortium’s analysis indicates that all the REDs will be financially viable in the medium term. There remains the issue as to how to support the financially weaker REDs in the initial years and ensure that they reach independent financial viability at broadly similar times.

7.18 Financial transition options include:

- adjustments to the reduce the rate of interest charged on debt: implicitly a guarantee from national government that will allow a lower rate of interest to apply;
- an adjustment of the opening balance sheet debt position by reallocating debt between REDs. This may require the consent of lenders but the objective would be to ensure that any individual RED is not placed in an unduly strong or weak position as a result of the investment and borrowing decisions of its predecessor organisations; and
- restricting dividend payments to allow the development of cash balances.

7.19 Under a balance sheet restructuring, which would take place following the financial due diligence in Stage III of the project, debt would be transferred, from one RED to another
according to the recommendations of the Financial Task team of the Holding Company. As for the tariff transition measures, international precedent exists for such moves.

7.20 If, for example, it was felt that RED 3 was financially weaker than RED 1, then the Holding Company could issue new debt to RED 1. The Holding Company could then pass the cash received to RED 3, thereby allowing it to repay a portion of its existing debt early, thus reducing its interest payments, and allowing it to attain financial viability earlier. Similar restructuring could take place to the balance sheets of the other stronger REDs (4 and 2) to support the other weaker REDs (5 and 6). It would be for the Holding Company to determine the form and term of the debt, having regard to international and local financial market conditions.

Costs and benefits of EDI restructuring

7.21 The restructuring of the EDI will not be costless, indeed we have made a broad assumption that the restructuring costs for each RED could amount to around R80m per RED per year. These costs, however, need to be set against the benefits that will accrue from restructuring. These can be divided into two categories:

- the strict financial return to customers in the form of lower costs; and
- the developmental benefits derived from having integrated, well funded organisations that can undertake a range of activities that will underpin regional development.

7.22 We have made a broad estimate of the financial benefit from EDI restructuring. Comparing the anticipated restructuring costs in the REDs, estimated at R2.4bn over five years, and illustrative Holding Company costs of R1.4bn over five years, with the potential size of the efficiency gains from industry restructuring, up to 3% per year on operating costs of around R6bn per year, yields a net present benefit over ten years of around R5bn. Furthermore, we estimate that a one year delay in the restructuring would result in a potential loss to consumers of around R350m in price reductions foregone.

7.23 The development benefits cannot easily be quantified but include:

- improved inward investor confidence from dealing with a well structured EDI; and
- the multiplier effect from being able to implement investment projects sooner and more efficiently.

Data accuracy and future financial analysis

7.24 The data used by the consortium in this stage of the project has been drawn from a number of South African sources. These include the NER, for the municipal data, Eskom, for its own distribution operations and the WEPS, the NECC, for electrification data, and the Municipal Demarcation Board (MDB), for data relating to the new demarcation zones, which are the building blocks for the REDs. They represent the best available information at this stage in the EDI restructuring project.
7.25 As with any exercise of this kind drawing together data which has been prepared for various purposes, at different times and on separate bases has revealed some inconsistencies between sources. Anomalies include:

- differences between national population figures and those available, for demarcation zone level, from the MDB web site;
- household numbers between NER and MDB sources relating to electrification; and
- anomalies within the data provided by municipalities and available from the NER.

7.26 The consortium has not carried out a detailed audit of the data provided and it has been necessary to make minor adjustments to the raw data received to ensure greater consistency between sources. In addition it has been necessary to use estimations where essential data is not available eg. an allocation of Eskom customer service area sales to demarcation zones. Where this has been done the basis used has been clearly documented in the volumes of the consortium’s main report.

7.27 The financial model was populated with data provided by Eskom, in respect of its regional operations, and the NER for the municipalities. The base year for the data used was 1998 and these were updated to a base year of 2000 by incorporating the number of new connections in each municipality and Eskom region. All data has been used on a consistent basis throughout the consortium’s work to develop the RED boundaries and assess their financial viability. The consortium has expressed its confidence that any remaining anomalies will not have a material impact on the assessment of financial viability of the REDs or the determination of the number of REDs.

7.28 It should also be noted that the purpose of the financial analysis undertaken during this stage of the project was to confirm the viability of the various RED options under consideration. It is not intended that this work be the basis either for determining the final end state tariffs or the transition path by which tariffs for different customer groups in each municipality are rationalised. Nor is it intended that the financial values derived for each RED in these projections should be the basis on which shares in the REDs will be allocated.

7.29 In Stage III of the project the operational and financial data appropriate to each RED will be validated by a process of due diligence and audit, supervised by the Holding Company. This will involve:

- allocating the assets, liabilities and customers of Eskom to the REDs;
- identifying and auditing the financial and operational balances of each municipality, including their translation to a consistent accounting basis;
- confirming the current rate of connection, to both grid and non-grid supplies, and developing a RED specific electrification plan (in association with the Holding Company’s electrification planning team); and
identifying the incidence of poor customers who would qualify for a subsidised tariff.

7.30 In the event that the results of the due diligence and audit process differ from those anticipated in this initial Stage I work, the Holding Company will have the power to adjust RED boundaries and implement some combination of the measures described above to ensure that the REDs are created in a balanced way.
VIII RED human resources planning

8.1 Effective human resource planning and the need to communicate clearly the implications of change are at the core of the Electricity Distribution Industry (EDI) restructuring project. Only if proper provision is made for addressing the concerns of employees regarding the transfer of their employment and for dealing with the consequences of skills imbalances will the restructuring be successful. Employees are the lifeblood of any organisation and the capacity of industry to deliver high levels of customer service and technical quality of supply, before, during and after the establishment of the REDs, will be critically affected by the way the people management aspects of the transformation are dealt with.

8.2 The EDI restructuring initiative will have important labour and employment law implications for existing employers, the REDs as new employers and the employees themselves. We recognise that the human resource component of our work constitutes one of the most critical areas of the whole EDI reform project. The proposed reform will impact some 46 000 people, employed within approximately 480 organisations in the industry. Many of these have only recently experienced significant change, and there has been uncertainty over the future of the EDI for some considerable time.

8.3 A critical element of the new arrangements in the EDI is to ensure rapid and effective skills development, consistent with the emergence of an efficient, modern, world-class electricity distribution industry. We also recognise very clearly the uncertainties created for the workforce in the sector by a reform programme of this sort – uncertainty made worse by the lengthy debate that has taken place already over the future of the EDI. It will be important to bring certainty to the sector as quickly as possible now, and to ensure that the reforms have a clear strategy within them to effect the skills’ development that will be required.

Comprehensive Human Resources Strategy

| Recommendation 37: EDI restructuring should take place within the framework of a comprehensive human resources strategy encompassing: (1) the organisational structure for the REDs, (2) the basis on which staff will be transferred, (3) development of specific solutions for key issues such as terms and conditions, organisation design and training, (4) a communications and change management programme and (5) the development of a comprehensive Social plan |

8.4 The development of a comprehensive human resources strategy for the industry is therefore the most critical task to be undertaken in the EDI restructuring project, and this is reinforced by the experience of those organisations who have already undertaken restructuring and consolidation of the municipal EDI (eg. Johannesburg and Eskom) and wider municipal activities (eg. Durban). In this stage of the project the consortium has considered:

- the *structure* of the strategy that will need to be executed if the transformation is to be successful,
• our recommendations on the essential planning issues on which immediate decisions should be taken to provide reassurance and comfort to those currently employed in the industry; and

• the range of issues to be addressed at each stage of the process, and, where sufficient additional work has already been undertaken, an initial assessment of potential outcomes.

8.5 We have identified the following key stages in the development of the comprehensive human resources plan for the EDI:

• First: to develop a view of the organisational structure for each RED which will allow it to operate efficiently and contribute to meeting the objectives of the restructuring;

• Second: to consider the principles under which staff from Eskom and the municipalities should be transferred to the REDs;

• Third: the key tasks to be undertaken and the issues which must be addressed to effect the transformation effectively;

• Fourth: the change management and communications strategy that will be necessary to support the process; and

• Fifth: the Social Plan that will be necessary to support those workers who cannot be readily accommodated within the new RED or existing municipal and Eskom structures.

RED organisational structure

<table>
<thead>
<tr>
<th>Recommendation 38: Each RED should have an organisational structure broadly along the lines shown in Figure 1 below. This is only indicative, and the final structure should be developed taking into account current good practices on corporate governance.</th>
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8.6 Our recommendations on the high level organisational structure for the REDs recognises that each RED has two main operational responsibilities: distribution and retail, which under the commercial arrangements for the introduction of retail competition must operate on an arms length basis and be accounted for separately. In addition there is a range of support services (eg. human resources and information technology) which should not be duplicated within each of the operating divisions. All these activities must be co-ordinated by a board of directors which will be accountable to the Holding Company and, in the medium term, to shareholders.

8.7 The proposed divisional organisation structure is illustrated in Figure 1 below. It comprises:

• a management board comprising:
  – a Chief Executive;
– an executive Finance Director;
– an executive Retail Director;
– an executive Distribution Director; and
– an executive Director of Corporate Services;

• a number of non-executives including;
  – a Chairperson
  – non-executive Deputy Chairperson; and
  – other non-executive Directors as required by the provisions of the King Commission;

• a Distribution Division, responsible for the construction, maintenance and operation of the distribution network;

• a Retail Division, responsible for the purchase and sale of electricity to customers in both the competitive and non-competitive parts of the retail market; and

• a Corporate Services Division, incorporating a Human Resources department, providing all non-core support services (internally or through contract with external parties) to the two main operating divisions.

Principles for transfer

Recommendation 39: The development of the overall human resource strategy for creation of the REDs should be guided by the five principles set out below.

8.8 It is essential for the stability of the industry and the preservation of its existing skill base that the principles under which staff will be transferred to the REDs are decided upon rapidly and communicated unambiguously. Uncertainty as to the future conditions, locations and terms of employment will cause a migration of the most talented workers away from the industry and lead the dissolution of centres of excellence at the very time they are most needed to support the transformation process. Both Eskom and the municipalities have expressed their concern that such migration is already taking place.

8.9 We propose that the transformation process be framed around the following principles:

• principle 1: that all staff currently employed within the EDI either with Eskom or the municipalities will be transferred to REDs – the purpose of EDI restructuring is to consolidate it so that it can better meet its operational and development objectives: it is not a rationalisation plan;
principle 2: that all existing EDI staff will be transferred to the REDs on the basis of their existing terms and conditions – no one currently employed in the industry will be worse off as a result of the restructuring, although a harmonisation process will then begin (Principle 4);

principle 3: that the transfer of staff will recognise both the existence of centres of excellence within the current EDI and respect the needs of the municipalities to maintain a balanced cadre of staff after restructuring;

principle 4: that the Holding Company will establish a national bargaining forum to begin discussions with labour and key stakeholders on a set of harmonised terms and conditions which would be introduced for new employees to the industry, and the intended timetable and strategy for their phased adoption for existing employees; and

principle 5: that in the event, after RED creation and a thorough skills’ audit, certain surpluses of skills are identified and it proves impossible for them to be retrained, any retrenchments will be dealt with through a comprehensive Social Plan developed for, and managed by, each RED.

8.10 Following from, or directly implied by, the above key principles:

initial conditions of service will be created, through the Holding Company, before personnel are transferred;

all existing electricity distribution businesses will be transferred as going concerns, under the terms of Section 197 of the Labour Relations Act (LRA);

all existing rights and obligations of all employees are honoured in full upon transfer to the REDs, whether or not such rights and obligations are covered by Section 197 of the LRA;

all existing arrangements will be transferred to the REDs on the date of establishment, after which it will be for the individual REDs to agree with workforce representatives any local additions or amendments to the centrally agreed terms and conditions, to reflect specific local circumstances, and to effect the phased harmonisation of terms and conditions for their employees; and

each RED will be under an obligation to prepare and implement a programme of training and skills development for its workforce, to enable them to operate effectively within the reformed EDI in South Africa, to the benefit of final customers and staff themselves.

Recommendation 40: The following principles should form the starting point for addressing future human resource arrangements.
Key issues to be addressed

8.11 The development of the human resource plan is the most complex task of the restructuring because of the many interdependencies between the issues, the need to keep employees informed and primacy of maintaining customer services during the transformation. We have considered the key issues which are likely to dominate the process, but others will inevitably emerge during the course of negotiations within the national bargaining forum, through the process of preparation for RED creation in Eskom and the municipalities and in the course of the skills’ audits.

Terms and conditions

8.12 Given the critical nature of the human resource arrangements, and our proposed approach to the establishment of an industry-wide central bargaining forum with labour representatives, our strong preference is that all details of future terms and conditions are now developed with that forum. Any proposals in this area must ultimately be agreed and owned by the participants in the sector. For this reason, we have stopped short of giving firm recommendations on any specific elements of the future terms and conditions, pending establishment of these central arrangements. We list, below, however, a number of initial views and observations which we believe may serve as helpful principles or starting points for those negotiations:

- **continuity and security of employment** – we believe that all existing rights of employees with respect to continuity and security of employment should be honoured in full upon transfer to the REDs. Decisions will be required as to precisely which of Eskom’s and municipalities’ employees should be transferred to the REDs. In our experience, a pragmatic rule will be required in this regard – typically that all employees who commit over 50% of their time to the activities of electricity distribution or retail should become RED employees;

- **harmonisation of terms and conditions** – the REDs will need, over time, to move to a harmonised set of terms and conditions of employment for their workforces. In doing so, the REDs will need to beware of achieving consistency through levelling up all employment terms for all employees. Such a policy would threaten the future financial viability of the REDs themselves, which is not in the long-term interest of customers, employees or shareholders. It may, therefore, be necessary to “grand-father” some of the terms and conditions for some existing staff, while adopting a new policy for the remainder of staff and all new staff;

- **pension arrangements** – there are a great many pension arrangements in the sector – far more than it will be practical for a RED to continue to administer in future. This issue is very complex and needs to be further developed by the Holding Company. Negotiations and consultations with existing pension funds need to take place before any decisions can be made on this issue; and

- **medical aid** – our initial preference on medical aid is for all RED employees to be provided with membership of an “open” medical scheme (i.e. scheme
open to the general public). (An alternative, however, which should be examined in the central bargaining process, is a more simple approach under which the REDs make salary allowances to staff, payable to a medical scheme of the employees’ own choice.) Again, this would ideally be established prior to creation of the REDs. If not, then again, employees could be transferred to the REDs on the basis of continuation of existing medical aid arrangements, prior to subsequent transfer to the new arrangements.

8.13 The Holding Company will establish a Human Resources workgroup to work with the national bargaining forum to develop the structure of the harmonised terms and conditions. The workgroup will comprise industry experts from Eskom and municipalities, external specialists to advice on the legal and actuarial aspects of the process and specialist negotiators with experience of other similar exercises. It will also develop a recommended structure for a REDs human resources department, an essential task as the view has been expressed that, especially on the municipal side, HR management is well developed.

**Organisation design**

8.14 We have set out our recommendations for the high level organisation structure of the REDs but the operating environment of each RED will be different so it will be necessary to develop more detailed end state structure. In addition, since, on creation, the REDs will actually comprise a number of independent businesses it will also be necessary to develop a RED specific transition plan to reach the end state.

8.15 The Holding Company will therefore need to establish an Organisation Design workgroup to assess these issues. It will consider the principles to be applied to the appropriate divisional structure for each RED, develop job competency descriptions, a gaps report and a migration strategy.

**Maintaining services and preserving expertise**

8.16 From the customer’s point of view EDI restructuring will not be regarded as a success if service quality declines at any stage in the process. The Holding Company will therefore need to put a priority on measures to maintain service standards and preserve the essential centres of excellence in Eskom and the municipalities which underpin service delivery.

8.17 One aspect of the programme management work which the Holding Company will need to undertake during the restructuring process will be to monitor day to day activities in EDI and to bring to management’s attention areas of weakness. While this may be an operational issue, the people management component must be dealt with in the human resources strategy to ensure that management and staff remain aware of the risk of distraction or disaffection during restructuring.

8.18 An associated issue is ensuring that centres of excellence, where expertise has been developed in depth by a team which has established a critical mass, are preserved. While it is acknowledged that many such teams exist in Eskom, it must remembered that the municipalities have developed skills in electrification, revenue management and marketing in urban areas. The restructuring process must avoid such teams being dispersed simply to ensure an equal balance of resources across the REDs. The Human Resources workgroup should therefore consider the activities of these teams and where within the restructured EDI
they should reside: this may include allocating them to an individual RED, to act on a national basis, or establishing an expert service organisation, owned by all the REDs.

**Skills audits and training strategy**

8.19 As part of the exercise of ring-fencing the municipal EDI and restructuring Eskom’s distribution activities a comprehensive audit of skills will need to take place. This will be an essential source of planning data for the REDs. Our discussions with stakeholders in the municipalities have indicated that, while most are adequately resourced from an engineering point of view, many are weak in support services such as IT, human resource management and finance. They would therefore anticipate that Eskom could provide the basis of skills in these areas.

8.20 The skills audit would be operated across the industry by the Human Resources workgroup and form the basis for a gap analysis. It would then be necessary to develop a training and development strategy which addressed:

- the skills to be developed;
- the need for affirmative action with specific focus on women and people with disabilities including increased representation of black people and women in senior management; and
- the implications of HIV / AIDS at all levels in the REDs.

**Change management and communications strategy**

8.21 If the benefits from EDI restructuring are to be realised the workforce will need to be prepared for change, assisted through it and feel they understand what stage has been reached in the process. For these reasons it will be essential that the Holding Company establishes a Change Management and Communications workgroup to provide itself and the REDs with strategies which will support the creation of REDs with supportive organisational cultures and with ready and successful people. This work will need to take into account the diversity of work environments, skills, languages and cultures of the organisations that will form the REDs.

8.22 The specific objective for the change management workstream will be to develop people-centred change interventions to integrate the different cultures and the skills in the industry. This will require the development of a commonly owned vision that would uphold and support the needs of the restructured industry.

8.23 The specific objective of the communication workstream is to develop an effective communication strategy which will inform and guide ongoing communications to all stakeholders. This communication process will provide information in respect of all the changes, developments and progress during restructuring, to ensure buy-in and cooperation, stability, instill and maintain confidence, manage expectations and monitor progress of the restructuring process. The communication process will, when necessary, also be consultative in its execution. This too will facilitate the necessary ownership by all stakeholders of the restructuring process.
Social plan

8.24 Even though all employees will be transferred to the new RED and most employees will have long-term careers, there may be a surplus component that will have to be accommodated in new ways and for which bold and innovative ideas and actions will be required. For this reason, a comprehensive social plan will have to be developed by the Holding Company as part of the transitional plans.

8.25 The objective of the plan will be to deal with surplus employees in a caring and socially acceptable manner by providing them with an explanation of the situation as well as the ability to deal with the realities of retrenchment by focussing on self-sufficiency.

8.26 The development of the comprehensive Social Plan will be a responsibility of the Holding Company and can only be completed in association with the skills’ audits and gap analysis that will be undertaken during Stage III of the project. We have, however, made a preliminary assessment of the implications of the transformation for the employees within the industry as a way of informing future work and to ensure that the process of planning any necessary measures can begin immediately. This Outline Social Plan has been developed using resources available to the consortium during its Stage I work and does not embody anything in the way of a detailed analysis of the specific conditions in any specific Eskom region or municipalities. The consortium believes, however, that it provides broad indications of the likely scale of the social measures that will be necessary as a result of EDI restructuring.

Objectives

8.27 The objective of the Social Plan is to avoid job losses and employment decline by managing the potential retrenchments actively and to ameliorate their effects on individual and local communities. The Social Plan should support the reintegration of retrenched people into the economy helping to revitalise affected local economies. In addition, the Social Plan should ensure that the skills, experience and loyalty of employees developed in the industry are retained and appropriately utilised.

Principles

8.28 We recommend that the following principles should guide the development of appropriate initiatives:

- absorption of affected employees into the non-core support service business units as far as possible: the Holding Company and REDs should explore the appropriateness of establishing businesses to support the REDs in the provision of non-core functions as well as in those functions requiring scarce and specialist skills and resources. In practical terms, this should include a research service of best practices, support to surplus staff in identifying viable enterprise/outsourcing opportunities, arrangements with financial institutions for financial support, support with the development of business plans to ensure access to finance, initial and ongoing training and support for a specified period to ensure the economic viability of the business as well as measures to get first opportunity to secure contracts from within the industry;
establishment of small and medium enterprises – the Holding Company and REDs should explore the establishment of home-based industries and other small businesses to accommodate the creation of jobs for women, particularly in rural areas. These initiatives should as far as possible be linked to rural electrification programmes;

- support programmes for surplus staff taking voluntary separation packages;
- education and training and counselling programmes for surplus staff; and
- funding for the plan.

8.29 The social plan is the counterpart to the financial transition plan outlined in Section VII: it provides a roadmap for the personnel in the industry to understand how they will be affected by the restructuring and what will happen in the event of retrenchment. This will allow stakeholders, especially organised labour, to have greater confidence in the process and contribute to the essential spirit of co-operation which will allow restructuring to move quickly ahead.

High level conclusions

8.30 Overall we conclude that, following efficiency drives in both Eskom and the major municipalities, that there are, on balance, more likely to be skills deficiencies than surpluses in the EDI. The main area of skills overlap is likely to be in administration of billing systems and customer account management. The need to undertake a substantial electrification programme will also tend to ensure that operating staff are retained rather than retrenched. Overall, therefore, we do not expect restructuring to give rise to a significant retrenchment problem – and in this we consider the EDI to be in a different situation to Transnet, SAB and the mining industry where substantial retrenchments have been identified.

8.31 We would, however, advise that it would be prudent to make provision for a certain level of retrenchment, say around 1,000 per year (ie around 160 staff per RED per year). We have set out below the scope of the measures which might be adopted and an indicative cost for the exercise.

Approach

8.32 Our approach to the development of the Outline Social Plan seeks to put in place three sets of measures:

- a set of interventions to avoid the need for retrenchment at all;
- plans to ensure that, where they are unavoidable, retrenchments are managed humanely; and
- where large-scale retrenchments have taken place then measures to assist the affected individuals and communities to find alternative forms of employment or sustainable livelihoods are put in place.
8.33 In addition, various sectors of industry have developed social plans to deal with their specific retrenchment requirements, notably the Transnet Social Plan. The EDI Social Plan will have to be complement existing Social Plans to avoid duplication of existing structures and facilities.

8.34 The development of the social Plan will have to consist of mainly three stages, namely:

- Phase 1: information gathering and the development of recommendations for a policy framework;
- Phase 2: negotiating with all stakeholders and refinement of the policy and plan; and
- Phase 3: implementation, which will take place in three stages:
  - Stage I – Planning: during which all necessary data will be assembled from Eskom, the municipalities and national government agencies regarding the extent of any skills surpluses and a range of measures than can and should be put in place to deal with any retrenchments – this will be concurrent with the preparation for RED creation; and
  - Stage II – Execution: during which the required measures will be put in place and the change management process will see affected workers being dealt with under the plan; and
  - Stage III – Monitoring: during which the effectiveness of the plan will be reviewed and reported to the Board of the Holding Company.
IX  Systems and processes for the REDs

9.1 Our purpose here has not been to develop a detailed review of existing systems and processes across the sector, nor to develop a system and process implementation plan for the REDs. However, we have undertaken an initial review of existing systems and processes in the EDI, with a view to understanding at this stage where the major systems and process issues lie, and the extent to which they might serve as a significant obstacle to the overall EDI reform process.

9.2 We wish to make observations on just three issues relating to RED systems and processes in this Blueprint Report.

9.3 First, the scale of the process redesign and new systems implementation task that will face the REDs should not be under-estimated. Existing systems, processes and data capture in the EDI is of very variable quality across the various existing distribution undertakings. Existing arrangements should, of course, be used, adapted and maintained wherever possible, in order to minimise the costs of establishing the REDs. We anticipate, however, that for the REDs to operate in future as modern efficient businesses, they will each need to develop integrated new business processes across each element of their operations, and procure and install major new systems in almost every area of the business. This is likely to include a requirement for new processes and systems in the areas of:

- billing, revenue collection, and customer management;
- pricing and tariffs;
- asset and work management;
- financial management and accounting; and
- management information.

**Recommendation 41:** Upon creation, the REDs should operate on the basis of all of the operational processes and systems currently employed, provided that the REDs are initially endowed with sufficient integrated systems and operational processes to enable them to operate effectively and comply with legal obligations. A mechanism or process must be developed to enable Eskom and the Municipal electricity undertakings which operate under different legislation to function under the Companies Act.

9.4 Second, in view of the scale of the implementation task, several years of transition will be required. It is unlikely, in our view, that the process of integration of a RED into a single cohesive business, operating with modern integrated processes and systems across its business, can be achieved any more quickly than around five years. RED establishment should not, in our view, wait for such work to be done. Indeed, in our experience, the work will only get done once the RED has been established and a focussed management team is in place to deliver the change. We recommend, therefore, that upon creation, the REDs should operate on the basis of all of the operational processes and systems currently employed. This will inevitably mean use of a vast array of different practices at the outset,
but should ensure that, on creation of the REDs there is minimal disturbance to the critical day-to-day operation of the business.

9.5 To enable such an approach, contracts will need to be put in place between the RED and a number of other parties currently performing services on which the RED will need to rely from the outset. This applies most particularly, for example, to customer billing, which will need to continue to be undertaken by existing Eskom and municipality billing departments under contract, until the RED is in a position to take on that task for itself.

**Recommendation 42: Initial work on developing processes and systems should be carried out on a common basis prior to legal establishment of the REDs.**

9.6 Third, while our recommended approach is very strongly based on early establishment of the REDs, in order for them to focus quickly on developing the processes and systems required for the future, we do recognise the value of some initial work being done in all of these areas on a common basis for all REDs prior to establishment. Such work would focus on the identification, for example, of preferred IT solutions and software packages best suited for all of the REDs in the various areas of their businesses identified above. This can then form the starting point for the new RED management teams, in developing the solution best suited to their own local needs. There would be no requirement on RED management to adopt the recommended industry solution (indeed it is critical that the RED management themselves “own” the adopted solution, rather than have any solution forced upon them). The common design work would, however, speed the process of RED development, by undertaking some basic design work once for all of the sector.
**Part B – Transition**

In this part we provide a summary of

- **Section X:** our key recommendations on the proposed Holding Company; and
- **Section XI:** our proposals for the overall transition plan.
X Holding Company structure

10.1 The White Paper envisages “the implementation of a legal Transitional Structure to manage the ongoing operations of the industry and implement the restructuring plan”. The White Paper does not use the expression “holding company” but envisages that the Transitional Structure will be a company controlled by a board of directors appointed by Government, which we have assumed could include local government. It is clear that the Transitional Structure is to have a limited life and must “fall away at a specific date, upon which the respective subsidiaries will have to be independent REDs”.

10.2 Following consideration of a number of alternative structures the Cabinet approved the EDI Holdings model as a transitional institutional mechanism to oversee the creation of financially viable, independent REDs. It further approved that the REDs should, initially, be subsidiaries of the EDI Holdings company (EDI Holdings).

10.3 We have developed our recommendations for the establishment in the light of framework outlined in the White Paper and the decisions on EDI Holdings taken by Cabinet.

Role

10.4 The ultimate objective of the EDI reform process is to establish independent viable REDs. Our starting point for the design of EDI Holdings has therefore been to consider, in discussion with stakeholders, the roles that it should play to enable that objective to be met.

10.5 The role of EDI Holdings should not be to take day to day operational responsibilities in the EDI (this would require the creation of a complex and expensive management structure to control distribution activities across the country). Nor should it take on the management tasks associated with the creation of the REDs as integrated operational businesses. These tasks will best be done by appointing management teams for each RED, and by placing with those management teams direct responsibility for the creation of their own businesses. In our experience, this alone will bring the focused effort, commitment and “ownership” of the process that will be required.

Recommendation 43: EDI Holdings should be established to control and direct the operations of the EDI for a transitional period and undertake the 6 key roles identified below – specifically: (1) to plan the establishment of the REDs, (2) to control the phased implementation of the REDs, (3) to plan and co-ordinate the national electrification programme, (4) to manage provision of short term support to critically weak distribution businesses prior to RED creation, (5) to lead the development of arrangements for support of low-income households, (6) to prepare an industry-wide Social Plan.

Role 1 - Planning for RED establishment

10.6 EDI Holdings should be established as soon as possible (see below for timing) and should assume immediate responsibility for planning and managing the establishment of the REDs. It would be responsible for all of the preparatory work which will need to be undertaken centrally and on behalf of all of the REDs, in order to enable the REDs to begin from a common starting point and without the need for them all to duplicate certain common
tasks. A number of these common early tasks have already been mentioned. They would include:

- development of the necessary primary legislation;
- asset valuation and developing the structure of the REDs’ initial financial arrangements, including negotiations with existing lenders;
- establishing a path for tariffs which will allow each RED to attain independent financial viability
- developing the codes and agreements required for the transitional regulatory regime;
- an HR strategy and social plan for each RED to harmonise terms and conditions;
- RED organisation design;
- defining the minimum systems requirements for Day One and the transition arrangements;
- supervision of preparatory restructuring undertaken by Eskom to align with the 6 RED boundaries;
- supervision and management of preparatory ring-fencing work undertaken by the municipalities, to identify and separate out their distribution activities prior to transfer to the REDs
- developing the minimum operating codes, standards and interface agreements necessary for Day One; and
- communicating the objectives of, and process for, restructuring throughout the industry.

10.7 The planning and preparatory tasks outlined above would be undertaken by workgroups, established by EDI Holdings, which would develop solutions appropriate both for the municipalities and Eskom, using teams of experts drawn from all sides of the industry.

Role 2 – To control the phased implementation of the REDs

Recommendation 44: The Holding Company should create six wholly owned subsidiaries as the basis for the REDs and determine the order by which assets are transferred to them. The Holding Company will retain effective control of the REDs through special voting shares which will expire when the REDs are fully established, operational and sustainable. These shares will allow the Holding Company to: (1) hold a veto over key RED management decisions, (2) approve the appointment of Directors and management teams of the REDs, (3) monitor and oversee the process of RED
establishment and (4) retain the option, in extreme circumstances, of reallocating staff, assets or financial resource among the REDs.

Recommendation 45: The Holding Company will issue limited voting shares to Eskom Distribution and the Municipalities in exchange for their distribution businesses for the duration of the transition period. These will be converted to ordinary shares thereafter and the Holding Company’s shares will be redeemed. The limited voting shares will allow Eskom and the municipalities to: (1) supervise the day to day activities of the REDs and (2) receive any dividends which are paid. They will not give the right to take decisions which might prejudice the interests of minority shareholders or municipalities which had not been incorporated into the RED. The limited voting shares will be subordinate to the special voting shares of the Holding Company.

10.8 EDI Holdings will be the vehicle by which the REDs are established. It will create a number of wholly owned subsidiaries, one for each RED, recruit the management teams and supervise the transfer of EDI operations from Eskom Distribution and the municipalities into the RED subsidiaries. As described in Section XI, this will take place on a phased basis over about a 2 year period.

10.9 During this phased transition process it will retain rights (through special voting stock) over certain operating decisions. This is in order to ensure that the interests of those municipalities which had yet to be transferred into the RED were not prejudiced, and to ensure, on behalf of government, the effective and successful creation of the REDs. At the end of the transition period EDI Holdings would surrender these rights leaving supervision of the REDs to their respective shareholders.

10.10 These transitional voting rights will include backstop rights, exercisable in defined extreme circumstances, to effect a reallocation of staff, assets and/or financial resources among the REDs. Such action would require specific Ministerial approval, and be triggered by overwhelming evidence of sustained financial or operational difficulty within one of the REDs. One option, for consideration in subsequent stages of the project, is for any such financial transfer to be done through a surcharge levied by EDI Holdings on REDs, which those REDs may subsequently recover through tariffs over an extended period.

10.11 After establishment of the REDs, EDI Holdings will retain a role to oversee and support the REDs for a short period. As noted above, it will be important that EDI Holdings does not, in any sense, remove responsibility from the REDs themselves for any aspect of implementation. We do, however, recognise that the RED management teams may benefit from access to support at the industry level for a period following establishment.

10.12 In its role of managing the transition process EDI Holdings will need to approve and supervise the work being undertaken by Eskom Distribution as it restructures its activities from the current seven operating divisions to structure of the six REDs. It will not own shares in Eskom Distribution which will remain under the control of the Eskom board, as a corporatised subsidiary following enactment of the Eskom Corporatisation Act. This will ensure that the Eskom Distribution benefits from access to the wider group skills pool and that its credit rating will be protected during the transition process.
Role 3 – To plan and co-ordinate the national electrification programme

10.13 We have recommended that implementation of the electrification programme be a specific regulatory obligation of the REDs. We recognise that, while much of the funding for the programme will come from national government sources through the Fiscus, responsibility for its implementation, at local level, will rest with Eskom and the Municipalities.

10.14 We believe that the task of planning and co-ordinating the programme is of such significance that this work should be undertaken centrally by a division of EDI Holdings. This division would:

- undertake the detailed planning and modelling of the programme - staff already carrying out this work would be transferred from Eskom, and where appropriate, the municipalities;
- liaise with the Department of Minerals and Energy to act as treasury manager for the programme;
- liaise with municipalities to ensure that the electrification resources available are consistent with the aspirations set out in the Integrated Development Plans;
- consider the appropriate balance between grid and non-grid supplies, recognising that non-grid supplies tend to be the most deprived areas, where municipalities have many competing demands on their limited financial resources and that requests for immediate off-grid supply may not be appropriate if the grid is to be extended within a foreseeable time; and
- ensuring, in advance of RED creation, an appropriate level of co-operation between non-grid concessionaires and related grid operators, and, after RED creation, that the RED was meeting its licence obligations relating to the support provided to its non-grid consumers under relevant service delivery agreements.

10.15 In this way EDI Holdings will be able to ensure both that EDI restructuring plans are developed in a way which best supports the implementation of the electrification programme, and that adequate priority is given to the programme during the transition process.

10.16 Upon dissolution of EDI Holdings, this role should pass to a dedicated National Electrification Agency, formed specifically to assume the task from EDI Holdings.

Role 4 – To manage provision of short term support to critically weak distribution businesses prior to RED creation

10.17 The phased approach to RED formation noted above and outlined in Section XI has been developed in the light of concerns that a more rapid implementation programme may be unduly risky and difficult to manage. Within such a phased approach, transitional arrangements will be required to provide support to those municipal distributors that are in greatest financial and operational difficulty, before they can be absorbed into a RED.
To date, such distributors have been brought under the umbrella of either Eskom or one of the larger and stronger municipal businesses. Until the REDs are formed, this will need to continue to be the case. It is proposed, however, that this process of “rescue” of the weaker municipal businesses now be done under the control and co-ordination of EDI Holdings. Specifically, it is proposed that:

- a dedicated team be established within EDI Holdings as a matter of top priority, to take direct responsibility for this issue; and

- this team will identify and monitor the position of the weakest distributors, in most urgent need of potential support, and take responsibility for identifying and negotiating new operational and financial support arrangements with Eskom and/or a stronger municipal business (as appropriate) for each such business, in priority order. These arrangements should be developed in a way that is consistent with the end-position as defined in this Blueprint, and hence on a more planned basis than hitherto.

In many instances financial failure is caused by inability to pay Eskom bulk supply charges. A key element of the short term financial solution for the businesses may well, therefore, be for an element of these to waived prior to RED establishment. In effect the failing RED would be offered as an operating franchise, with the operator taking the benefit from performance improvements.

These arrangements will continue to require the goodwill of Eskom and other municipalities, as EDI Holdings will be unable to enforce any revised arrangements prior to legislation. The priority task will be to secure interim operational and financial support to these distributors, prior to absorption into a RED. This interim solution need not involve formal transfer of the assets of the weak business to Eskom or a stronger municipal business. Indeed to avoid the need for a double transfer, the EDI Holdings team should seek, wherever possible, either to leave formal asset ownership with the current owner, or effect a direct transfer to EDI Holdings itself in anticipation of their transfer to a RED.

The team within EDI Holdings would also undertake the necessary financial analysis to determine a ranking of the financial health of distributors, and hence the order in which municipalities should be transferred to the REDs during the phased transfer process. As discussed in Section XI, we currently anticipate that this will be done in 4 broad phases, as follows, to enable first the core of the new RED to be established, and then for the weakest businesses to be added as quickly as possible thereafter.

The EDI Holdings team would monitor the financial health of the municipalities to determine whether the order of transfer should be amended: the transfer of failing municipalities could be accelerated and that of those which prove to be stronger could be deferred.

Role 5 - To lead the development of arrangements for protection of low-income households

It is a Government priority that all consumers in South Africa should have access to basic needs, including electricity, at affordable prices. Many of consumers who have been supplied through the electrification programme, and others who are supplied on an off-grid
basis, find it difficult to afford the service at its full price so it will be necessary to introduce a social support tariff. This tariff should be implemented in a way that does not compromise the move to financial viability for the industry.

10.24 We recommend that EDI Holdings should establish a task team that would be responsible for determining the arrangements to be introduced to meet national government’s objectives regarding the electricity basic services support tariff. This would involve:

- reviewing the appropriate level of basic services, including the level of provision and the criteria for qualification (currently 50kWh per month is proposed for all households);

- carrying out the preliminary analysis to determine the structure of stepped tariffs which would be required to ensure that the programme is self financing, within the territory of each RED;

- designing and conducting a pilot programme during 2001 which could apply to both grid and non-grid supplied consumers; and

- recommending to national government the most effective manner in which the electricity basic services support tariff should be implemented on a national basis, covering the method to be adopted, the consumers who should bear the cross subsidy and the order of priority for its introduction, to ensure the needs of the poorest households are addressed first.

10.25 In the event that funding for an element of the social support tariff is made available from the Fiscus EDI Holdings would manage its disbursement to relevant authorities.

10.26 The social support task team would also have responsibility for preparing and executing other aspects of the programme to provide access to electricity supplies for poor families. This will include:

- designing the arrangements to ensure universal access to electricity supplies, both on- and off-grid;

- determining the obligations that should be placed on REDs to connect consumers; and

- deciding on the form of advice that should be provided to consumers by the REDs to ensure the efficient and safe use of electricity.

**Role 6 - To prepare an industry-wide Social Plan.**

10.27 The restructuring of the EDI will be one of the most significant projects ever to be undertaken in South Africa. It will involve up 46 000 direct employees transferring to new entities and be the cause of significant consequent restructuring within remaining municipal enterprises. This process will, inevitably, lead to significant uncertainty amongst the workforces of all the affected organisations: Eskom Distribution, municipal EDI and municipal non-EDI. It will only be possible to dispel this uncertainty and build support
amongst stakeholders in organised labour if the EDI transformation plan is complemented by a comprehensive Social Plan.

10.28 In a previous section we discussed the scope of the Social Plan which each RED would be required to develop. There is an additional need, however, for work to begin as soon as is practically possible, to develop an overall national Social Plan for the EDI, within which the RED specific plan should fit. The structure would be the same as that outlined earlier for the REDs.

10.29 We recommend that the Holding Company establish a task team to undertake this essential work.

10.30 The human resources task team would also have prime responsibility for convening a central bargaining forum that would initiate negotiations with organised labour. Apart from being an essential part of the process of preparing for RED establishment, these negotiations would be an important input into the development of the Social Plan itself.

Timing

<table>
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<tr>
<th>Recommendation 45:</th>
<th>The Holding Company should be established as a company under the Companies Act as soon as possible with a target date of 1 April 2001.</th>
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<th>Recommendation 46:</th>
<th>The Holding Company should be given the explicit objective of 1 January 2003 for legal establishment of the REDs. This will be the start of a phased transfer of assets from existing owners, starting with Eskom and the major municipalities.</th>
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10.31 We recommend that EDI Holdings be established as a company under the Companies Act as quickly as possible, eg. April 2001, so that it can become the driving vehicle to achieve the establishment of the REDs, and fulfil the other critical transitional roles noted above. It should be given the explicit objective of establishing all of the REDs as fully operational independent companies within four years.

10.32 The White Paper envisages the Holding Company should have a limited life and be dissolved once the REDs are fully established. We propose that EDI Holdings be established with an initial life of 6 years, at which time the ongoing need for the company should be reviewed.

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<th>Recommendation 47:</th>
<th>The activities of the Holding Company should be reviewed after six years to determine whether it should be dissolved, or should remain in place for a defined further period. This review should be performed against pre-agreed criteria relating to the extent of independence of the REDs at that time.</th>
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10.33 At the end of this period national government should also determine the most effective way of dealing with its residual functions of planning the electrification programme and managing the social support tariff. At this stage we recommend that these functions should be managed by a state funded institution, but the ultimate decision will need to be
made taking into account the recommendations of the board of the Holding Company to the Minister.

Ownership and governance

10.34 We have considered a number of options for ownership and governance of the Holding Company. For the Holding Company to play the role envisaged, it will need to be established quickly, and carry with it the support of all of the stakeholders in the sector. Our recommendations on Holding Company ownership and governance are driven by these key considerations.

**Recommendation 48: The Holding Company should be owned 100% by national government through the Minister of Minerals and Energy.**

10.35 We recommend that EDI Holdings be wholly owned by national government (through the Minister for Minerals and Energy). This we believe will be by far the simplest and quickest ownership arrangement to put in place, and should be achievable by the 1 April 2001 target date. Multiple ownership options will, we fear, be more complex and time consuming to achieve, and are not in any case required, given the governance arrangements which we recommend below.

**Recommendation 49: The Articles of Association of the Holding Company should provide for the Minister to appoint its board as summarised below.**

10.36 We recommend that the Minister identify the stakeholders in the EDI that should have a direct role in the governance of EDI Holdings from the outset. Consistent with our recommendation for the REDs, we recommend that the board of directors of the Holding Company be selected on the basis of its skills and competence to do the job. The key issue of Holding Company governance will, therefore, be the appointment of its Board of Directors. We recommend that the Articles of Association of the EDI Holdings provide for broad consultation in the appointment of that Board. Specifically we propose:

- the appointment of a selection panel drawn from stakeholders identified by the Minister;
- this selection panel should be responsible for inviting applications and interviewing candidates for each board vacancy and making recommendations to the Minister; and
- in addition, normal protections for board members would be entrenched in the Articles of Association – including clear and objective grounds for dismissal, requirements as to the necessary skills, a reasonably long term of office (e.g. three years) and an impartial appeal mechanism.

10.37 In this way the appointments process for the board of directors will be seen to be transparent and to command stakeholder support.

10.38 It will be necessary to limit, in its Articles of Association, the Holding Company’s powers to amalgamate, dissolve or otherwise restructure materially the RED subsidiaries in
such a way as to compromise the establishment of the REDs with the structure and boundaries envisaged in this blueprint report.

**Organisation and staffing**

10.39 Work to plan for the establishment of EDI Holdings will be undertaken in Stage II of the project. We have, however, considered the high level organisation and staffing arrangements for the company, on the above model, for its role, ownership and governance.

**Recommendation 50:** Until the REDs are established, the Holding Company should be a project-based organisation with project teams focused on work required to implement the REDs and task teams to deal with the specific areas of executive responsibility.

10.40 The company will, at the outset and until the REDs are established, be very much a project-based organisation, with teams focused on the work required to implement the REDs and to prepare the initial set of common policies and guidance for the new RED management teams. We therefore recommend a structure for the EDI Holdings as follows:

- a management board comprising:
  - a Chief Executive;
  - Deputy Chief Executive
  - a Finance Director;
  - a Human Resources Director;
  - a Business Systems Director;
  - an Operations Director;
- a number of non-executives including:
  - a Chairperson
  - non-executive Deputy Chairperson; and
  - other non-executive Directors as required by the provisions of the King Commission;
- small HC Finance, HR and business systems groups reporting to the appropriate HC director;
- an electrification planning group, reporting to the Operations director;
- a financial task team and a social support task team, reporting to the Finance director;
• a Social Plan task team reporting to the Human Resources director; and

• a series of ten specific project teams, which, at present, we envisage would be in each of the areas of legal, finance, tariffs, regulation, human resources, organisation design, business systems, network operations and change management. Each team would report to a full time project manager and the respective HC director.

10.41 Work to define the specific projects in each area, the corresponding resource requirements and the necessary funding will be undertaken in Stage II of the project.

Recommendation 51: The project teams should comprise full time staff, including both employees of the Holding Company and temporary and permanent secondees from the industry. Secondees should not represent their parent organisations.

10.42 The project teams would be staffed by a mixture of full time employees of the HC and full time secondees from the stakeholders in the industry. As a minimum, all Board Directors would be full time employees, as ideally would the project managers. All secondees from the industry would be selected because of their particular knowledge and skills, and would not be there to represent their parent organisations. In Stage II, we will give further consideration to the terms and conditions of employment by the HC, including matters such as eligibility for subsequent employment by the REDs.

Stakeholder involvement

10.43 The central objective of the proposed structure for the activities of the Holding Company is to draw in expertise from the industry, whether it resides in Eskom or the municipalities, to the restructuring process at the same time as ensuring that customer service does not suffer. Furthermore the Holding Company has an objective to establish the REDs as independent new businesses without allegiance to either of their predecessor organisations.

10.44 For this reason the board of the Holding Company will be established on a competence, as opposed to stakeholder, basis. The selection panel will be drawn from stakeholders and it is to be expected that candidates for many of the key positions will come from Eskom or the municipalities, bringing with them a depth of professional experience. It will also, however, be important to draw skills in from outside the industry and to engage directors with experience from other restructuring exercises.

10.45 Eskom will play a pivotal role in providing expertise to the workgroups which the Holding Company will establish the carry out most of the preparatory work required by the restructuring. One way in which it will be able to do this, in a way which least disrupts day to day operations, will be by providing a small number of individuals who will be able to operate as intermediaries between the HC workgroups and Eskom’s centres of excellence in particular fields.

10.46 The municipalities will also be expected to contribute specialist skills in planning urban electrification, customer management and marketing but it is recognised that they will, overall, be able to provide fewer resources as secondees to the HC’s workgroups.
Funding

**Recommendation 52: The Holding Company should primarily be financed from a surcharge on the Eskom bulk supply price or WEPS price.**

10.47 EDIRC understands that certain funds may be made available from the Fiscus to support elements of the establishment of the Holding Company. It is, however, common international practice for consumers, who, ultimately, will be the true beneficiaries of restructuring, to bear the costs of the process. We therefore recommend that the activities of the holding company should be financed by a levy on the Eskom bulk supply tariff, or, the WEPS price when it is introduced. We estimate that the Holding Company costs would add around 1% to final customer tariffs.

Monitoring and review of Holding Company activities

10.48 The Holding Company will be responsible for determining the overall transition plan under which industry restructuring takes place and for monitoring it throughout the transition period until each RED is regarded as self-sufficient. To co-ordinate this process the Holding Company will establish a function staffed by a number of full time senior managers with responsibility for overseeing discrete areas of the transformation.

10.49 The main tasks of the restructuring function would be to:

- develop an industry wide project plan;
- identify key milestones within the timetable, and the risks to those milestones being reached;
- monitor restructuring activities being undertaken within Eskom and municipalities to ensure their compatibility with the overall project plan;
- monitor the activities of the individual workstreams and workgroups to identify key issues that will impact on the project timetable or require any adjustments to be made to the end state defined in the Blueprint report.

10.50 The restructuring group would report on a monthly basis to the board of the Holding Company, which may consider it appropriate to establish a regular forum with National Government and other key stakeholders to ensure timely briefing on the implementation of the restructuring process.

10.51 As the restructuring process evolves the group may wish to make recommendations to the Board and the financial management task team relating to, but not restricted to:

- the timetable for industry’s transition;
- adjustments to shareholdings and / or boundaries; and
the different capacities shown by each RED in managing its establishment and the consequential support from the Holding Company which may be required.

**Review process and review criteria**

10.52 We have proposed that the activities of the Holding Company should be subject to a review five years after its establishment. While it is not appropriate, at this stage, to define all of the elements that would comprise the review, the regular reports of the restructuring group to the Board of the Holding Company should provide a basis on which it would be carried out.

10.53 An initial draft of the terms of reference for the review would be prepared by the Board of the Holding Company, for endorsement by the National government. The review would consider the capacity of each RED in, at least, the following areas:

- **financial viability**: the ability to fund capital, operating and debt service costs and earn an appropriate return on capital, from internal and centrally granted sources, within a tariff structure approved by the NER;

- **human resources**: the capacity of the RED to meet its operating and management requirements with an appropriately skilled and balanced workforce;

- **operational**: the technical and customer service standards the RED is reaching;

- **transition**: the extent to which the REDs transition plan has been completed and the business is operating in the line with the end state set envisaged under the Blueprint;

- **boundaries**: the appropriateness, in the light of operating experience, of the RED boundaries established on creation;

- **electrification**: the effectiveness of the RED’s management of the electrification programme and the appropriateness of the choice of on- and off-grid solutions; and

- **social plan**: the extent of actual and prospective retrenchments and the experience, within the RED, of developing alternative employment measures.

10.54 The review would:

- take representations from RED management and NER on each issue;

- compare the performance of each RED against each objective;

- determine whether ongoing support was required, and to which REDs it was appropriate to provide such support; and
• make a recommendation as to the most effective way that support could be
given – eg. from the continued activities of the Holding Company, by winding
up the Holding Company and providing support from a specialist agency or
from inter-RED service clubs.

10.55 The Board of the Holding Company would present its review finding to national
government.
XI Overall transition plan

11.1 Transition to the ultimate objective of fully independent and financially viable REDs, operating in a new commercial and regulatory environment will take a number of years. The key elements of this transition have been identified in each of the preceding sections of this blueprint report, and are discussed in each of the relevant Volumes of the consortium’s main report.

11.2 We believe that a gradual approach to transition, supervised and managed by the Holding Company, will best meet the industry’s need for restructuring in a financially secure environment while at the same time ensuring that government’s social and development priorities are met. A structured and phased approach will allow the Holding Company to monitor the industry’s progress towards the creation of independent financially viable REDs and allow essential elements of the plan to be advanced or deferred as implementation proceeds.

Recommendation 53: The key elements and provisional timing of the transitional arrangements should be as summarised below.

11.3 We propose that the transition should take place in three distinct phases as described below.

Phase 1: Establishment of EDI Holdings (March 2001 to June 2001)

Objectives

11.4 Work should begin as soon as possible to establish EDI Holdings as a limited company, 100% owned by national government with a Board of Directors appointed by the Minister of Minerals and Energy. This will cover all the legal and planning work which will equip the Holding Company with the tools to prepare the transition plan and carry out the other essential tasks which form part of the EDI restructuring strategy.

11.5 We believe that this work should begin in March 2001 and should be completed by June 2001.

Key tasks

11.6 The main tasks during this phase will be:

- authorisation and release of funding for the establishment of EDI Holdings and development of a specific mechanism for ongoing funding from a levy on the Eksom bulk supply tariff;

- legal formation of EDI Holdings under the Companies Act with 100% national government shareholding, and with articles of association providing for:
  - review by government of its activities after six years;
• creation of six subsidiaries, to be the REDs

• appointment, by the Minister, of the board of directors;

• development of organisational and infrastructure plans and budgets for the initial phase of restructuring;

• establishment of a national electrification planning and co-ordinating team drawn from resources in Eskom and the municipalities;

• establishment of task teams to address:
  – the support required by the distributors in greatest financial distress;
  – the arrangements to support the needs of low income consumers; and
  – the development of an industry wide Social Plan;

• establishment of the workgroups which will undertake the necessary planning and preparatory work necessary to create the REDs, including a programme management group which will define and monitor the overall transition plan.

**Phase 2: Ring-fencing of distribution businesses (July 2001 to December 2002).**

**Objectives**

11.7 The industry has expressed concern that the restructuring process must be done in a well-structured and orderly manner – there should be no “big bang”. It is proposed therefore that the process of RED formation should begin with an 18-month period during which all existing distribution activities are separated and ring-fenced from their current parent organisations. This should be done under the overall management and supervision of EDI Holdings who would provide support from the workgroups to address specific issues.

11.8 Towards the end of this Phase EDI Holdings would begin the task of creating the REDs and recruiting their management teams while NER should introduce the WEPS and finalise details of the initial regulatory environment for the REDs.

11.9 We believe that these activities can begin in July 2001 and should be completed by December 2002.

**Holding Company**

11.10 Throughout this phase the Holding Company will:

• manage the activities of the workgroups in preparing for RED implementation;

• plan and co-ordinate the electrification programme (this will continue into Phase 3);
assist, through the financial task team, municipalities suffering financial
distress by seeking amalgamation or operating franchises with Eskom or more
financially secure municipalities. The work of this team will include
monitoring the financial position of the whole EDI and developing the priority
ordering by which municipalities are transferred into the REDs;

- prepare recommendations to government relating to support for low income
consumers, and establish and manage the agreed arrangements thereafter (this
work will continue into Phase 3); and

- develop the national Social Plan, in association with the relevant workgroup
and municipalities (this work will continue into Phase 3).

11.11 Towards the end of this Phase, from around July 2002, the HC will:

- establish the six RED subsidiaries, as required under its articles of association,
with provision for three classes of share:

  - voting shares, to be owned by the Holding Company until the end of
the transition period, at which stage they would be redeemed;

  - dividend shares with limited voting rights, to be issued to current
owners of EDI assets (Eskom Distribution and the municipalities),
which would convert to ordinary shares on redemption of the Holding
Company’s shares; and

  - a “golden share” to be owned by the Minister for a period of up to
five years after the end of the transition period;

- appoint the board of directors for each RED and approve the management
contracts of senior management. The initial board will be in place for up to
three years, after which it could be replaced by one appointed by shareholders.

**Eskom Distribution**

11.12 The Eskom Conversion Bill will be approved by Parliament and Eskom Distribution
will be constituted as a separate legal subsidiary of the Eskom board, with service contracts
with other parts of the organisation where necessary.

11.13 Eskom Distribution will develop plans for restructuring from its present seven
operating regions into the six REDs. These plans will be presented to NER and the Holding
Company, in its role of planning the industry’s transition, for approval. Implementation of
these plans will then proceed, monitored by EDI Holdings to ensure consistency with the
overall transition plan.

11.14 Support for this restructuring will be available from the HC. The restructuring which
needs to take place within Eskom is complex involving:
• separation of computer systems and data for asset management, customer services, finance and human resources;

• establishment of financial balances for the six regions which will map on to the REDs;

• review of operational locations and their responsibilities;

• potential relocation of staff;

• metering and boundary projects to develop the necessary operational interface agreements.

11.15 Eskom Distribution has expressed its desire to manage this process internally, concurrently with its separation from Eskom Generation / Transmission. EDIRC concurs with this view and believes that Eskom has most of the required specialist skills in-house or can procure them from its usual suppliers (e.g. IT solutions providers for data separation, auditors in the case of financial separation and metering operators for the metering projects).

11.16 A liaison manager reporting to the Holding Company will monitor Eskom’s restructuring activities. This will ensure that, if there is a deficiency in capacity, the Holding Company will be able to assign members of an appropriate workgroup to support Eskom’s activities. This may include the Legal workgroup and the Operational workgroup regarding the development of operational interface agreements and asset identification, the Business Systems workgroup on data migration and systems realignment issues and the Human Resources workgroup on relocation issues.

Municipalities

11.17 A major exercise will need to take place within the municipalities to identify the electricity distribution activities. This will need to include assets, liabilities, systems and staff. The objective of the exercise will be to develop, within each municipality, a catalogue of the people, assets and liabilities that will be transferred to the REDs, and the residual relationships with the municipality that will be secured through contract with the REDs after transfer. One output of this task will be separate financial statements for each business. It will be important, during this stage, that day to day operations within municipalities are not affected by this exercise.

11.18 This business separation exercise will prepare the essential groundwork for RED creation and will be supported by the workgroups established by the Holding Company. In addition, municipalities would make essential inputs to the development of the industry wide social plan developed by the Holding Company.

11.19 It is anticipated that, compared to Eskom Distribution’s restructuring, the task of identifying and separating the municipalities’ EDI activities will be more complex and involve more external support. The key workgroups to be involved will be the Finance workgroup and the Human Resources workgroup. It is likely that the Holding Company will have to deploy significant resources from outside the industry as a result of the lack of capacity within the municipalities.
11.20 This support will include:

- accountants to collect the necessary financial information and prepare financial balances for the EDI activities, ensuring consistency of treatment with that adopted by Eskom;

- financiers to establish the circumstances surrounding external debt and conduct negotiations with lenders;

- human resource experts to carry out a skills audit of the municipality, identify the staff who spend the majority of their time working in the EDI and make recommendations on whether the full complement of such staff should transfer to the RED, having regard to the skills’ requirements of the municipality; but

- the workload relating to IT systems is likely to relatively limited as it is the intention to establish the REDs on the basis of existing business systems and processes.

NER

11.21 NER would:

- complete pilot tests of the WEPS during 2001;

- introduce WEPS on a national basis for all municipalities in 2002;

- develop the essential elements of the transitional regulatory environment; and

- liaise with the Holding Company regarding the development of arrangements for the introduction of retail competition.

**Phase 3: RED establishment (January 2003 to December 2004)**

**Objectives**

11.22 The formation of the REDs as operating entities will take place in a phased manner over this 2-year period. It is currently envisaged that the REDs will first receive the distribution businesses of Eskom and one or two of the major municipalities or Metros in the RED area, followed by a phased absorption of other municipalities over the period. The precise phasing and order of absorption will be determined by EDI Holdings, and can be controlled by EDI Holdings during this period to ensure a smooth transition. RED management will be responsible for integrating their endowments into stand-alone businesses, and could call upon EDI Holdings for support as required.

11.23 During the period of RED creation, EDI Holdings will retain special voting rights in the REDs to ensure that it retains sufficient control over the implementation programme to enforce the adoption of government policy with respect to the reform process. These special voting arrangements will fall away once EDI Holdings is satisfied that the REDs are fully established and operating. These special voting rights will give EDI Holdings an effective
veto over all RED management appointments and key operational / financial decisions of the REDs, and back-stop rights, in extreme circumstances, to re-allocate staff, assets and financial resources among the REDs during the transition period.

11.24 We believe that this process of phased transfer of businesses to the REDs can commence in January 2003, and be completed in 2 years to end-December 2004.

Order of transfer

11.25 The order in which the operations of Eskom Distribution and the municipalities will be transferred into the REDs will be determined by the financial task team of the Holding Company, with a view to stabilising the overall financial state of the industry and ensuring that REDs are financially balanced from the outset.

11.26 We recommend the following approach stages, which will be subject to review by the Holding Company:

• transfer of Eskom and major municipalities, as the principal building blocks of the REDs, to ensure broad financial balance, and the establishment of a “core” business in each RED;

• after stabilisation of the first blocks, transfer of the weakest municipalities which have been subject to operating franchise arrangements;

• shortly thereafter, transfer of further weak municipalities; and finally

• integration of the financially sound medium sized municipalities.

Holding Company

11.27 During this third phase, the Holding Company would:

• determine the order of transfer and make formal recommendations to the Minister, who would be empowered, under the legislation, to mandate the transfers;

• retain rights over certain management decisions within the REDs during the transition, to protect the interests of minorities and municipalities yet to be incorporated, and to ensure successful establishment of all 6 REDs over this transition period;

• adjudicate between REDs and municipalities over requests for limited revisions to RED boundaries and to transfer assets and people between REDs to ensure a faster and more balanced transition to financial viability;

• have the right, during the transition period, to institute limited financial transfers between REDs to maintain financial stability. These would be effected by a surcharge on the tariffs of contributing REDs, subject to approval by NER;
make recommendations to NER regarding the planning assumptions to be used when setting tariffs, including (but not limited to) the cost efficiency targets to be used, the target rate of return, the depreciation profile and other variables which may influence the tariff path without compromising the transition to a REDs financial viability; and

monitor the financial viability of the weaker REDs with a view to intervening to provide additional financial support, if necessary, including, adjusting their debt burden (through reallocation to the stronger REDs), revising boundaries, transferring assets, reallocating staff, and, in extreme circumstances raising a surcharge on the WEPS to fund short term financial support.

**Eskom Distribution and municipalities**

11.28 Eskom and the municipalities contributing to the REDs will receive, in the first instance, shares with limited voting rights, valued at the time of transfer (as opposed to a single national valuation). These shares would be converted to ordinary shares on redemption of the Holding Company’s interest in the REDs. The limited voting shares will allow shareholders:

- control over day to day operation – provided this was not at the expense of minority shareholders or municipalities yet to be transferred into the RED; and
- to receive dividends.

11.29 It may initially be necessary for the REDs to procure certain services (eg. billing and payroll) from the municipalities or Eskom Distribution. In such cases the parties would enter a cost reflective service contract.

11.30 The new tariff arrangements would ensure that the financial transfers from the EDI to other municipal services, through a local government levy and transfer payments, remained at current levels. In this way local government finances will not be compromised by the establishment of the REDs.

**REDs**

11.31 RED management would be responsible for the tasks of:

- integrating initial endowments into standalone businesses; and
- developing longer term plans for integrated systems and services.

11.32 These activities would be undertaken with assistance from the Holding Company if necessary.

11.33 The boards of the REDs will be responsible for day to day management, subject to financial oversight from the Holding Company.
NER

11.34 During this phase NER would:

- issue a transitional licence to each RED, to be coterminous within two years of complete establishment of all the REDs; and
- introduce the transitional regulatory arrangements.

11.35 NER will introduce the first stage of retail competition as soon as practically possible after the complete establishment of all of the REDs.
Part C – Implementation

In this part we describe the key elements of our proposed approach to implementation of the new arrangements. We describe in turn:

- **Section XII**: the legal arrangements required to implement our proposals; and

- **Section XIII**: an outline of our proposed approach to implementation.
XII Legal arrangements

12.1 Implementation of the proposed arrangements will require a number of key legal arrangements to be put in place. It is summarised here as they represent the foundation of our proposed implementation arrangements, and elements of them may prove to be on the critical path.

12.2 **HC company creation** - This will be a legal task, requiring the legal creation of a company under the Companies Act, wholly owned by national government.

12.3 **RED company creation** - This will be a legal task, requiring the legal creation of six companies under the Companies Act, owned, initially by the HC. The Articles of Association of the HC should mandate their creation and limit the powers of the HC to restructure them. Shares with limited voting right will be issued to national and local government in the proportions determined by relative net asset contribution.

**Recommendation 54: Primary legislation should be drafted and enacted as soon as possible to perform the key elements of the reform programme as summarised below.**

12.4 **Primary legislation** – This will be required to perform the following key elements of the reform programme:

- transfer assets, liabilities, staff, rights and obligations to the REDs by operation of law, allowing for multiple transfer dates;
- create the new regulatory regime to be administered by NER and to strengthen NER’s powers and accountability;
- create the necessary legal framework for the EDI which will involve amendments to the existing legal framework to modernise it and to reflect the new structures and functions that are being put in place (e.g. separation of distribution from retailing);
- design special provisions that may be necessary to achieve specific policy objectives (e.g. the cross-subsidy to support the social support tariff for low income customers); and
- the relationship between the HC and REDs during and, if appropriate, after the transition

12.5 Given the long lead-in times for the development and passing of the necessary legislation, work on this should begin as soon as possible. The overall philosophy is to develop legislation that does not need to be changed as the industry develops and which can accommodate different trading arrangements. Ideally, the legislation would envisage any possible end-state including the restructuring of the wider electricity supply industry.
Recommendation 55: Local Government legislation be monitored and amended, where necessary, to ensure it aligns with our proposals for restructuring and regulation of the EDI.

12.6 Local Government Legislation – Legislation such as the Municipal Systems Bill, Municipal Structures Amendment Act and the Municipal Finance Management Bill needs to be monitored and amended where necessary to ensure alignment with the proposals for restructuring and regulation of the EDI.

Recommendation 56: Licences, agreements and other legal instruments necessary for establishment of the REDs should be drafted under the co-ordination of the Holding Company.

12.7 Regulatory licences – These will need to be prepared and issued to the REDs upon establishment and to each applicant for a licence to retail electricity in the competitive retail market.

12.8 Loan agreements and security arrangements – These will need to be amended with existing lenders, or new loan agreements put in place, depending on the approach to debt transfer agreed with existing lenders.

12.9 Connection and use of system agreements – These will need to be put in place for third party use of the distribution network of each RED, with respect to the competitive retail market.

12.10 MMSD Service Delivery Agreements – These will need to be put in place to specify the agreement for service delivery, between each RED and its relevant multi-jurisdictional municipal service district, consistent with the RED’s licence.

12.11 Service agreements – These will need to be put in place between each RED and all parties who will continue to provide services to the RED on an interim basis while the RED establishes its preferred longer term arrangements for the provision of such services.
XIII Implementation approach

Recommendation 57: The overall approach to implementation should be as described below.

13.1 Our recommendations on the overall approach to implementation, in the light of the recommendations made above on the transitional arrangements and the role of the EDI Holdings, are described in Volume VIII of the consortium’s main report. In summary:

- we recommend that the Ministerial Sub-Committee convened by the Minister of Minerals and Energy, should retain overall responsibility for the whole of the EDI reform process, from the decision to proceed with restructuring through to the implementation of fully stand-alone REDs, at the end of the transition period;

- the next stage of work is to plan for the formation and operation of the Holding Company: much relevant work has already been undertaken and is contained in the consortium’s draft Stage II report;

- following revision to the consortium’s draft Stage II report the work to create and staff the HC should begin immediately, indeed some of this work can be undertaken in parallel with the HC planning work (for e.g. the appointment of the HC Directors and other key members of staff). The HC should be established by 1 April 2001;

- the HC management should be responsible for all activities to plan for and establish the REDs, and to prepare the common starting point for the REDs as described earlier. This work should involve the new management teams for the new REDs when they are appointed; and

- upon establishment of the REDs, the RED management teams would be responsible for integrating their Day One endowments, and subsequent tranches of municipalities into fully stand-alone businesses, drawing on support from the HC.

13.2 EDIRC believes these planning arrangements represents the best way forward.

13.3 There is, in particular, a commonly held view in the industry, which we share, that implementation will now proceed most effectively if experts from across the industry can be drawn together into a single set of integrated planning and design teams. This is what we propose in the initial work of the proposed HC. While these cross-industry teams may need support from specialist advisors, the process will be most effective if it is led by those who, in future, will have direct responsibility for implementing and operating the new arrangements in the reformed EDI.
Glossary

Captive customer: a customer that must purchase electricity from (the retail business of) its host RED.

Contestable customer: a customer that is free to choose its electricity retailer.

Distribution: the transport of electricity on low voltage networks, including construction, operation and maintenance of the distribution network.

Generation: the production of electricity.

HC : Holding Company (EDI Holdings)

MMSD: multi-jurisdictional municipal service district.

RED: regional electricity distributor, responsible for distribution and retail to captive customers in its area.

Retail: the bulk purchase and repackaging and resale of generation, transmission and distribution services to customers, including all related customer-service activity such as meter reading, billing, cash collection and customer handling.

SDA: service delivery agreement between MMSD and RED.

Transition period: period between first and last transfers of assets into the REDs

Transmission: the bulk transport of electricity on high voltage networks.