



Medium Term Revenue and Expenditure Framework (MTREF)

Annexure 4

MFMA BUDGET CIRCULARS & NERSA CIRCULARS

2016/2017



Municipal Budget Circular for the 2016/17 MTREF

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Introduction

The budget circular is compiled annually to guide municipalities on how to prepare their budget inputs. This circular focuses on the preparation of the 2016/17 Medium Term Revenue and Expenditure Framework (MTREF), reference should also be made to the previous circulars. This guidance includes national policy imperatives that should be accommodated and other relevant information. The circular provides a summary of South Africa's economic outlook, inflationary targets, financial management issues and specific reference on how to give effect to National Treasury's Municipal Budget and Reporting Regulations (MBRR). The key focus of this circular is the 2016 Local Government Elections, the demarcation process and the changes to the local government grant allocations.

1. 2016 Local Government Elections and the budget process

Local government elections are likely to be scheduled between May and August 2016; the proposed date is yet to be determined. Elections are important events – when we reaffirm our commitment to democratic and accountable government by choosing representatives of the people who will guide the work of local government for the next five years.

The following four risks need to be explicitly managed:

1. In terms of section 13 of the Municipal Property Rates Act, 2004 (Act No 6 of 2004)(MPRA) and sections 24 and 42 of the Municipal Finance Management Act, 2003 (Act No 56 of 2003)(MFMA), new tariffs for property rates, electricity, water and any other taxes and similar tariffs may only be implemented from the start of the municipal financial year (1 July). This means that the municipal council must approve the relevant tariffs before the commencement of 1 July; and, should this not happen, the municipality will not be able to increase its taxes and tariffs. Failure to obtain Council approval for the annual tariff increases would most likely cause an immediate financial crisis that may lead to the provincial executive intervening in the municipality in terms of section 139 of the Constitution;
2. In terms of section 16 of the MFMA, a municipal council must approve the annual budget for the municipality before the start of the financial year, and should a municipal council fail to do so, section 26 of the MFMA prescribes that the provincial executive **must** intervene. This provincial intervention may include dissolving the municipal council and appointing an administrator to run the municipality;
3. The outgoing council may be tempted to prepare an 'election friendly budget' – with unrealistically low tariff increases and an over-ambitious capital expenditure programme. The outcome of this approach will undoubtedly be unfunded municipal budgets that threaten their respective municipalities' financial sustainability and service delivery; and
4. Given that the timing of election campaigning coincides with the municipal public budget consultations; and there is a risk that these consultations may be neglected or used to serve the narrow interests of political parties.

In the build-up to the 2016 local government elections, municipalities are encouraged to act towards ensuring financial sustainability. Now, more than ever before, it is paramount for sound municipal decision-making so that long-term sustainability of municipal finances and service delivery is achieved beyond the election period.

Municipal finances are presently volatile and there is severe pressure to maintain healthy cash flows and maintain effective cost containment measures. It is therefore imperative that municipalities refrain from suspending credit control and debt collection efforts in a bid to win votes.

Furthermore, as the current composition and leadership of municipal councils will, for the most part, be responsible for the compilation of the 2016/17 medium-term revenue and expenditure (MTREF) budgets, councils are advised to prioritise expenditure appropriations aligned to the policy intent as described in the integrated development plans (IDPs). Infrastructure provisioning for water, sanitation, roads and electricity remain key priorities.

In addition the outgoing council is advised to critically consider the financial implications before entering into new long-term contracts that are not of priority to the municipality and avoid if possible, committing the incoming council. In addition, refrain from purchasing cars and from incurring expenditure at this stage that will financially burden the incoming council.

During this time of transition, all stakeholders should work together to ensure that municipalities continue to perform their functions efficiently and effectively. The Mayor and municipal manager should now be engaging in the process of the annual review of the fifth and last year of the IDP in terms of section 34 of the Municipal Systems Act (MSA) and the 2016/17 budget preparation process in terms of section 21 of the MFMA. It is particularly important to ensure that arrangements for the review of IDPs and preparation of budgets continue seamlessly as these processes cannot be delayed in anticipation of the announcement of an election date.

The uncertainty of the date of Election Day means that the newly elected councils may not be duly constituted by 31 May 2016 and therefore they will be unable to consider the annual budget before the start of the new municipal financial year. If the election date falls within the latter part of May 2016 and if there is any delay in declaring the election results or if the results are legally contested then it is unlikely that the new councils will be able to consider and pass the annual budget before the start of the new municipal financial year. In fact, in the case of district municipalities, there is a high probability that they will not be constituted in time to consider the annual budgets since they depend on the finalisation of the local municipality election results relevant to their respective districts. The same will apply if the election is held in June, July or August. It is for this reason that it is recommended that the outgoing council should adopt the 2016/17 MTREF budget before the start of the new financial year.

In deciding on the schedule for the 2016/17 budget process, the Mayor and municipal manager must also note that the MFMA read together with the Municipal Budget and Reporting Regulations only allows for a 'main adjustments budget' to be tabled after the mid-year budget and performance assessment has been tabled in council, i.e. after 1 January 2017. In addition, the permitted scope of an adjustments budget is quite limited in that taxes and tariffs may not be increased or decreased (refer to section 28(6) of the MFMA), and any additional revenues may only be appropriated to programmes and projects already budgeted for (refer to section 28 of the MFMA). Therefore the idea of the current council passing a 'holding budget' which the new council will change substantially through an adjustments budget soon after the start of the municipal financial year is not legally permitted.

Though an IDP is a five year strategic document of council, municipalities should note that when a new council takes office after each local government election, the norm has been that the first year of such a new council is primarily confined to implementing the last adopted IDP. Subsequent to this, it is normally in the second year of the new council where the newly

elected council will adopt its new and thoroughly interrogated and consulted IDP. This process mostly leads to an overlap of the last year of outgoing council into the new council.

It is each municipal council's prerogative to decide when to approve its annual budget. However, to assist municipalities, National Treasury proposes that councils consider adopting the following approach for their 2016/17 budget process:

Outgoing council approves 2016/17 budget	
1.	Current Mayor prepares a budget schedule that brings the review of the IDP and the tabling of the budget forward to late February or the beginning of March 2016;
2.	Community consultations on the annual budget conducted in the remainder of March and early April 2016;
3.	Officials complete technical work on annual budget by mid-April 2016;
4.	Current council approves annual budget and reviewed IDP before the end of April 2016; and
5.	Council implements annual budget from 1 July 2016.
Benefits	
	<ul style="list-style-type: none"> Minimises the risk of being without an approved budget at the start of the financial year; Ensures continuity of operations; and Safeguards the financial sustainability of the municipality by ensuring tariff increases are locked in before the start of the financial year.
Risks	
	<ul style="list-style-type: none"> New council may not concur with the priorities set out in the annual budget approved by the outgoing council, and therefore they may be reluctant to be held accountable for the implementation thereof.
Mitigating factors	
	<ul style="list-style-type: none"> New council should note the overlapping year of the last year of the IDP into the first year of new council; and Note that MFMA section 28(6) does not allow for tariff increases during the financial year of implementation of the adopted budget.

2. Financial Implications of the demarcation process

According to section 21 of the Municipal Demarcation Act, 1998 (Act No 27 of 1998), the Municipal Demarcation Board (MDB) must determine municipal boundaries and may re-determine any municipal boundaries. In June 2011, the MDB began an intensive three year consultative process of reviewing municipal boundaries. This process was concluded in 2013, and resulted in 17 local municipalities being affected by major boundary redeterminations. As a result of these changes the total number of municipalities is reduced by 8 municipalities.

Following the 2013 cycle of municipal boundary redeterminations, the Minister of Cooperative Governance and Traditional Affairs (CoGTA) submitted additional proposals requesting the MDB to consider the re-configuration of boundaries of certain municipalities. These proposals were submitted to the MBD in January, February and April 2015 in terms of section 22(2) of the Act, which gives the Minister of CoGTA the right to request the MDB to consider specific boundary changes. The process of considering these applications was finalised in 2015, resulting in 32 local municipalities being affected. As a result of these changes the total number of municipalities is reduced by a further 13 municipalities.

In total there will be a net reduction of 21 municipalities resulting in a total number of 257 municipalities in the country. A list of affected municipalities is attached as Annexure B.

Implications for municipalities that are merging (if the election is held before 1 July 2015):

- The demarcation changes are only effective from the date of the local government elections, therefore each existing municipality must compile an individual budget for the 2016/17 MTREF;
- The individual budgets will be consolidated for the newly demarcated municipality after the local government elections, regardless of the new allocations that will be published in the 2016 Division of Revenue Bill;
- In order to ensure seamless consolidation of budgets after the elections, the merging municipalities are urged to start working as a team on the planning and technical processes; and
- During the period between the date of the election and the start of the new municipal financial year on 1 July 2016 the current arrangements for the payment of staff and creditors are required to be maintained.

In addition, municipalities should be aware of the role of the Change Management Committee (CMC) of overseeing joint planning between the municipalities in preparation for the consolidated budget after the local government elections.

National Treasury will provide further information on the implications of the mergers if the elections are after the start of the 2016/17 municipal financial year. This will be done in the second budget circular to be issued in March 2016. In this scenario the currently existing municipalities would continue to exist for the beginning of the 2016/17 financial year before the mergers come into effect on the date of the election. Existing councils will have to adopt budgets and municipalities will be eligible to receive a pro-rata portion of their equitable share and some grant allocations for the period prior to the new municipal boundaries coming into effect.

2.1 Support provided to municipalities

To support the newly amalgamated municipalities to undertake a smooth transition, the Municipal Demarcation Transition Grant (MDTG) was established with a time span of three years (2015/16 to 2017/18). The purpose of the grant is to subsidise the additional institutional and administrative costs arising from major boundary changes due to come into effect after the 2016 local government elections. The grant only subsidises additional administrative costs related to the mergers (such as merging and changing administrative systems and costs related to transferring staff). It does not provide for any infrastructure funding.

All affected municipalities are also being supported by provincial departments of cooperative governance. A Change Management Committee has been established for each re-demarcation, with representation from all of the affected municipalities and their respective district municipalities and the provinces. The Department of Cooperative Governance has also established a national Municipal Demarcation Transitional Committee with the aim of coordinating the various transitional measures that need to be put in place for the affected municipalities.

The 2016 DORA will set out the funding that will be provided to the affected municipalities, and these municipalities, CMCs and affected provinces must ensure that they adhere to the conditions attached to the MDTG. In particular, business plans must be timeously submitted to the Department of Cooperative Governance so as to ensure that transfers are done in accordance with the payment schedules.

2.2 Impact of demarcation changes on financial transfers to municipalities

Implications for Local Government Equitable Share (LGES) allocations

The LGES is allocated through a formula that takes account of several factors including the number of poor households and households in a municipality, their incomes and the ability of the municipality to raise its own revenue. In calculating municipalities' equitable share allocations for 2016/17 all of these indicators will be updated in line with the new municipal boundaries. The resultant changes in the affected municipalities' equitable share allocations will be implemented by National Treasury and details of the new allocations will be published in the 2016 Division of Revenue Bill.

Implications for Municipal Infrastructure Grant (MIG) allocations

The MIG is allocated through a formula in a similar manner to the LGES (the MIG formula is based on infrastructure backlogs). The MIG formula will also be updated with data reflecting the changed municipal boundaries. The resultant changes in the affected municipalities' MIG allocations will be implemented by National Treasury and details of the new allocations will be published in the 2016 Division of Revenue Bill.

Implications for other conditional grant allocations

Allocations of other conditional grants are made to municipalities by the responsible national departments, often on a project basis. Allocations for conditional grants are only made for one year and the amounts published for the outer years in the schedules of the Division of Revenue Act are published for indicative purposes only and are not guaranteed. Departments will make their allocations for the 2016/17 financial year based on the new boundaries of municipalities. For municipalities that have been merged this means that previous indicative allocations are likely to be made to the new municipality that incorporates the municipal area where a project was planned and indicative amounts were published, however there is no guarantee of this.

Preparations for each major boundary re-determination are being overseen by a Change Management Committee (CMC). These CMCs are expected to play a coordinating role and exercise oversight over the preparation of a joint budget as well as any business plans required for conditional grants. The business plans can then be approved by the new council as soon as it has been constituted.

Transfers to municipalities will be gazetted in terms of the new municipal boundaries for the 2016/17 financial year.

2.3 Implications for assets and liabilities of municipalities

The changes to municipal boundaries are published by the MECs for local government in provincial gazettes in terms of section 12 of the Municipal Structures Act, 1998 (Act No 117 of 1998)(LGMSA). Section 14 of this Act regulates the effects that changes to municipal boundaries will have on existing municipalities. It also stipulates that the section 12 notice issued by the MEC for local government must provide for:

- The disestablishment of a municipality (or part of a municipality);
- The vacation of office by councilors of the existing municipality;
- The transfer of staff from the existing municipality to the superseding municipality (this must be done in accordance with labour legislation);
- The transfer of assets, liabilities and administrative and other records from the existing municipality to the superseding municipality (creditors of the existing municipality must be paid by the new municipality); and
- The extent to which existing by-laws will still apply.

The 2016/17 municipal budget preparation must make provision for any changes contained in these section 12 notices. The outgoing Council will as a result still be responsible for the preparation and conclusion of the Annual Financial Statements and the audit process.

3. The South African economy and inflation targets

The 2015 Medium Term Budget Policy Statement notes that the global economic outlook has been weaker than anticipated. Growth in developing economies has moderated in response to lower commodity prices, subdued domestic demand and reduced capital inflows. Growth in some developed economies has offset this slowdown. The South African economy is expected to grow by 1.5 per cent in 2015, 1.7 per cent in 2016 and 2.6 per cent in 2017. Domestic inflation is lower, largely as a result of declining oil prices. However, the depreciation of the Rand and the current drought gripping many parts of the country, however, pose some risk to the inflation outlook. Furthermore the electricity supply shortages pose the largest domestic risk to growth.

Persistent high unemployment remains one of South Africa's most pressing challenges. Difficult trading conditions and low business confidence levels have limited hiring during 2015. The formal sector lost 76 000 jobs, with sharp declines in manufacturing and construction, as well as community, social and personal services.

These economic challenges will continue to pressurise municipal revenue generation and collection hence a conservative approach is advised for projecting revenue. These circumstances make it essential for municipalities to reprioritise expenditure and implement stringent cost-containment measures.

Municipalities must take the following macro-economic forecasts into consideration when preparing their 2016/17 budgets and MTREF.

Table 1: Macroeconomic performance and projections, 2014 - 2018

Fiscal year	2014/15	2015/16	2016/17	2017/18	2018/19
	Actual	Estimate	Forecast		
CPI Inflation	5.6%	5.5%	6.0%	5.8%	5.8%

Source: Medium Term Budget Policy Statement 2015

Note: the fiscal year referred to is the national fiscal year (April to March) which is more closely aligned to the municipal fiscal year (July to June) than the calendar year inflation.

4. Key focus areas for the 2016/17 budget process

4.1 Local government conditional grants and additional allocations

The purpose of the conditional grants is to deliver on national government priorities relating to service delivery. Additional funding is allocated in the form of unconditional allocations such as the equitable share and the sharing of the general fuel levy. The main purpose of the equitable share is to fund the provision of free basic services to the poor.

The 2015 Medium Term Budget Policy Statement indicates that over the 2016 MTEF period, transfers to local government total R350.6 billion, with 59.5 per cent transferred as unconditional allocations and the rest as conditional grants. The division of available funds to local government have increased to R106.9 billion or 9.2 per cent of the national revenue for 2016/17. These funds are expected to increase to R128.4 billion by 2018/19.

Municipalities are advised to use the indicative numbers as set out in the 2015 Division of Revenue Act to compile their 2016/17 MTREF. In terms of the outer year (2018/19 financial year), it is proposed that municipalities conservatively limit funding allocations to the indicative numbers as proposed in the 2015 Division of Revenue Act for 2017/18. The DoRA is available at <http://www.treasury.gov.za/legislation/acts/2015/Default.aspx>

It is imperative that municipalities reflect the conditional grant allocations as per the 2016 Division of Revenue Bill once available, and plan effectively to utilise these allocations appropriately so as to avoid requesting roll-overs.

Changes to local government allocations

- The *local government equitable share* is being increased by R6 billion over the MTEF to provide some relief for the impact of increasing costs of bulk water and electricity and rapid growth in households.
- The *municipal demarcation transition grant* allocation is being increased to subsidise the additional administrative costs in respect of the re-demarcations. This includes increased allocations for demarcations approved in 2013 and allocations for demarcations approved in 2015.
- The *municipal systems improvement grant* will become an indirect grant so that it can support more strategic capacity building interventions at municipalities. The initiatives funded from this grant will be aligned to the Back-to-Basics strategy and the Department of Cooperative Governance and the National Treasury will jointly decide on the details of how this programme will work.
- The *municipal human settlements capacity grant* was introduced in 2014/15 to facilitate the development of capacity to manage human settlements programmes in anticipation of the assignment of the housing function to cities. However, there is no longer a need for this standalone grant as the assignment process was subsequently suspended indefinitely. The grant will be terminated in 2016/17. Cities will be allowed to use 3 per cent of the *urban settlements development grant* to improve their capacity with regard to the built-environment functions.
- The indirect *bucket eradication programme grant* was due to end in 2015/16 but will be extended to 2016/17 to complete the eradication of bucket sanitation systems in formal residential areas. Sanitation upgrading and bucket system eradication in informal areas will continue to be funded through the *urban settlements development grant*, *human settlements development grant* and *municipal infrastructure grant*.

Reforms to local government fiscal framework

The second phase of the collaborative review of the local government infrastructure grant system led by the National Treasury has been concluded. Several changes will be introduced over the 2016 MTEF period to streamline these grants and improve the value and sustainability of associated investments. Proposed reforms to be introduced from 2016 include:

- Enabling the use of funds for the renewal, refurbishment and rehabilitation of existing infrastructure, alongside asset management systems to plan and prioritise maintenance;

- Reforming the public transport network grant to support financially sustainable transit networks in large cities by using a formula to allocate the grant, thereby giving cities a clear financial envelope within which to plan;
- Consolidating urban grants over the MTEF to tackle challenges in the built environment;
- Rationalising grants to reduce complexity and administrative burdens. Several water and sanitation grants are being merged;
 - The *municipal water infrastructure grant*, the *water services operating subsidy grant* and the *rural households infrastructure grant* will be merged into a single grant that will be targeted at reticulation and on-site-solutions in low capacity municipalities.
- Introducing greater differentiation between urban and rural areas. Secondary cities in particular will see changes to their planning requirements.

National Treasury has initiated a process of reviewing development charges. A national draft policy framework on development charges has been developed and processes are underway to consult on the policy. The consultations will convene early next year. More detailed information on these consultation processes will be provided in due course. For more information in this regard, you can contact Ms Judy Mboweni at Judy.Mboweni@treasury.gov.za or Ms Mmachuene Mpyana at Mmachuene.Mpyana@treasury.gov.za.

4.2 Reporting indicators

The National Treasury has engaged in a process of rationalising the reporting regime for the eight metropolitan municipalities with an aim to reduce the reporting burden whilst also creating a pool of indicators that will enable government to monitor progress on the outcomes and impact of municipal spending. This process has progressed significantly with regards to the outcomes and impact indicators whilst the rationalisation of the inputs, activities and output indicators is still undergoing rigorous consultations. The metropolitan outcomes and impact indicators are linked to the Built Environment Performance Plans (BEPPs) and therefore the Integrated City Development Grant (ICDG); whereas the inputs, outputs and activities indicators are linked directly to the Service Delivery Budget Implementation Plan (SDBIP) only as it relates to the built environment. When finalised, these indicators will assist the process of standardising the SDBIP.

The functional outcomes indicators are due to be finalised for the next budget cycle whilst the work on the input and output indicators is ongoing. Over time these reforms will also be extended to non-metropolitan municipalities.

4.3 Municipal Standard Chart of Accounts (*mSCOA*)¹

The *mSCOA* Regulations apply to all municipalities and municipal entities with effect from 1 July 2017 and only eleven months remain for preparation and implementation readiness as the 2017/18 MTREF budgets will all have to be aligned to *mSCOA*.

The implementation of *mSCOA* must be considered a business reform and it requires a significant change in municipal business processes; and it involves systems conversion and/

¹ The Minister of Finance promulgated the Municipal Regulations on a Standard Chart of Accounts in government gazette Notice No. 37577 on 22 April 2014.

or re-implementation. Further, *mSCOA* requires organisational change as it is not only a financial reform that is being introduced.

The 2016/17 tabled budget or consolidated budget must include an annexure containing the municipality's *mSCOA* project plan and progress to date.

National Treasury has a dedicated website to support municipalities with their *mSCOA* readiness efforts. The following information is available:

- The current *mSCOA* classification framework;
- The *mSCOA* Project Summary Document;
- All Municipal *SCOA* Circulars, providing hands-on support on how to undertake preparation and implementation;
- Integrated Consultative Forum (ICF) – documentation and presentations of the *mSCOA* piloting process; and
- The Frequently Asked Questions Database (FAQ Database) – where previously asked questions and responses can be accessed and new questions may be logged.

For more information on *mSCOA* and other benefits of the reform, visit: <http://mfma.treasury.gov.za/RegulationsandGazettes/MunicipalRegulationsOnAStandardChartOfAccountsFinal/Pages/default.aspx>

5. The revenue budget

National Treasury continues to encourage municipalities to keep increases in rates, tariffs and other charges at levels that reflect an appropriate balance between the interests of poor households, other customers and ensuring the financial sustainability of the municipality. For this reason municipalities ***must justify in their budget documentation all increases in excess of the 6.0 per cent*** projected inflation target in the budget narratives.

Municipalities are not maximising the revenue generation potential of their revenue base and this, together with the increasing unemployment and the decline in economic growth means that there is just not sufficient municipal own revenue to supplement the national funding sources to local government.

It is therefore necessary for municipalities to ensure that their tariffs are adequate to, at the minimum, cover the costs of bulk services and also to ensure that all properties are correctly billed for property rates and all services rendered.

5.1 Eskom bulk tariff increases

In terms of the Multi Year Price Determination (MYPD) for Eskom's tariffs approved by the National Energy Regulator of South Africa (NERSA), a tariff increase of 8 per cent has been approved for the 2016/17 financial year. However, Eskom has applied to NERSA to use tariff increases in 2016/17 to compensate for an under-recovery of R22.8 billion in 2013/14. Such an application is allowed in terms of the NERSA's methodology for calculating the MYPD. A similar Eskom application was approved by NERSA for 2015/16.

NERSA is now in the process of reviewing this application. Until a decision on Eskom's application is announced by NERSA, municipalities are advised to base their planning on the 8 per cent increase already approved by NERSA. However, municipalities should be aware that it is possible that a higher tariff increase could be approved and take this possibility into account in their planning for the 2016/17 MTREF. NERSA expects to make a decision on Eskom's application by February 2016.

Municipalities are urged to examine the cost structure of providing electricity services and to apply to NERSA for electricity tariff increases that reflect the total cost of providing the service so that they work towards achieving financial sustainability.

5.2 Water and sanitation tariff increases

Municipalities should consider the full cost of rendering the water and sanitation services when determining tariffs related to these two services. If the tariffs are low and result in the municipality not recovering their full costs, the municipality should develop a pricing strategy to phase-in the necessary tariff increases in a manner that spreads the impact on consumers over a period of time. Should this not be the case, municipalities will be required to clearly articulate the reasons and remedial actions to rectify this position in their budget document. It is expected that the tariffs will differ per municipality depending on the bulk water tariff increases charged by their respective water boards.

Municipalities are urged to design an Inclining Block Tariff (IBT) structure that is appropriate to its specific circumstances, and ensures an appropriate balance between 'low income customers' and other domestic, commercial and business customers, and the financial interests of the municipality. While considering this structure, municipalities are advised to evaluate if the IBT system will be beneficial to them depending on consumption patterns in their areas.

In light of the current drought being experienced across large parts of the country, and to mitigate the need for water tariff increases, municipalities must put in place appropriate strategies to limit water losses to acceptable levels. In this regard municipalities must ensure that water used by its own operations is charged to the relevant service, and not simply attributed to water losses.

6. Funding choices and management issues

Municipalities should carefully consider the costs associated with service delivery while keeping in mind affordability and inflation when setting revenue raising measures. Once again, approving tariffs that are far below levels representing cost of providing the services would negatively impact on the financial sustainability of municipalities.

Furthermore municipalities must consider the following when compiling their 2016/17 MTREF budgets:

- improving the effectiveness of revenue management processes and procedures; and
- pay special attention to cost containment measures by, amongst other things, controlling unnecessary spending on nice-to-have items and non-essential activities.

6.1 Employee related costs

The South African Local Government Bargaining Council recently entered into a three-year *Salary and Wage Collective Agreement* for the period 01 July 2015 to 30 June 2018. The agreement reached is as follows:

- 2015/16 Financial Year – 7 per cent
- 2016/17 Financial Year – average CPI (Feb 2015 – Jan 2016) + 1 per cent
- 2017/18 Financial Year – average CPI (Feb 2016 – Jan 2017) + 1 per cent

Municipalities are advised to use this Salary and Wage Agreement preparing their 2016/17 MTREF budgets.

6.2 Remuneration of councilors

Municipalities are advised to budget for the actual costs approved in accordance with the gazette on the Remuneration of Public Office Bearers Act: Determination of Upper Limits of Salaries, Allowances and Benefits of different members of municipal councils published annually by the Department of Cooperative Governance.

6.3 Service level standards

In spite of a broad guideline on the minimum service standards having been issued with MFMA Circular No. 75, many municipalities did not incorporate the service level standards in their respective budget documentation nor submit these to National Treasury. All municipalities are again advised to formulate service level standards which must form part of their 2016/17 MTREF tabled budget documentation. The said service level standards must, together with the budgets, tabled before their respective municipal councils by no later than 31 March 2016.

It is noted that the same service level standards do not apply across all municipalities. Therefore, the hereon provided outline is intended to guide municipalities with the development of their respective service level standards. The outline can be amended to suit the requirements of individual municipalities. Municipalities are advised to also consider other guideline documents issued by other institutions available on the link indicated below.

A framework was developed as an outline to assist municipalities in finalising their service level standards. The outline can be accessed on the link below:

<http://mfma.treasury.gov.za/Circulars/Documents/Forms/AllItems.aspx?RootFolder=/Circulars/Documents/Circular 75 - 2015 MTREF&FolderCTID=&View={06AB24E7-1C64-4A80-A0FA-273E6A829094}>

6.4 Outcomes of the Financial Management Capability Maturity Model (FMCMM)

In prioritising the upcoming MTREF decisions, municipalities should review the detailed analysis of the results of the FMCMM assessments with the results of the 32 financial ratios that provide a holistic picture of the financial capability and sustainability of the municipality. These reports have been communicated to all municipalities and should be read in conjunction with the most recent budget reviews and feedback provided by National Treasury and Provincial Treasuries. Key aspects requiring attention should be discussed with the municipal council and management so that they can be prioritised for resource allocation and implementation.

Comments on these assessments and any other related legislative advice on the MFMA can be submitted to the MFMA helpdesk facility at: MFMA@treasury.gov.za

6.5 Hand-over reports for the newly elected council

Each municipal manager, working together with the Chief Financial Officer (CFO) and senior managers, is encouraged to prepare a hand-over report that can be tabled at the first meeting of the newly elected council. The aim of this hand-over report is to provide the new councils important orientation information regarding the municipality, the state of its finances, service delivery and capital programme, as well as key issues that need to be addressed.

It is proposed that the hand-over report should include:

- An overview of the demographic and socio-economic characteristics of the municipality;

- An overview of the organisational structure of the municipality, with the names and numbers of senior managers;
- An overview of key municipal policies that councillors need to be aware of, and where they can obtain the full text of such policies;
- An overview of issues that still need to be addressed in relation to the municipality's turnaround strategy;
- An overview of the municipality's financial health, with specific reference to:
 - Its cash and investments, and its funding of commitments (Table A8);
 - Cash coverage of normal operations (see Supporting Table SA10);
 - Creditors outstanding for more than 30 days, along with reasons for delayed settlement;
 - Current collection levels and debtors outstanding for more than 30 days; and
 - Extent of existing loans, and associated finance and redemption payments.
- The municipality's 2014/15 audit outcome, and its strategy to address audit issues;
- An overview of the provision of basic services, including plans to address backlogs;
- An overview of the state of the municipality's assets, with particular reference to the asset management plan, and repairs and maintenance requirements;
- A list of the main infrastructure projects planned for the 2016/17 budget and MTREF;
- A list of key processes requiring council input over the next six months, e.g. revision of the IDP, approval of specific policies etc. and
- Any other information deemed to be important.

In addition to the hand-over report, each new councillor should be given the municipalities' revised IDP, the adopted 2016/17 budget (if already passed), the mid-year budget and performance assessment report for 2015/16, and the latest monthly financial statement, and the annual report for 2014/15.

Municipal managers should submit their municipality's hand-over report to the relevant provincial department responsible for local government, provincial treasuries, the Department of Co-operative Governance (DCoG) and to National Treasury.

7. Conditional Grant Transfers to Municipalities

7.1 Pledging of conditional grants

Read together with paragraph 4.5 of MFMA Circular No. 51, all conditions for the considerations of the conditional grant pledge should be aligned with the provisions of section 46 of the MFMA regarding long-term borrowing.

While pledging of conditional grants assists in accelerating capital projects, municipalities are cautioned that pledging will only be approved for projects that have gone through a proper planning process as well as meeting the criteria for pledging as per MFMA Circular No. 51.

8. The Municipal Budget and Reporting Regulations

National Treasury has released Version 2.8 of Schedule A1 (the Excel Formats). This version incorporates minor changes (see Annexure A). Therefore **ALL** municipalities **MUST** use this version for the preparation of their 2016/17 Budget and MTREF.

Download Version 2.8 of Schedule A1 by clicking [HERE](#)

The Municipal Budget and Reporting Regulations, formats and associated guides are available on National Treasury's website at:

<http://mfma.treasury.gov.za/RegulationsandGazettes/Pages/default.aspx>

8.1 Assistance with the compilation of budgets

If municipalities require advice with the compilation of their respective budgets, specifically the budget documents or Schedule A1, they should direct their enquiries to their respective provincial treasuries or to the following National Treasury official as follows:

	Responsible NT officials	Tel. No.	Email
Eastern Cape	Templeton Phogole	012-315 5044	Templeton.Phogole@treasury.gov.za
	Matjatji Mashoeshoe	012-315 6567	Matjatji.Mashoeshoe@treasury.gov.za
Free State	Vincent Malepa	012-315 5539	Vincent.Malepa@treasury.gov.za
	Cethekile Moshane	012-315 5079	Cethekile.moshane@treasury.gov.za
	Katlego Mabiletsa	012-395 6742	Katlego.Mabiletsa@treasury.gov.za
Gauteng	Kgomotso Baloyi	012-315 5866	Kgomotso.Baloyi@treasury.gov.za
	Nomxolisi Mawulana	012-315 5460	Nomxolisi.Mawulana@treasury.gov.za
KwaZulu-Natal	Bernard Mokgabodi	012-315 5936	Bernard.Mokgabodi@treasury.gov.za
	Johan Botha	012-315 5171	Johan.Botha@treasury.gov.za
Limpopo	Una Rautenbach	012-315 5700	Una.Rautenbach@treasury.gov.za
	Sifiso Mabaso	012-315 5952	Sifiso.Mabaso@treasury.gov.za
Mpumalanga	Jordan Maja	012-315 5663	Jordan.Maja@treasury.gov.za
	Anthony Moseki	012-315 5174	Anthony.Moseki@treasury.gov.za
Northern Cape	Willem Voigt	012-315 5830	Willem.Voigt@treasury.gov.za
	Mandla Gilimani	012-315 5807	Mandla.Gilimani@treasury.gov.za
North West	Sadesh Ramjathan	012-315 5101	Sadesh.Ramjathan@treasury.gov.za
	Makgabo Mabotja	012-315 5156	Makgabo.Mabotja@treasury.gov.za
Western Cape	Vuyo Mbunge	012-315 5661	Vuyo.Mbunge@treasury.gov.za
	Kevin Bell	012-315 5725	Kevin.Bell@treasury.gov.za
Technical issues with Excel formats	Elsabe Rossouw	012-315 5534	lqdataqueries@treasury.gov.za

National Treasury, together with the provincial treasuries, will undertake a compliance check and, where municipalities have not provided complete budget information, the municipal budgets will be returned to the mayors and municipal managers of the affected municipalities for the necessary corrections. Municipal managers are reminded that the annual budget must be accompanied by a 'quality certificate' in accordance with the format as set out in item 31 of Schedule A in the Municipal Budget and Reporting Regulations.

The National Treasury would like to emphasise that where municipalities have not adhered to the Municipal Budget and Reporting Regulations, ***those municipalities will be required to go back to the municipal council and table a complete budget document aligned to the requirement of the Municipal Budget and Reporting Regulations.***

Municipalities with municipal entities are once again reminded to prepare consolidated budgets and in-year reports for both the parent municipality and its entity or entities in that they to produce:

- An annual budget, adjustments budget and monthly financial reports for the parent municipality in the relevant formats; and
- A consolidated annual budget, adjustments budget and monthly financial reports for the parent municipality and all its municipal entities in the relevant formats.

The A Schedule that the municipality submits to National Treasury must be a consolidated budget for the municipality (plus entities) and not the budget of the parent municipality only.

9. Budget process and submissions for the 2016/17 MTREF

9.1 Submitting budget documentation and schedules for 2016/17 MTREF

To facilitate oversight of compliance with the Municipal Budget and Reporting Regulations, accounting officers are reminded that:

- Section 22(b)(i) of the MFMA requires that **immediately** after an annual budget is tabled in a municipal council, it must be submitted to the National Treasury and the relevant provincial treasury in both printed and electronic formats. If the annual budget is tabled to council on 31 March 2016, the final date of submission of the electronic budget documents and corresponding electronic returns is **Friday, 01 April 2016**. The deadline for submission of hard copies including council resolution is **Friday, 8 April 2016**.
- Section 24(3) of the MFMA, read together with regulation 20(1), requires that the approved annual budget must be submitted to both National Treasury and the relevant provincial treasury **within ten working days** after the council has approved the annual budget. If the council only approves the annual budget on 30 June 2016, the final date for such a submission is **Thursday, 14 July 2016**, otherwise an earlier date applies.

The municipal manager must submit:

- the budget documentation as set out in Schedule A (version 2.8) of the Municipal Budget and Reporting Regulations, including the main Tables (A1 - A10) and ALL the supporting tables (SA1 – SA37) in both printed and electronic formats;
- the draft service delivery and budget implementation plan in both printed and electronic format;
- the draft integrated development plan;
- the council resolution;
- signed Quality Certificate as prescribed in the Municipal Budget and Reporting Regulations; and
- schedules D, E and F specific for the entities.

Municipalities are required to send electronic versions of documents and the A1 schedule to lqdocuments@treasury.gov.za.

If the budget documents are too large to be sent via email (exceeds 4MB) please submit to lqbigfiles@gmail.com. Any problems experienced in this regard can be addressed with Elsabe Rossouw at Elsabe.Rossouw@treasury.gov.za.

Municipalities are required to send printed submissions of their budget documents and council resolution to:

For couriered documents

Ms Linda Kruger
National Treasury
40 Church Square
Pretoria, 0002

For posted documents

Ms Linda Kruger
National Treasury
Private Bag X115
Pretoria, 0001

In addition to the above mentioned budget documentation, metropolitan municipalities must submit the Built Environment Performance Plan (BEPP) tabled in council on 31 March 2016 to Yasmin.coovadia@treasury.gov.za. If the BEPP documents are too large to be sent via email (exceeds 4MB) please submit to yasmin.coovadia@gmail.com or send to Yasmin Coovadia via Dropbox; any problems experienced in this regard can be addressed with

Yasmin.Coovadia@treasury.gov.za. Hard copies of the BEPP may be sent to Yasmin Coovadia, National Treasury, 3rd floor 40 Church Square, Pretoria, 0002 or Private Bag X115, Pretoria, 0001.

9.2 Budget reform returns to the Local Government Database for publication

For publication purposes, municipalities are still required to use the Budget Reform Returns to upload budget and monthly expenditure to the National Treasury Local Government Database. All returns are to be sent to lgdatabase@treasury.gov.za. Municipalities are requested to submit returns for both the draft budget and the final adopted budget. This will assist the National and provincial treasuries with the annual benchmark process.

The aligned electronic returns may be downloaded from National Treasury's website at the following link: http://mfma.treasury.gov.za/Return_Forms/Pages/default.aspx.

9.3 Publication of budgets on municipal websites

In terms of section 75 of the MFMA, all municipalities are required to publish their tabled budgets, adopted budgets, annual reports (containing audited annual financial statements) and other relevant information on the municipality's website. This will aid in promoting public accountability and good governance.

All relevant documents mentioned in this circular are available on the National Treasury website, <http://mfma.treasury.gov.za/Pages/Default.aspx>. Municipalities are encouraged to visit it regularly as documents are regularly added / updated on the website.

Contact



national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

Post Private Bag X115, Pretoria 0001
Phone 012 315 5009
Fax 012 395 6553
Website <http://www.treasury.gov.za/default.aspx>

JH Hattingh

Chief Director: Local Government Budget Analysis

07 December 2015

Annexure A – Changes to Schedule A1 – the ‘Excel formats’

As noted above, National Treasury has released Version 2.8 of Schedule A1 (the Excel Formats). It incorporates the following changes:

No.	Sheet	Amendment	Reason
1	A10	Cost of free basic services	Improve reporting of cost of free basic services provided including in informal settlements.
2	SA1	Revenue foregone	Improve reporting on revenue foregone and cost of free basic services.
3	SA9	Provision of free basic services	To provide detailed breakdown of free basic services which links to A10.

Annexure B – Municipalities affected by redeterminations

Redeterminations Finalised by the MDB in 2013 and 2015

Province	Affected Local Municipalities	Impact
Redeterminations finalised in 2013		
Gauteng	Randfontein and Westonaria	Reduction of 1 Municipality
KwaZulu - Natal	Vulamehlo and Umdoni	Reduction of 1 Municipality
	Hlabisa and The Big 5 False Bay	Reduction of 1 Municipality
	Umtshezi and Imbabazane	Reduction of 1 Municipality
	Ezingoleni and Hibiscus Coast	Reduction of 1 Municipality
	Emnambithi/Ladysmith and Indaka	Reduction of 1 Municipality
	Kwa Sani and Ingwe	Reduction of 1 Municipality
	Ntambanana, Mthonjaneni and uMhlathuze	Reduction of 1 Municipality . (Ntambanana disestablished with 8 wards. Ward s1-4 incorporated into Mthonjaneni; wards 5-8 incorporated into uMhlathuze)
Redeterminations finalised in 2015		
KwaZulu - Natal	Mooi Mpopana and Umvoti	No reduction in number of Municipalities. Portion of Mooi Mpopana (Cadham voting district) incorporated into Umvoti.
Mpumalanga	Mbombela and Umjindi	Reduction of 1 Municipality
Free State	Mangaung and Naledi	Reduction of 1 Municipality
North West	Ventersdorp and Tlokwe	Reduction of 1 Municipality
Northern Cape	Mier and //Khara Hais	Reduction of 1 Municipality
Limpopo	Mutale, Thulamela, Makhado and Musina	Reduction of 1 Municipality (Mutale disestablished. Parts of Mutale are incorporated into Thulamela and Musina. Parts of Makhado and Thulamela are incorporated to form a new municipality.)
	New Municipality	Parts of Makhado and Thulamela are incorporated to form a new municipality .
	Aganang, Blouberg, Molemole and Polokwane	Reduction of 1 Municipality . (Aganang disestablished; parts of Aganang incorporated into Blouberg, Molemole and Polokwane).
	Fetakgomo and Greater Tubatse	Reduction of 1 Municipality
	Modimolle and Mookgopong	Reduction of 1 Municipality
Eastern Cape	Gariep and Maletswai	Reduction of 1 Municipality
	Nxuba and Nonkobe	Reduction of 1 Municipality
	Inkwanca, Tsolwana and Lukanji	Reduction of 2 Municipalities (all 3 amalgamated into 1)
	Camdeboo, Baviaans and Ikwezi	Reduction of 2 Municipalities (all 3 amalgamated into 1)

Annexure C – Previous MFMA Circulars

Budget management issues dealt with in previous MFMA Circulars

Municipalities are reminded to refer to MFMA Circulars 48, 51, 54, 55, 66, 67 and 70 with regards to the following issues:

1. Mayor's discretionary funds and similar discretionary budget allocation – National Treasury regards allocations that are not designated for a specific purpose to be bad practice and discourage them (refer to MFMA Circular 51).
2. Unallocated ward allocations – National Treasury does not regard this to be a good practice, because it means that the tabled budget does not reflect which ward projects are planned for purposes of public consultation and council approval (refer to MFMA Circular 51).
3. New office buildings – Municipalities are required to send detailed information to National Treasury if they are contemplating building new main office buildings (refer to MFMA Circular 51).
4. Virement policies of municipalities – Municipalities are reminded of the principles that must be incorporated into municipal virements policies (refer to MFMA Circular 51).
5. Providing clean water and managing waste water – Municipalities were reminded to include a section on 'Drinking water quality and waste water management' in their budget document (refer to MFMA Circular 54).
6. Renewal and repairs and maintenance of existing assets – Allocations to repairs and maintenance, and the renewal of existing infrastructure must be prioritised. Municipalities must provide detailed motivations in their budget documentation if allocations do not meet the required benchmarks set out in MFMA Circular 55 and 66.
7. Credit cards and debit cards linked to municipal bank accounts are not permitted – On 02 August 2011 National Treasury issued a directive to all banks informing them that as from 01 September 2011 they are not allowed to issue credit cards or debit cards linked to municipal bank accounts (refer to MFMA Circular 55).
8. Water and sanitation tariffs must be cost reflective - refer to MFMA Circular 66.
9. Solid waste tariffs – refer to MFMA Circular 70.
10. Variances between 4th Quarter section 71 results and annual financial statements – refer to Circular 67.
11. Additional In-Year reporting requirements – refer to MFMA Circular 67.
12. Appropriation statement (reconciliation: budget and in-year performance)- reference is made to circular 67. It came to the attention of National Treasury that a number of municipalities did not include the appropriation statement as part of their 2012/13 or 2013/14 annual financial statement. In terms of the Standards of GRAP 24 on the Presentation of Budget Information in Financial Statements, municipalities are required to present their original and adjusted budgets against actual outcome in the annual financial statements. This is considered an appropriation statement and the comparison between the budget and actual performance should be a mirror image of each other as it relates to the classification and grouping of revenue and expenditure as has been the case in a national and provincial context. This statement is subject to auditing and accordingly supporting documentation would be required to substantiate the compilation of this statement.
13. Eliminating non-priority spending – The 2013 MTBPS emphasised the need for government to step-up its efforts to combat waste, inefficiency and corruption (refer to MFMA circular 70).
14. Council oversight over the budget process – refer to MFMA Circular 70.

Conditional grant issues dealt with in previous MFMA Circulars

Municipalities are reminded to refer to MFMA Circulars 48, 51, 54, 55 and 67 with regards to the following issues:

1. Accounting treatment of conditional grants: Municipalities are reminded that in accordance with accrual accounting principles, conditional grants should only be treated as 'transfers recognized' revenue when the grant revenue has been 'earned' by incurring expenditure in accordance with the conditions of the grant.
2. VAT on conditional grants: SARS has issued a specific guide to assist municipalities meeting their VAT obligations – **VAT 419 Guide for Municipalities**. To assist municipalities accessing this guide it has been placed on the National Treasury website at: <http://mfma.treasury.gov.za/Guidelines/Pages/default.aspx>
3. Interest received and reclaimed VAT in respect of conditional grants: Municipalities are reminded that in MFMA Circular 48, National Treasury determined that:
 - Interest received on conditional grant funds must be treated as 'own revenue' and its use by the municipality is not subject to any special conditions; and
 - 'Reclaimed VAT' in respect of conditional grant expenditures must be treated as 'own revenue' and its use by the municipality is not subject to any special conditions.
4. Appropriation of conditional grants that are rolled over – As soon as a municipality receives written approval from National Treasury that its unspent conditional grants have been rolled-over it may proceed to spend such funds (refer to MFMA Circular 51 for other arrangements in this regard).
5. Pledging of conditional grant transfers – the 2015 Division of Revenue Bill contained a provision that allows municipalities to pledge their conditional grants. The end date for the pledges is extended to 2017/18. The process of application as set out in MFMA Circular 51 remains unchanged.
6. Separate reporting for conditional grant roll-overs – National Treasury has put in place a separate template for municipalities to report on the spending of conditional grant roll-overs. Municipalities are reminded that conditional grant funds can only be rolled-over once, so if they remain unspent in the year in which they were rolled-over they MUST revert to the National Revenue Fund.
7. Payment schedule – National Treasury has instituted an automated payment system of transfers to municipalities in order to ensure appropriate safety checks are put in place. Only the primary banking details verified by National Treasury will be used for effecting transfers.
8. Conditional grant transfers/payments, the responsibilities of transferring and receiving authorities and the criteria for the rollover of conditional grants – It is important that the transfers made to municipalities' are transparent, and properly captured in the municipalities' budgets. MFMA Circular no: 67 in this regard refers. The criterion for the rollover of conditional grants is stipulated in MFMA Circular no: 51.

MBRR issues dealt with in previous MFMA Circulars

Municipalities are reminded to refer to MFMA Circulars 48, 51, 54, 55 with regards to the following issues:

1. Budgeting for revenue and 'revenue foregone' – The 'realistically anticipated revenues to be collected' that must be reflected on the Budgeted Statement of Financial Performance (Tables A2, A3 and A4) must exclude 'revenue foregone'. The definition

of 'revenue foregone' and how it is distinguished from 'transfers and grants' is explained in MFMA Circular 51.

2. Preparing and amending budget related policies – Information on all budget related policies and any amendments to such policies must be included in the municipality's annual budget document (refer to MFMA Circular 54).
3. 2013/14 MTREF Funding Compliance Assessment – All municipalities were required to perform the funding compliance assessment outlined in *MFMA Funding Compliance Guideline* and to include the relevant information outlined in MFMA Circular 55 in their 2015/16 budgets (refer to MFMA Circular 55).
4. Tabling a funded budget - It is critical that municipalities adopt and implement funded budgets as per Section 18 of the MFMA. Tables A7 and A8 which if completed correctly by the municipality, it will provide most of the information required to evaluate whether a municipality's operating and capital budgets are **funded** or not.



Municipal Budget Circular for the 2016/17 MTREF

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Introduction

The budget circular is compiled annually to guide municipalities on how to prepare their budget inputs. This circular is a follow-up to the MFMA Budget Circular No.78 that focused on the preparation of the 2016/17 Medium Term Revenue and Expenditure Framework (MTREF). This guidance includes national policy imperatives that should be accommodated and other relevant information. The circular provides a summary of South Africa's economic outlook, inflationary targets, financial management issues and specific reference on how to give effect to National Treasury's Municipal Budget and Reporting Regulations (MBRR). The key focus of this circular is the impact of the date of the 2016 Local Government Elections on municipalities affected by re-demarcations and the changes to the local government grant allocations.

1. 2016 Local Government Elections and the budget process

1.1 Impact of Local Government Elections on demarcation changes

The date of the 2016 local government elections has not yet been declared, which means that it is also not yet known when the new demarcations will come into effect. The re-demarcation could take place before or after the start of the 2016/17 municipal financial year, which begins on 01 July 2016.

Allocations published in the 2016 Division of Revenue Bill are based on the new municipal boundaries because these new demarcations will be in effect for the majority of the 2016/17 municipal financial year. The following guidance was provided in the MFMA Budget Circular No. 78:

If the elections are held before 01 July 2016, merging municipalities will be expected to:

- Compile individual budgets for the 2016/17 MTREF and work as a team with other affected municipalities on the planning and technical processes in compiling the consolidated budget for the newly demarcated municipality; and
- Complete the remaining weeks of the financial year on their existing budget structures (and existing demarcations). The allocations published in the 2016 Division of Revenue Bill will then be transferred to the re-demarcated municipalities from 01 July 2016.

However, additional clauses have been added to section 38 of the 2016 Division of Revenue Bill to enable the National Treasury to gazette revised allocations if the elections take place after 01 July 2016.

If elections are held after 01 July 2016, the following is expected:

- Revised allocations to be transferred to the current 278 municipalities for the period between 01 July 2016 and the date of the elections (when the re-demarcated municipal boundaries will come into effect);
- The remaining allocations will be transferred to the re-demarcated municipalities after the elections;
- Merging municipalities to compile individual budgets for the 2016/17 MTREF and work as a team with other affected municipalities on the planning and technical processes in compiling the consolidated budget for the newly demarcated municipality; and
- Municipalities to implement the individual budgets until the new re-demarcations come into effect.

In areas affected by major re-demarcations the focus of the budget process for the 2016/17 MTREF should be on preparing the budget of the new municipalities that will come into effect

on the date of the 2016 local government elections. Public consultations and decisions regarding tariffs and spending priorities should be focused on how these new institutions will be funded and deliver services. As elections must be held by mid-August (in terms of the requirements of section 24 of the Municipal Structures Act) these new municipalities will be responsible for delivering services for the majority of the 2016/17 financial year and over the rest of the medium term period. Preparation of these budget documents should be led by the Change Management Committee established to manage the implications of re-demarcations in each area.

The councils of the pre-election municipalities affected by the boundary change must jointly consider the budget for the new municipality to be established to ensure that all the issues are addressed e.g. budget related policies. The draft budget prepared by the Change Management Committee and agreed to by the pre-election councils should then be adopted by the newly elected council as soon as possible after it is constituted. If there are changes to be made, they must be considered during the 2016/17 adjustments budget or the 2017/18 MTREF.

Municipalities that will be merged or disestablished on the date of the local government elections must also prepare 2016/17 MTREF budgets for their existing municipality. If the election is held after 01 July then expenditure and the collection of revenue will be done in terms of this budget until the budget of the new council is adopted. The budgets that these municipalities prepare must be aligned to the budget for the new municipality described above.

If two municipalities are merging then the total of the transfers they budget to receive should be equal to the total allocated to the new municipality in the 2016 Division of Revenue Bill. Municipalities can use the proportion of funds allocated to each municipality in terms of the 2015 Division of Revenue Act as a guide to how to apportion 2016/17 MTEF allocations between the existing municipalities. For example, if municipality 1 and municipality 2 are merging to form municipality 3 and municipality 1 received an equitable share twice as large as municipality 2 in 2015/16, then municipality 1 should prepare a 2016/17 MTREF budget based on receiving 66.6 per cent of the equitable share allocation published for municipality 3 in the 2016 Division of Revenue Bill.

If the local government election date is after 01 July 2016, National Treasury will gazette how much will be transferred to each pre-election municipality for the period between 01 July 2016 and Election Day. In terms of the requirements and process set out in section 38 of the 2016 Division of Revenue Bill, this gazette will be issued within 2 weeks after the election date is announced or the Bill is enacted (whichever date is later).

The changes to municipal boundaries result in some significant changes to municipal allocations in 2016/17. To cushion the impact of these changes, all municipalities will receive at least 95 per cent of the equitable share formula allocation indicatively allocated to them in 2016/17 in the 2015 Division of Revenue Act. For merged municipalities, this guarantee will be based on the sum of the equitable share allocations to the previously separate municipalities. In cases where a municipality has been split, the guarantee is applied to an area's share of the former municipality's equitable share, based on its portion of the population in the former municipality.

The role of the Change Management Committee is critical in ensuring that budget policies for the newly demarcated municipalities are developed. The MECs for local government have issued provincial gazettes in terms of section 14 of the Municipal Structures Act, 1998 (Act No 117 of 1998)(LGMSA) detailing the transitional process for municipalities affected by re-demarcations.

2. The South African economy and inflation targets

The 2016 Budget Review notes that since the tabling of the Medium Term Budget Policy Statement (MTBPS) in October 2015 the global economic crisis has deepened, exposing the depth of South Africa's external vulnerabilities and the internal constraints that limit its potential for growth. Global conditions have exposed South Africa's own economic weaknesses, with projected GDP growth revised down to 0.9 per cent for 2016 improving gradually to 1.7 per cent in 2017 and 2.4 per cent in 2018.

The weaker outlook is as a result of lower commodity prices, higher borrowing costs, drought and diminished business and consumer confidence. Constrained electricity supply continues to limit growth and deter fixed investment. Exchange rate depreciation is contributing to a higher inflation outlook during 2016.

These factors are expected to ease over the medium term. An upturn in global trade and investment, improved policy certainty, recovering consumer and business confidence, and greater availability and reliability of electricity in the outer years should support stronger growth.

Job creation remains one of the most pressing concerns for the economy. Headline employment grew by 3.7 per cent in the first three quarters of 2015. According to Statistics South Africa, 19 000 jobs were created in the formal sector and 273 000 in the informal sector in the first three quarters of 2015. The unemployment rate stood at 25.5 per cent in the third quarter of 2015, with the number of South Africans categorised as long-term unemployed 5.7 per cent higher than in 2014.

Higher inflation and weaker employment growth will impact on the ability of all municipalities to generate and collect revenue on services, to keep expenditures within budgeted allocations, and to borrow to fund capital expenditure programmes at affordable rates. Therefore it is critical for municipalities to review how they conduct their business to ensure value for money is obtained in all their expenditures, that revenue administration systems are operating effectively, that borrowing programmes are realistic, and that creditors (including bulk service providers) continue to be paid timeously and in full.

Municipalities must take the following macro-economic forecasts into consideration when preparing their 2016/17 budgets and MTREF.

Table 1: Macroeconomic performance and projections, 2014/15 – 2018/19

Fiscal year	2014/15	2015/16	2016/17	2017/18	2018/19
	Actual	Estimate	Forecast		
CPI Inflation	5.6%	5.4%	6.6%	6.2%	5.9%
Real GDP growth	1.6%	0.9%	1.2%	1.9%	2.5%

Source: 2016 Budget Review

Note: the fiscal year referred to is the national fiscal year (April to March) which is more closely aligned to the municipal fiscal year (July to June) than the calendar year inflation.

3. Key focus areas for the 2016/17 budget process

3.1 Local government conditional grants and additional allocations

The purpose of the conditional grants is to deliver on national government priorities relating to service delivery. Additional funding is allocated in the form of unconditional allocations such as the equitable share and the sharing of the general fuel levy. The main purpose of the equitable share is to fund the provision of free basic services to the poor.

Over the 2016 MTEF period, R339.6 billion will be transferred directly to local government and a further R22.9 billion has been allocated to indirect grants. Direct transfers to local government over the 2016 MTEF period account for 9.1 per cent of national government's non-interest expenditure. The total spending on local government increases to 9.8 per cent of national non-interest expenditure when indirect transfers are added.

Direct transfers to local government grow at an annual average rate of 6.8 per cent over the 2016 MTEF period. Transfers to local government tabled in the 2016 MTEF have been reduced to make funding available for other government priorities. Over the MTEF period, local government allocations decrease by R967 million. Despite these reductions, total allocations to local government still grow at an annual average rate of 6.7 per cent over the MTEF period.

Municipalities are reminded that all allocations included in the budgets must correspond to the allocations listed in the Division of Revenue Bill. All the budget documentation can be located on the National Treasury website by clicking on the link below:
<http://www.treasury.gov.za/documents/national%20budget/2016/>

Changes to local government allocations

- The *local government equitable share* - the 2016 budget reduces the baseline allocation by R300 million, or 0.6 per cent, in 2016/17. In 2017/18 and 2018/19, R1.5 billion and R3 billion are added respectively to offset the rising costs of basic services. These amounts revise downwards the 2015 MTBPS medium-term projection of an additional R6 billion. This change is as a result of government's reprioritisation of expenditure.
- The *municipal demarcation transition grant* allocation – a total of R409.3 million has been allocated in 2016/17 and 2017/18 to fund the changes in municipal boundaries in affected municipalities.
- The *municipal systems improvement grant* has been reconfigured as an indirect grant from 2016/17 to help poorly performing municipalities with revenue collection, performance management and record keeping. Regional management support will also be provided to groups of municipalities facing common institutional weaknesses.
- A total of R350 million is added to the *bucket eradication programme grant* in 2016/17 to complete the eradication of bucket sanitation systems in formal residential areas. The *urban settlements development grant*, the *human settlements development grant* and the *municipal infrastructure grant* will continue to fund the upgrade of sanitation in informal settlements through various projects focused on improving these areas. An amount of R155 million is also reprioritised into the *regional bulk infrastructure grant*.
- There is also a small shift of funds from the *municipal infrastructure grant* to the *urban settlements development grant* to account for the absorption of Naledi Local Municipality (which receives the *municipal infrastructure grant*) into Mangaung Metropolitan Municipality (which receives the *urban settlements development grant*).

Reforms to local government infrastructure grants

The National Treasury, in collaboration with the Department of Cooperative Governance, the Department of Planning, Monitoring and Evaluation, SALGA and the FFC, has reviewed the system of local government infrastructure grants. Following an intergovernmental review of the local government infrastructure grant system, significant changes are being made to the way these grants are structured. The changes include:

- Allowing municipalities to use conditional grant funds to repair and refurbish existing infrastructure. Spending of grant funds on refurbishment should be focused on infrastructure serving the poor and does not remove the responsibility of municipalities to fund routine maintenance from the equitable share and own revenues. This will improve services and secure future revenue streams.
- Reducing the number of water and sanitation grants from four to two by merging of the previous *municipal water infrastructure grant*, the *water services operating subsidy grant* and the *rural household infrastructure grant* to create a new *water services infrastructure grant*. The regional bulk infrastructure grant is to fund large bulk-water and sanitation projects, and the water services infrastructure grant is to fund construction and refurbishment of reticulation schemes and on-site services in rural municipalities.
- A new formula to allocate the R6 billion per year set aside to upgrade public transport in 13 cities. The previous system incentivised cities to plan overly expensive systems in the hope of receiving more funding. The new formula provides greater certainty about the long-term support government will provide, and allows cities to plan affordable and sustainable infrastructure upgrades.

4. Revenue management

National Treasury continues to encourage municipalities to keep increases in property rates, tariffs for trading services and charges for other municipal own revenue sources within the parameters of the country's inflation rate. Furthermore, municipalities must adopt a tariff setting methodology that achieves an appropriate balance between the interests of poor households and other customers while ensuring financial sustainability of the municipality. Demand management is becoming increasingly necessary as the country faces water shortages and an unstable electricity supply. The approach to tariff setting should consider all these factors and strive to achieve an equitable balance.

It is anticipated that the cost of providing municipal services will grow at a faster rate than the transfers from national government. Resource scarcity will most likely increase the cost of bulk purchases in respect of water and electricity beyond the country's inflationary targets.

Furthermore, providing for free basic services in the case of poorer households must be carefully considered and, where some municipalities have opted to provide this benefit to ALL households, this may not be financially sustainable in the long-term. Where appropriate, a municipality should re-evaluate the costs and benefits of universal or targeted provision of free basic services subsidies, in order to protect their delivery to poor households in particular. At no point should the provision of these subsidies remove resources from programmes that will expand access to infrastructure services for presently un-served households.

Where municipalities do not have an adequate revenue base and where municipalities face a combination of challenges such as resource scarcity, high unemployment and slower than average economic growth, an aggressive approach to curbing non-core spending and improving operational efficiencies is strongly advised.

4.1 Tariff setting

There are several tools available and methodologies employed to determine the appropriate tariffs for water and electricity services. Municipalities may favour different approaches but the principles of tariff setting should be consistently applied.

Municipalities should consider the following practicalities when setting tariffs:

- Costs of bulk purchases and the fluctuation in the seasonal cost thereof;
- Consumption patterns to enable better demand planning and management; and
- In the event that municipalities have been under recovering costs, embark on a process to correct their tariff structures over a reasonable time period so that cost reflective tariffs are achieved.

The tariff setting process is reliant on sound baseline information such as the number of properties within the municipal area of jurisdiction, the values of these properties, the number of households identified as indigent or poor, the consumption patterns in respect of basic services and the growth patterns within the various geographic areas.

4.2 Eskom bulk tariff increases

In terms of the Multi Year Price Determination (MYPD) for Eskom's tariffs approved by the National Energy Regulator of South Africa (NERSA), a tariff increase of 9.4 per cent has been approved for the 2016/17 financial year. However NERSA has not yet approved and published guidelines on municipal electricity price increase for the 2016/17 financial year.

Municipalities are urged to examine the cost structure of providing electricity services and to apply to NERSA for electricity tariff increases that reflect the total cost of providing the service so that they work towards achieving financial sustainability.

5. Funding choices and management issues

Municipalities should carefully consider the costs associated with service delivery while keeping in mind affordability and inflation when setting revenue raising measures. Once again, approving tariffs that are far below levels representing the cost of providing the services would negatively impact on the financial sustainability of municipalities.

5.1 Employee related costs

The South African Local Government Bargaining Council recently entered into a three-year *Salary and Wage Collective Agreement* for the period 01 July 2015 to 30 June 2018. The agreement reached is as follows:

- 2015/16 Financial Year – 7 per cent
- 2016/17 Financial Year – average CPI (Feb 2015 – Jan 2016) + 1 per cent
- 2017/18 Financial Year – average CPI (Feb 2016 – Jan 2017) + 1 per cent

Municipalities are advised to use this Salary and Wage Agreement preparing their 2016/17 MTREF budgets.

5.2 Remuneration of councilors

Municipalities are advised to budget for the actual costs approved in accordance with the gazette on the Remuneration of Public Office Bearers Act: Determination of Upper Limits of Salaries, Allowances and Benefits of different members of municipal councils published on 21 December 2015 by the Department of Cooperative Governance.

5.3 Cost containment measures

In the 2016 State of the Nation Address by the President, the cost containment measures announced by the Minister of Finance in 2013 were re-emphasised. It was highlighted that excessive and wasteful expenditure has been reduced, but there is still more to be done to cut

wastage. In addition the President announced some new measures which include, amongst others:

- Curtailment of overseas trips and the submission of strong motivations by those requesting permission to travel i.e. the benefit to the country needs to be proved; and
- Institution of further restrictions on conferences, catering, entertainment and social functions.

The Minister of Finance announced further measures in his budget speech on 24 February 2016. The Mayors of municipalities were urged to join in eliminating wasteful expenditure in government.

The advice provided in MFMA Budget Circular (No. 58, 66, 70, 72, 74 and 75) on cost containment measures and elimination of non-priority spending is still applicable to municipalities. A separate MFMA Circular will be issued on cost containment measures. In addition National Treasury is firstly in a process of reviewing the National Treasury instruction on cost containment measures which was issued to accounting officers of departments and secondly, determining its applicability to local government. Once the process has been concluded, a Regulation on cost containment measures applicable to local government will be issued.

Municipalities were advised in MFMA Circular No. 70 to align their budgeting policies to the cost containment measures to the extent possible as approved by Cabinet in 2013. Municipalities are requested to table the cost containment measures in council and to submit evidence thereof to the National and Provincial Treasuries together with the budget documentation in terms of the MFMA.

5.4 2016/17 MTREF budget assessment

The National Treasury has continuously advised municipalities in previous budget circulars on financial management issues to be considered when compiling budgets. The 2016/17 MTREF budget assessment will critically consider the following:

- Cost reflective tariffs;
- Appropriateness of budget assumptions;
- Provision for asset renewal and maintenance;
- Credibility and level of funding of the budget (funded or not funded); and
- Alignment of the budgets to municipality's plans.

Therefore municipalities must ensure that their 2016/17 MTREF addresses the items listed above and further submit the methodology applied in setting tariffs when submitting budget documentation to the National Treasury in terms of the MFMA.

6. Conditional Grant Transfers to Municipalities

6.1 Overspending of conditional grants

Expenses incurred against conditional grants should be made in line with the allocations stated in the Division of Revenue Act (DoRA) as required by the Municipal Budget and Reporting Regulations (MBRR) in supporting tables SA 18 and 19. Municipalities must therefore adopt their annual budget in line with the allocations made in the DoRA.

In instances where municipalities overspent against their budgeted programmes, own revenue source should be used against such expenditure items. This implies that a debtor cannot be raised against the transferring national officer's future allocations.

6.2 Criteria for the rollover of conditional grant funds

The criteria published in MFMA Budget Circular No. 75 are still applicable when considering rollover requests. Municipalities must submit the required information or application to National Treasury by 31 August 2016, if not, the application will not be considered.

When considering rollover requests from municipalities, all unspent cash backed grants should be classified only as "Cash and cash equivalents". This number must also reconcile with the cash flow statements. All conditional grants must be spent in line with the conditions for which they are set for. They must not be invested.

6.3 Payment procedure on conditional grants

Conditional grants are paid in line with the approved payment schedule and are captured and authorised three days in advance. These payments include revised payment schedules, amended payment schedules, and withheld payments and rollovers credit payments.

7. The Municipal Budget and Reporting Regulations

National Treasury has released Version 2.8 of Schedule A1 (the Excel Formats). This version incorporates minor changes (see Annexure A). Therefore **ALL** municipalities **MUST** use this version for the preparation of their 2016/17 Budget and MTREF.

Download Version 2.8 of Schedule A1 by clicking [HERE](http://mfma.treasury.gov.za/RegulationsandGazettes/Pages/default.aspx)

The Municipal Budget and Reporting Regulations, formats and associated guides are available on National Treasury's website at:

<http://mfma.treasury.gov.za/RegulationsandGazettes/Pages/default.aspx>

7.1 Assistance with the compilation of budgets

If municipalities require advice with the compilation of their respective budgets, specifically the budget documents or Schedule A1, they should direct their enquiries to their respective provincial treasuries or to the following National Treasury official as follows:

	Responsible NT officials	Tel. No.	Email
Eastern Cape	Templeton Phogole	012-315 5044	Templeton.Phogole@treasury.gov.za
	Matjatji Mashoeshoe	012-315 6567	Matjatji.Mashoeshoe@treasury.gov.za
Free State	Vincent Malepa	012-315 5539	Vincent.Malepa@treasury.gov.za
	Cethekile Moshane	012-315 5079	Cethekile.moshane@treasury.gov.za
	Katlego Mabiletsa	012-395 6742	Katlego.Mabiletsa@treasury.gov.za
Gauteng	Kgomotso Baloyi	012-315 5866	Kgomotso.Baloyi@treasury.gov.za
	Nomxolisi Mawulana	012-315 5460	Nomxolisi.Mawulana@treasury.gov.za
KwaZulu-Natal	Bernard Mokgabodi	012-315 5936	Bernard.Mokgabodi@treasury.gov.za
	Johan Botha	012-315 5171	Johan.Botha@treasury.gov.za
Limpopo	Una Rautenbach	012-315 5700	Una.Rautenbach@treasury.gov.za
	Sifiso Mabaso	012-315 5952	Sifiso.Mabaso@treasury.gov.za
Mpumalanga	Jordan Maja	012-315 5663	Jordan.Maja@treasury.gov.za
	Anthony Moseki	012-315 5174	Anthony.Moseki@treasury.gov.za
Northern Cape	Willem Voigt	012-315 5830	Willem.Voigt@treasury.gov.za
	Mandla Gilimani	012-315 5807	Mandla.Gilimani@treasury.gov.za
North West	Sadesh Ramjathan	012-315 5101	Sadesh.Ramjathan@treasury.gov.za

	Makgabo Mabotja	012-315 5156	Makgabo.Mabotja@treasury.gov.za
Western Cape	Vuyo Mbunge	012-315 5661	Vuyo.Mbunge@treasury.gov.za
	Kevin Bell	012-315 5725	Kevin.Bell@treasury.gov.za
Technical issues with Excel formats	Elsabe Rossouw	012-315 5534	lgdataqueries@treasury.gov.za

National Treasury, together with the provincial treasuries, will undertake a compliance check and, where municipalities have not provided complete budget information, the municipal budgets will be returned to the mayors and municipal managers of the affected municipalities for the necessary corrections. Municipal managers are reminded that the annual budget must be accompanied by a 'quality certificate' in accordance with the format as set out in item 31 of Schedule A in the Municipal Budget and Reporting Regulations.

The National Treasury needs to emphasise that where municipalities have not adhered to the Municipal Budget and Reporting Regulations, ***those municipalities will be required to go back to the municipal council and table a complete budget document aligned to the requirement of the Municipal Budget and Reporting Regulations.***

Municipalities with municipal entities are once again reminded to prepare consolidated budgets and in-year reports for both the parent municipality and its entity or entities in that they are to produce:

- An annual budget, adjustment budget and monthly financial statements for the parent municipality in the relevant formats; and
- A consolidated annual budget, adjustments budget and monthly financial statements for the parent municipality and all its municipal entities in the relevant formats.

The A Schedule that the municipality submits to National Treasury must be a consolidated budget for the municipality (plus entities) and not the budget of the parent municipality only.

8. Budget process and submissions for the 2016/17 MTREF

8.1 Submitting budget documentation and schedules for 2016/17 MTREF

To facilitate oversight of compliance with the Municipal Budget and Reporting Regulations, accounting officers are reminded that:

- Section 22(b)(i) of the MFMA requires that ***immediately*** after an annual budget is tabled in a municipal council, it must be submitted to the National Treasury and the relevant provincial treasury in both printed and electronic formats. If the annual budget is tabled to council on 31 March 2016, the final date of submission of the electronic budget documents and corresponding electronic returns is **Friday, 01 April 2016**. The deadline for submission of hard copies including council resolution is **Friday, 8 April 2016**.
- Section 24(3) of the MFMA, read together with regulation 20(1), requires that the approved annual budget must be submitted to both National Treasury and the relevant provincial treasury ***within ten working days*** after the council has approved the annual budget. If the council only approves the annual budget on 30 June 2016, the final date for such a submission is **Thursday, 14 July 2016**, otherwise an earlier date applies.

The municipal manager must submit:

- the budget documentation as set out in Schedule A (version 2.8) of the Municipal Budget and Reporting Regulations, including the main Tables (A1 - A10) and ALL the supporting tables (SA1 – SA37) in both printed and electronic formats;
- the draft service delivery and budget implementation plan in both printed and electronic format;
- the draft integrated development plan;
- the council resolution;
- signed Quality Certificate as prescribed in the Municipal Budget and Reporting Regulations;
- **schedules D, E and F specific for the entities;**
- signed budget locking certificate as found on the website;
- service level standards; and
- mSCOA implementation plan and progress to date.

Municipalities are required to send electronic versions of documents and the A1 schedule to lgdocuments@treasury.gov.za.

If the budget documents are too large to be sent via email (exceeds 4MB) please submit to lgbigfiles@gmail.com. Any problems experienced in this regard can be addressed with Elsabe Rossouw at Elsabe.Rossouw@treasury.gov.za.

All new municipalities must submit the 2016/17 MTREF as soon as it is adopted by the newly elected council.

Municipalities are required to send printed submissions of their budget documents and council resolution to:

For couriered documents

Ms Linda Kruger
National Treasury
40 Church Square
Pretoria, 0002

For posted documents

Ms Linda Kruger
National Treasury
Private Bag X115
Pretoria, 0001

In addition to the above mentioned budget documentation, metropolitan municipalities must submit the Built Environment Performance Plan (BEPP) tabled in council on 31 May 2016 to Yasmin.coovadia@treasury.gov.za. If the BEPP documents are too large to be sent via email (exceeds 4MB) please submit to yasmin.coovadia@gmail.com or send to Yasmin Coovadia via Dropbox; any problems experienced in this regard can be addressed with Yasmin.Coovadia@treasury.gov.za. Hard copies of the BEPP may be sent to Yasmin Coovadia, National Treasury, 3rd floor 40 Church Square, Pretoria, 0002 or Private Bag X115, Pretoria, 0001.

8.2 Budget reform returns to the Local Government Database for publication

For publication purposes, municipalities are still required to use the Budget Reform Returns to upload budget and monthly expenditure to the National Treasury Local Government Database. All returns are to be sent to lgdatabase@treasury.gov.za.

Municipalities are requested to submit returns for both the draft budget and the final adopted budget.

This will assist the National and provincial treasuries with the annual benchmark process. The aligned electronic returns may be downloaded from National Treasury's website at the following link: http://mfma.treasury.gov.za/Return_Forms/Pages/default.aspx.

8.3 Municipal Standard Chart of Accounts (*mSCOA*)¹

The *mSCOA* Regulations apply to all municipalities and municipal entities with effect from 1 July 2017 and only seven months remain for preparation and implementation readiness as the 2017/18 MTREF budgets will all have to be aligned to *mSCOA*. It is critical for municipalities to start budgeting on *mSCOA* by September 2016 to go live on 01 July 2017.

Municipalities are reminded that the current reporting requirements will remain in place until the National Treasury considers the implementation of the *mSCOA* and the new reporting reforms are no longer a risk. Those who do not adhere to the prescribed reporting according to the MBRR and the submission of the Budget reform returns to the National Treasury Local Government database will be regarded as non-compliant for publication purposes (refer to paragraph 8.2).

Municipalities that are implementing the *mSCOA* must use the latest version of the *mSCOA* classification framework at the link below when compiling the 2016/17 MTREF.

<http://mfma.treasury.gov.za/RegulationsandGazettes/MunicipalRegulationsOnAStandardChartOfAccountsFinal/Pages/default.aspx>

The MBRR Schedules will remain as is until further notice.

8.4 General

Municipalities use external service providers' e-mails as a result of weak or poor Information and Communication Technology (ICT). The affected municipalities are urged to use official e-mail addresses linked to the institution; therefore they must address the ICT challenges experienced.

Contact



national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

Post Private Bag X115, Pretoria 0001

Phone 012 315 5009

Fax 012 395 6553

Website <http://www.treasury.gov.za/default.aspx>

JH Hattingh

Chief Director: Local Government Budget Analysis

07 March 2016

¹ The Minister of Finance promulgated the Municipal Regulations on a Standard Chart of Accounts in government gazette Notice No. 37577 on 22 April 2014.

Annexure A – Changes to Schedule A1 – the ‘Excel formats’

As noted above, National Treasury has released Version 2.8 of Schedule A1 (the Excel Formats). It incorporates the following changes:

No.	Sheet/ Table	Amendment	Reason
1	A10	Cost of free basic services	Improve reporting of services provided including informal settlements.
2	SA1	Revenue foregone	Improve reporting on revenue foregone and cost of free basic services.
3	SA9	Provision of free basic services	To provide detailed breakdown of free basic services which links to A10.

Annexure B – Previous MFMA Circulars

Budget management issues dealt with in previous MFMA Circulars

Municipalities are reminded to refer to MFMA Circulars 48, 51, 54, 55, 66, 67 and 70 with regards to the following issues:

1. Mayor's discretionary funds and similar discretionary budget allocation – National Treasury regards allocations that are not designated for a specific purpose to be bad practice and discourage them (refer to MFMA Circular 51).
2. Unallocated ward allocations – National Treasury does not regard this to be a good practice, because it means that the tabled budget does not reflect which ward projects are planned for purposes of public consultation and council approval (refer to MFMA Circular 51).
3. New office buildings – Municipalities are required to send detailed information to National Treasury if they are contemplating building new main office buildings (refer to MFMA Circular 51).
4. Virement policies of municipalities – Municipalities are reminded of the principles that must be incorporated into municipal virements policies (refer to MFMA Circular 51).
5. Providing clean water and managing waste water – Municipalities were reminded to include a section on 'Drinking water quality and waste water management' in their budget document (refer to MFMA Circular 54).
6. Renewal and repairs and maintenance of existing assets – Allocations to repairs and maintenance, and the renewal of existing infrastructure must be prioritised. Municipalities must provide detailed motivations in their budget documentation if allocations do not meet the required benchmarks set out in MFMA Circular 55 and 66.
7. Credit cards and debit cards linked to municipal bank accounts are not permitted – On 02 August 2011 National Treasury issued a directive to all banks informing them that as from 01 September 2011 they are not allowed to issue credit cards or debit cards linked to municipal bank accounts (refer to MFMA Circular 55).
8. Water and sanitation tariffs must be cost reflective - refer to MFMA Circular 66.
9. Solid waste tariffs – refer to MFMA Circular 70.
10. Variances between 4th Quarter section 71 results and annual financial statements – refer to Circular 67.
11. Additional In-Year reporting requirements – refer to MFMA Circular 67.
12. Appropriation statement (reconciliation: budget and in-year performance)- reference is made to circular 67. It came to the attention of National Treasury that a number of municipalities did not include the appropriation statement as part of their 2012/13 or 2013/14 annual financial statement. In terms of the Standards of GRAP 24 on the Presentation of Budget Information in Financial Statements, municipalities are required to present their original and adjusted budgets against actual outcome in the annual financial statements. This is considered an appropriation statement and the comparison between the budget and actual performance should be a mirror image of each other as it relates to the classification and grouping of revenue and expenditure as has been the case in a national and provincial context. This statement is subject to auditing and accordingly supporting documentation would be required to substantiate the compilation of this statement.
13. Eliminating non-priority spending – The 2013 MTBPS emphasised the need for government to step-up its efforts to combat waste, inefficiency and corruption (refer to MFMA circular 70).
14. Council oversight over the budget process – refer to MFMA Circular 70.

Conditional grant issues dealt with in previous MFMA Circulars

Municipalities are reminded to refer to MFMA Circulars 48, 51, 54, 55 and 67 with regards to the following issues:

1. Accounting treatment of conditional grants: Municipalities are reminded that in accordance with accrual accounting principles, conditional grants should only be treated as 'transfers recognized' revenue when the grant revenue has been 'earned' by incurring expenditure in accordance with the conditions of the grant.
2. VAT on conditional grants: SARS has issued a specific guide to assist municipalities meeting their VAT obligations – **VAT 419 Guide for Municipalities**. To assist municipalities accessing this guide it has been placed on the National Treasury website at: <http://mfma.treasury.gov.za/Guidelines/Pages/default.aspx>
3. Interest received and reclaimed VAT in respect of conditional grants: Municipalities are reminded that in MFMA Circular 48, National Treasury determined that:
 - Interest received on conditional grant funds must be treated as 'own revenue' and its use by the municipality is not subject to any special conditions; and
 - 'Reclaimed VAT' in respect of conditional grant expenditures must be treated as 'own revenue' and its use by the municipality is not subject to any special conditions.
4. Appropriation of conditional grants that are rolled over – As soon as a municipality receives written approval from National Treasury that its unspent conditional grants have been rolled-over it may proceed to spend such funds (refer to MFMA Circular 51 for other arrangements in this regard).
5. Pledging of conditional grant transfers – the 2015 Division of Revenue Bill contained a provision that allows municipalities to pledge their conditional grants. The end date for the pledges is extended to 2017/18. The process of application as set out in MFMA Circular 51 remains unchanged.
6. Separate reporting for conditional grant roll-overs – National Treasury has put in place a separate template for municipalities to report on the spending of conditional grant roll-overs. Municipalities are reminded that conditional grant funds can only be rolled-over once, so if they remain unspent in the year in which they were rolled-over they MUST revert to the National Revenue Fund.
7. Payment schedule – National Treasury has instituted an automated payment system of transfers to municipalities in order to ensure appropriate safety checks are put in place. Only the primary banking details verified by National Treasury will be used for effecting transfers.
8. Conditional grant transfers/payments, the responsibilities of transferring and receiving authorities and the criteria for the rollover of conditional grants – It is important that the transfers made to municipalities' are transparent, and properly captured in the municipalities' budgets. MFMA Circular no: 67 in this regard refers. The criterion for the rollover of conditional grants is stipulated in MFMA Circular no: 51.

MBRR issues dealt with in previous MFMA Circulars

Municipalities are reminded to refer to MFMA Circulars 48, 51, 54, 55 with regards to the following issues:

1. Budgeting for revenue and 'revenue foregone' – The 'realistically anticipated revenues to be collected' that must be reflected on the Budgeted Statement of Financial Performance (Tables A2, A3 and A4) must exclude 'revenue foregone'. The definition

of 'revenue foregone' and how it is distinguished from 'transfers and grants' is explained in MFMA Circular 51.

2. Preparing and amending budget related policies – Information on all budget related policies and any amendments to such policies must be included in the municipality's annual budget document (refer to MFMA Circular 54).
3. 2013/14 MTREF Funding Compliance Assessment – All municipalities were required to perform the funding compliance assessment outlined in *MFMA Funding Compliance Guideline* and to include the relevant information outlined in MFMA Circular 55 in their 2015/16 budgets (refer to MFMA Circular 55).
4. Tabling a funded budget - It is critical that municipalities adopt and implement funded budgets as per Section 18 of the MFMA. Tables A7 and A8 which if completed correctly by the municipality, it will provide most of the information required to evaluate whether a municipality's operating and capital budgets are **funded** or not.

Mr Grant Easton
Municipal Manager
Knysna Municipality
P.O. Box 21
KNYSNA
6570

Date:
15 March 2016

Enquiries:
Tel +27 44 801 2264

Dear Mr Easton

2016/17 ESKOM STANDARD TARIFF INCREASES

On 7 March 2016, the National Energy Regulatory of South Africa (Nersa) approved the 2016/17 average price increase to the standard tariffs of 9.4%. The standard tariff increase of 9.4% recovers the 2016/17 multi-year price determination (MYPD3) allowed revenue plus an additional R10.257billion from the 2013/14 Regulatory Clearing Account (RCA) balance.

The RCA is a globally accepted regulatory principle that provides an MYPD3 risk mechanism to cater for changes in the previous decision. Through the RCA, Nersa may allow Eskom the recovery of variances between the MYPD decision's forecasted costs and Eskom's actual costs.

Nersa approved the 2016/17 Eskom schedule of standard tariffs with the following increases

Effective 1 April 2016, non-local authority tariff increases

9.4% for Urban and rural tariffs – all rates except the affordability subsidy charge

Homelight tariff

- 7.2% Homelight 20A Block 1 rate
- 9.0% Homelight 20A Block 2 rate

8.61% Affordability subsidy charge

As per the MYPD3 decision, to cater for affordability the Homelight 20A increases are 7.2% for Block 1 and 9.0% for Block 2.

The increase to the affordability subsidy charge is 8.61% to recover the incremental subsidy due to the lower Homelight 20A tariff increase.

Effective 1 July 2016, local authority tariff increase

7.86% for all local-authority tariffs

The local authority tariff increase of 7.86% is effective from 1 July 2016 through to 30 June 2017. During the April to June 2016 three month period, the 2015/16 local authority tariffs are applicable.

Due to the higher than 9.4% local authority revenue recovery during April to June, a lower 7.86% local authority tariff increase is applicable from 1 July 2016 to 30 June 2017.

It is important to note that the tariff increases are applied on the 2015/16 tariff rates and if a customer, on a year-on-year basis, changes the way they use electricity (time-of-use, season and volume differences), the customer's electricity cost changes may be different from the tariff increase.

For the Eskom schedule of standard prices, tariff rates and tariff analysis tools, visit the website www.eskom.co.za/tariffs.

Yours sincerely



Abduragmaan Jacobs
KEY CUSTOMER RELATIONS MANAGER (WESTERN CAPE OPERATING UNIT)

24th March 2016
.....
Date

ANNEXURE 1

MUNICIPAL TARIFF GUIDELINE INCREASE, BENCHMARKS AND PROPOSED TIMELINES FOR MUNICIPAL TARIFF APPROVAL PROCESS FOR THE 2016/17 FINANCIAL YEAR

Consultation Paper

07 March 2016

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Abbreviations and Acronyms

A	Ampere
BP	Bulk Purchase
BPI	Bulk Purchase Increase
CC	Capital Charges
c/kWh	Cents per kilowatt-hour
CCI	Capital Charges Increase
CPI	Consumer Price Index
D-forms	Distribution Forms
EPT	Electricity Pricing and Tariffs
ERA	Electricity Regulation Act, 2006 (Act no.4 of 2006)
ERTSA	Eskom Retail Tariff Structural Adjustment
IBT	Inclining Block Tariff
kVA	Kilovolts-Amps
kWh	Kilowatt-hour
LF	Load Factor
MD	Maximum Demand
MFMA	Municipal Finance Management Act, 2003 (Act no.56 of 2003)
MWh	Megawatt-hour
MYPD	Multi-Year Price Determination
NERSA	National Energy Regulator of South Africa
OC	Other Costs
OCI	Other Costs Increase
R	Repairs
RCA	Regulatory Clearing Account
RI	Repairs Increase
S	Salaries
SI	Salaries Increase
TOU	Time-of-Use
V	Volt

1. EXECUTIVE SUMMARY

The National Energy Regulator (NERSA) is the regulatory authority over the energy sector in South Africa and its mandate includes the regulation of the electricity supply industry. In terms of section 4(ii) of the Electricity Regulation Act, 2006 (Act No. 4 of 2006) ('the ERA'), the Energy Regulator must regulate electricity prices and tariffs.

The Energy Regulator, on an annual basis, approves a percentage guideline increase and reviews the municipal tariff benchmarks. The guideline assists the municipalities in the preparation of their budgets and tariff adjustment applications. The benchmarks are revised and used in the evaluation of the municipal tariff applications. These benchmarks are developed per tariff category.

On 10 November 2015 NERSA received Eskom's Regulatory Clearing Account (RCA) application for the first year (2013/14) of the third Multi-Year Price Determination (MYPD3) period. The RCA is an account in which all variances in Eskom's allowed expenses are deposited. The balance in the RCA account can either be in Eskom's or the customers' favour. NERSA applies a prudence test to all the costs presented by Eskom in their application.

The Energy Regulator made its determination on Eskom's RCA on 01 March 2016. Subsequently, the determination on Eskom's Retail Tariff Structural Adjustment (ERTSA) was approved on 07 March 2016.

The municipal tariff guideline increase is developed based on Eskom's approved bulk price increase of electricity to municipalities and the increase on the municipalities' cost structures. Hence the approval of the municipal guideline increase subsequent to the determination of ERTSA. It should be noted that it is for this reason that the consultation on the guideline increase and benchmarks for the 2016/17 financial year will be taken into consideration in March/ April 2016.

The Energy Regulator is requesting the stakeholders to comment on the guideline increase, the benchmarks and the proposed timelines as set out in this consultation paper. The comments should be addressed to: **Ms Tabisa Nkopo** or **Ms Nthabiseng Mapitsing** at **The National Energy Regulator, Kulawula House, 526 Madiba Street, Arcadia, Pretoria** or

emailed to: municguideline@nersa.org.za. The deadline for the submission of comments is 07 April 2016.

NERSA will not hold a public hearing on the key issues highlighted in the consultation paper, but will follow the notice and comment procedure in terms of Section 4 (3) of the Promotion to Administration Justice Act, 2000 (Act No. 3 of 2000). This is due to the fact that in the past, few to no presenters attended the public hearing to make representations to NERSA.

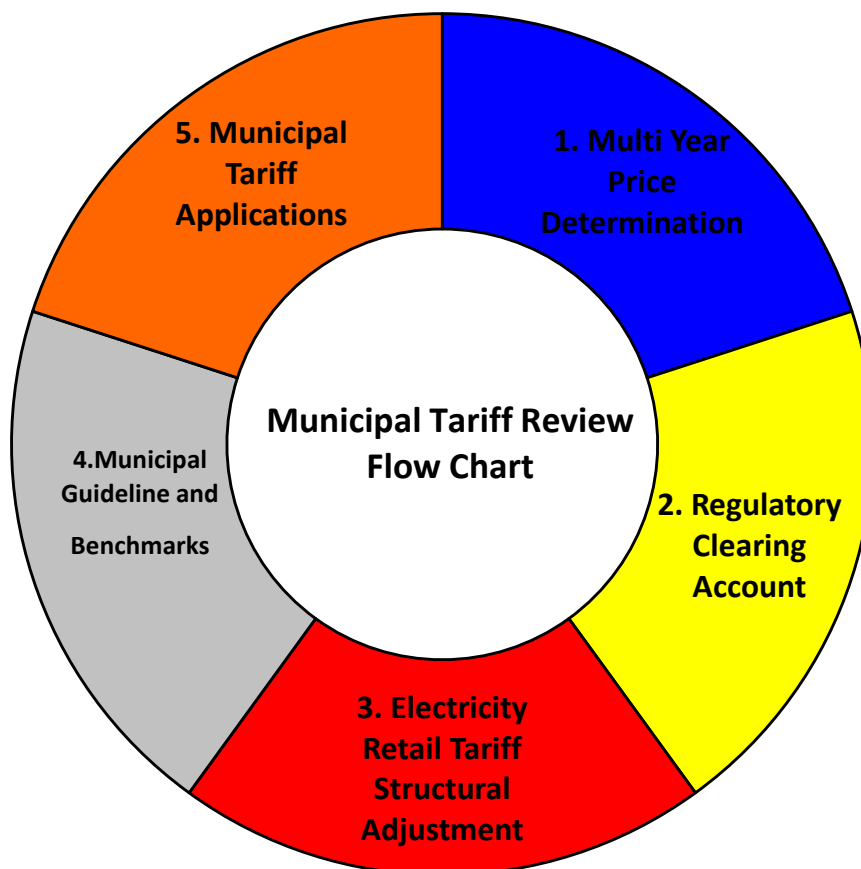
2. BACKGROUND

The consultation paper incorporates price or tariff adjustments by municipal distributors, the municipal tariff benchmarks, tariff applications and the approval processes. Eskom generates approximately 95% of the energy that is consumed in the country and the municipal distributors purchase their energy from Eskom. All municipalities are informed about the approved guideline percentage increase. This is not an automatic increase for the municipalities and private distributors. As a result, NERSA allows licensees to submit their proposed price adjustments or tariff increases annually for approval by the Energy Regulator.

Benchmarks are based on five tariff/customer categories and the corresponding average consumption levels. NERSA acknowledges that these are average consumption levels and that there may also be other tariff classes at various municipalities that will cater for other customer classes or consumption levels. Where such circumstances exist, the municipality's tariff applications will be treated on a case-by-case basis.

According to the NERSA timelines, the municipal tariff guideline and benchmarks will be approved in April 2016. Municipalities are required to submit their tariff applications to NERSA as soon as possible upon receipt of the municipal tariff guideline letter.

2.1. The municipal tariff review flow chart



2.2. Issues considered in the analysis of the municipal tariff review

NERSA approved a Cost of Supply (COS) study framework as it is a requirement of the Electricity Pricing Policy (EPP). The municipalities purchase power at the bulk supply tariff and sell it to end users at a tariff that is associated with a specific customer category. The tariff rates for customers in each tariff category are computed to reflect the cost of electricity supply to that category of customers. Therefore, municipalities are urged to perform cost of supply studies so that the revenue earned by the municipalities per tariff category is aligned with the cost to supply electricity.

The following factors, among others, will be taken into account when determining the average cost to supply:

- a) bulk purchases;
- b) bad debts;
- c) reasonable energy losses;
- d) direct and indirect charges;
- e) salaries and wages; and
- f) capital charges.

Furthermore, the municipalities' overall financial and technical performance will be reviewed prior to a final decision on the overall tariff increase. Indicators to be considered in this regard mainly include:

- a) percentage surplus;
- b) percentage energy losses;
- c) percentage power costs;
- d) repairs and maintenance;
- e) bad debt provision; and
- f) average selling price/average purchase price ratio.

2.3. Submission of D-form information

NERSA held workshops and one-on-one interactions with municipalities per province in order to assist municipalities with the completion of the Distribution forms (D-forms). This process ran parallel with the submission of the D-forms. Access to the D-form templates can be obtained through the NERSA website (www.nersa.org.za). The closing date for the submission of the D-forms is 31 October annually. Municipalities that have been contacted by NERSA regarding inaccurate or outstanding data are required to ensure that accurate information is submitted timeously to NERSA, in order to ensure that proper analysis is done and the approval of the tariff applications is achieved. The distribution forms that are primarily used for the tariff approval process are D1 (Financial information), D2 (Market information) and D3 (Human Resources information).

These forms contain information regarding the financial position, efficiency levels of the municipality, data regarding the customer's

consumption patterns and the number of customers per tariff category. This information assists NERSA in the analysis of the tariffs and in determining the revenues that the municipality collects from the various tariff categories.

NERSA will not consider any municipal tariff applications without the submission of appropriate and accurate D-form information.

3. DETERMINATION OF THE MUNICIPAL TARIFF GUIDELINE

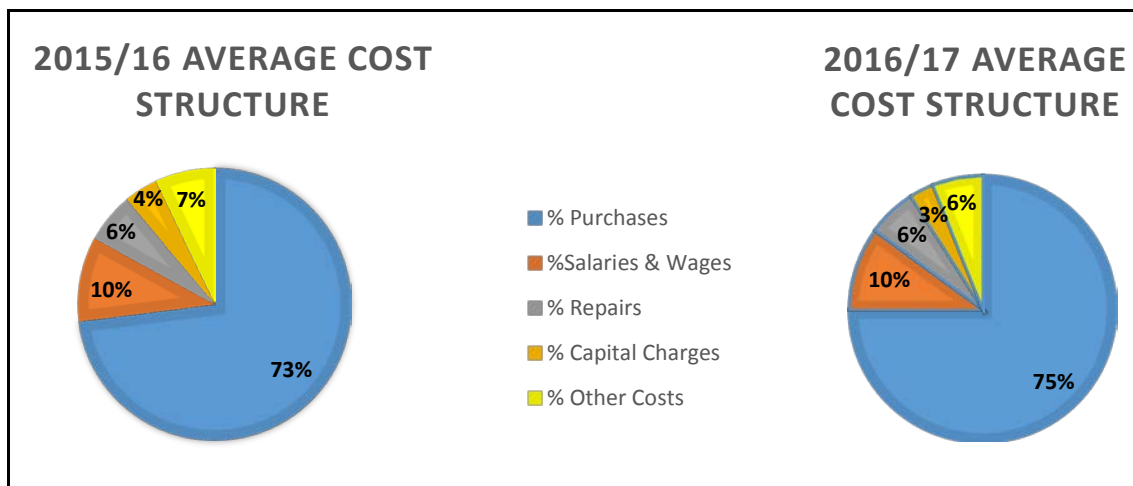
The following issues and assumptions were made when developing the percentage guideline increase for 2016/17.

On 01 March 2016 NERSA granted Eskom an average increase of 9.4% to Eskom's RCA application for the first year (2013/14) of the MYPD3 control period. Furthermore, the ERTSA application was approved on 07 March 2016, leading to a bulk increase of 7.86% for municipalities. This is due to the Municipal Finance Management Act, 2003 (Act No. 56 of 2003) ('the MFMA') time lag (the municipalities' implementation date is 01 July whereas Eskom's financial year starts on 01 April).

The following issues were considered when developing the percentage guideline increase for 2016/17:

- a) The 2013/14 D-form information was used to determine whether there would be changes to the municipality's cost structures.
- b) A stratified random sampling amounting to 126 D-forms was done.
- c) The chosen sample would be useful in determining whether the weights of the cost drivers that have been developed need to be revised or maintained.

The pie chart below indicates the findings from the analysis done from the various sized municipalities.



The data from the computed various sized municipalities indicated a change in the weights of the cost structures. The municipal bulk purchases have increased from 73% to 75%; this increase results from Eskom's cumulative electricity prices. The average percentage for salaries and wages has been maintained at 10% in order for municipalities to incorporate the recruitment of skilled staff, additional staff and the allowance for paying scarce skills allowance. NERSA requires municipalities to spend 6% of their total ring-fenced electricity revenue on repairs and maintenance to ensure a sustainable electricity supply system. The capital charges and other costs weights decreased from 4% to 3% and 7% to 6% respectively, due to increase in the weight of bulk purchases.

Municipalities must submit their specific cost drivers should they be different from the ones presented by NERSA in the consultation paper. This will assist NERSA in considering municipalities on a case-by-case basis based on their actual cost structures.

Stakeholder Comment # 1

Stakeholders are invited to comment on the changes in the breakdown of the cost weighting that NERSA has taken into consideration when developing the guideline.

In developing the guideline, the following assumptions on cost increases were made:

- a) Bulk purchases will increase by 7.86% as indicated in the Eskom standard tariff submission for the 2016/17 financial year.
- b) Consumer Price Index (CPI) – 6.6%¹.
- c) Salary increases – CPI plus 1%².
- d) Repairs and maintenance, capital charges and other costs will increase by CPI.

3.1. The formula for calculating the guideline increase:

$$\begin{aligned}\text{MG} &= (\text{BP} \times \text{BPI}) + (\text{S} \times \text{SI}) + (\text{R} \times \text{RI}) + (\text{CC} \times \text{CCI}) + (\text{OC} \times \text{OCI}) \\ &= (75 \times 0.07857) + (10 \times 0.076) + (6 \times 0.066) + (3 \times 0.066) + (6^3 \times 0.066) \\ &= 5.893 + 0.760 + 0.396 + 0.198 + 0.396 \\ &= \underline{\underline{7.64\%}}\end{aligned}$$

Where:

- MG = % Municipal Guideline Increase
- BP = % Bulk purchases
- BPI = % Bulk purchase increase
- S = % Salaries
- SI = % Salaries increase
- R = % Repairs
- RI = % Repairs increase
- C = % Capital charges
- CCI = % Capital charges increase
- OC = % Other costs
- OCI = % Other costs increase

¹ As indicated in the National Treasury (Budget Review) 2016

² As indicated in Circular No. 31/2015: Salary and Wage Collective Agreement

³ The 'capital charges and other costs' has been reduced due to increase in the weight of bulk purchase.

Table 3: Calculation of the guideline for the 2016/17 financial year

COST LINE ITEM	REVISED MUNIC % OF TOTAL COST	EXPECTED INCREASE %	WEIGHTED AVERAGE EXPECTED INCREASE %
Purchases	75	7.857	5.893
Salaries and wages	10	7.6	0.760
Repairs & Maintenance	6	6.6	0.396
Capital charges in total	3	6.6	0.198
Other Costs ⁴	6	6.6	0.396
% increase			7.64

Municipalities applying for an increase that is above the guideline will have to justify their increases to the Energy Regulator and the approval will be based on the following requirements:

- a) a detailed plan on the additional funds requested needs to be presented to NERSA as part of the motivation for the above-guideline increase (the municipality must provide a detailed revenue analysis whereby it indicates the revenue when using the approved guideline percentage increase versus the actual required revenue and the list of items, i.e. repairs and maintenance, where the extra funds will be allocated);
- b) the approved funds must be ring-fenced to ensure that the extra funds are strictly utilised for the identified projects;
- c) municipalities must report to NERSA on a six-monthly basis on how the additional funds are utilised; and
- d) funds not utilised for the purpose for which they were approved will be clawed back in the following financial year.

4. THE MUNICIPAL ELECTRICITY TARIFF BENCHMARKS

4.1. The municipal electricity tariff benchmarks for the 2015/16 financial year

The existing benchmarks are based on five assumed tariff/customer categories, as set out below.

⁴ Charges allocated from and to municipal departments, general expenses (costs related to the Municipal Electricity Department but not indicated on the D-forms).

4.1.1 Current benchmarks

- **Domestic (Block 1 – 4)**

Table 1: Average Domestic Benchmarks

Domestic Inclining Block Tariffs (IBTs)			
Block 1 (0 – 50 kWh) (c/kWh)	Block 2 (51 – 350 kWh) (c/kWh)	Block 3 (351 – 600 kWh) (c/kWh)	Block 4 (>600 kWh) (c/kWh)
72 – 79	93 – 100	134 – 141	160 – 166

The alternative domestic Inclining Block Tariff (IBT) structures and benchmarks are as indicated below.

- **Domestic Low**

Table 2: Average Domestic Low

Domestic Inclining Block Tariffs (IBTs)	
Block 1 (0 – 350 kWh) (c/kWh)	Block 2 (351 – 600 kWh) (c/kWh)
91 – 96	132 – 138

- **Domestic High**

Table 3: Domestic High

Domestic Inclining Block Tariffs (IBTs)	
Block 1 (0 - 350 kWh) (c/kWh)	Block 2 (351 - 600 kWh) (c/kWh)
89 – 94	130 – 136
Basic Charge (R/month)	

- **Domestic Non-IBT Benchmark**

Table 4: Average Domestic Non-IBT Benchmarks

Domestic Non - Inclining Block Tariffs (IBTs)	
Domestic Low 400 kWh (c/kWh)	Domestic High 800 kWh (c/kWh)
101 – 107	126 – 131

4.2. Commercial Benchmarks

4.2.1 Commercial Benchmarks Prepaid and Conventional Single Phase

- Commercial Prepaid Single Phase

Table 5: Average Benchmarks for Commercial Prepaid Single Phase

Commercial – Prepaid (2000 kWh)
c/kWh
167 – 174

- Commercial Conventional Single Phase - Low

Table 6: Average benchmark for Commercial Low

Commercial – Low (2000 kWh)
c/kWh
155 – 160

- Commercial Conventional Single Phase - Medium

Table 7: Average benchmark for Commercial Medium

Commercial – Medium (3000 kWh)
c/kWh
150 - 156

- Commercial Conventional Single Phase - High

Table 8: Average benchmark for Commercial High

Commercial – High (7000 kWh)
c/kWh
132 - 138

4.3.1 Commercial Benchmarks Prepaid and Conventional Three Phase

- Commercial Prepaid Three Phase

Table 9: Average Benchmarks for Commercial Prepaid Three-Phase

Commercial – Prepaid (5500 kWh)
c/kWh
167 – 174

- Commercial Conventional Three Phase – Low

Table 10: Average benchmark for Commercial Low

Commercial – Low (5500 kWh)
c/kWh
117 – 122

- Commercial Conventional Three Phase – Medium

Table 11: Average benchmark for Commercial Medium

Commercial-Medium (11500 kWh)
c/kWh
111 – 116

- Commercial Conventional Three Phase – High

Table 12: Average benchmark for Commercial High

Commercial (22000 kWh)
c/kWh
108 – 113

4.3. Agriculture Benchmarks

- Agriculture Low

Table 13: Average benchmark for Agriculture Low

Agriculture – Low (2000 kWh)
c/kWh
180 – 185

- Agriculture Medium

Table 14: Average benchmark for Agriculture Medium

Agriculture – Medium (3000 kWh)
c/kWh
171 – 176

- Agriculture High

Table 15: Average benchmark for Agriculture – High

Agriculture – High (7000 kWh)
c/kWh
146 – 151

4.4. Industrial Benchmark

- Industrial Low

Table 16: Average benchmark for Industrial – Low

Industrial – Low (43800 kWh)
c/kWh
151 – 159

- Industrial Medium

Table 17: Average benchmark for Industrial – Medium

Industrial – Medium (98 550 kWh)
c/kWh
148 – 154

- Industrial High

Table 18: Average benchmark for Industrial – High

Industrial- High (730 000 kWh)
c/kWh
134 – 139

4.4.1 Time-of-Use Benchmark

Table 19: Average benchmarks for Industrial TOU

Industrial (Based on Eskom's Nightsave) 43 800 kWh (c/kWh)	Industrial (Based on Eskom's Megaflex)) 43 800 kWh (c/kWh)
185 – 191	122 – 128

5. THE FINANCIAL BENCHMARKS

The table below indicates the weights of the financial benchmarks for the 2016/17 financial year. The municipalities that operate within these benchmarks are considered to run a sustainable and efficient electricity business.

Financial benchmarks

	Current Benchmarks	Revised Benchmarks	Financial Benchmarks (Acceptable Range) ⁵
Percentage Power cost	73%	75% ⁶	58% - 78%
Percentage Surplus	15%	15% ⁷	10% - 20%
System losses	10%	10% ⁸	5% - 12%
Average Sales Price/Average Purchase Price ratio	1:1.58	1:1.58	1:1.58 – 1:1.62
Repairs & Maintenance	Minimum of 6%		
Debt collection rate	95%		

⁵ The acceptable ranges are NERSA's allowable ranges.

⁶ In accordance with the municipal cost structure as indicated in the municipal tariff guideline consultation paper.

⁷ The applicable financial benchmark for municipalities.

⁸ The applicable technical benchmark for municipalities.

- The municipalities are encouraged to improve their debt collection rate, as this will assist them in collecting revenue that will enable them to be efficient and effective, as well as sustainable.

Stakeholder Comment # 2

Stakeholders are invited to comment on whether NERSA should consider other indicators when determining the efficiency of the municipality.

6. MUNICIPAL TARIFFS ABOVE THE NERSA BENCHMARKS

Municipalities applying for tariffs that are outside the approved benchmarks must justify such increases and the following information must be submitted:

- the total number of customers per tariff category – municipalities that do not have an appropriate customer base must submit the full detail of its customer profile, as well as the associated revenues;
- expected revenues per tariff category;
- the forecasted total sales;
- the average maximum demand per tariff (where applicable);
- the actual consumption; and
- the load profile in percentages (both summer and winter, where applicable).

The municipalities are encouraged to develop time-of-use tariffs in order to enable the customer to benefit from shifting their load. This will also enable municipalities to charge their customers prices that are similar to what Eskom is charging them.

7. THE PROPOSED MUNICIPAL ELECTRICITY TARIFF BENCHMARKS FOR 2016/17

7.1 The revised benchmarks

The benchmarks for the 2016/17 financial year have been developed as follows for the different tariff categories.

7.1.1 Domestic Benchmarks (Block 1 – 4)

- Block 1 – The 2015/16 benchmarks were increased by CPI⁹ of 6.6%.
- Block 2 – The 2015/16 benchmarks were increased by CPI plus 1% (6.6 % + 1%¹⁰).
- Block 3 and 4 – The 2015/16 benchmarks were increased by the municipal tariff guideline increase of 7.64%¹¹.

Table 20: Average Domestic Benchmarks

Domestic Inclining Block Tariffs (IBTs)			
Block 1 0-50 kWh c/kWh	Block 2 51-350 kWh c/kWh	Block 3 350-600 kWh c/kWh	Block 4 >600 kWh c/kWh
77 - 84	101 - 108	144 - 152	173 - 179

7.1.2 The alternative domestic IBT benchmarks were developed as follows:

- Domestic Low & High
 - Block 1 – The 2015/16 benchmarks were increased by 7.10%.
 - Block 2 – The 2015/16 benchmarks were increased by the municipal tariff guideline increase of 7.64%.

⁹ The 6.6% is the current CPI as indicated in the Budget Review 2016.

¹⁰ The second block has been increased by 7.10% to align it to the Eskom Homelight tariffs.

¹¹ The 7.64% is in accordance with the municipal tariff guideline increase for the 2016/17 financial year.

- **Domestic Low**

Table 21: Average Domestic

Domestic Inclining Block Tariffs (IBTs)					
Block 1 (0 – 350kWh)			Block 2 (351 – 600 kWh)		
c/kWh			c/kWh		
98	-	103	142	-	149

- **Domestic High**

Table 22: Average Domestic High

Domestic Inclining Block Tariffs (BTs)					
Block1 (0 -350 kWh)			Block 2 (351 – 600 kWh)		
c/kWh			c/kWh		
95	-	101	140	-	146
Basic Charge (R/month)					

7.1.3 The domestic tariffs Non-IBT

- This tariff is developed for those municipalities that are unable to implement IBTs.
- The 2015/16 domestic Non-IBT tariff benchmarks were increased by the municipal tariff guideline increase of 7.64%.

Table 23: Average Domestic Non-IBT

Domestic Inclining Block Tariffs (IBTs)					
Domestic Low (400 kWh)			Domestic High (800 kWh)		
c/kWh			c/kWh		
108	-	115	136	-	141

7.2 Commercial Benchmarks

7.2.1 Commercial Benchmarks Prepaid and Conventional Single Phase

The commercial single phase tariffs for the 2015/16 benchmark were increased by the municipal tariff guideline increase of 7.64%.

- **Commercial Prepaid Single Phase**

Table 24: Average Benchmarks for Commercial Prepaid Single

Commercial – Prepaid (2000 kWh)		
c/kWh		
180	-	187

- **Commercial Conventional Single Phase – Low**

Table 25: Average benchmark for Commercial

Commercial – Low (2000 kWh)		
c/kWh		
167	-	172

- **Commercial Conventional Single Phase - Medium**

Table 26: Average benchmark for Commercial Medium

Commercial – Medium (3000 kWh)		
c/kWh		
161	-	168

- **Commercial Conventional Single Phase - High**

Table 27: Average benchmark for Commercial -

Commercial - High (7000kWh)		
c/kWh		
142	-	149

7.2.2 Commercial Benchmarks Prepaid and Conventional Three Phase

- The commercial three-phase prepaid tariff for the 2015/16 benchmark were increased by the municipal tariff guideline increase of 7.64%.

- **Commercial Prepaid Three-Phase**

Table 28 : Average Benchmarks for Commercial Prepaid Three-Phase

Commercial – Prepaid (5500 kWh)		
c/kWh		
180	-	187

- The commercial conventional three phase tariffs have been revised as comments received from municipalities indicated they were too low. The benchmark is developed by benchmarking against the 2015/16 average energy rates for municipalities.

- **Commercial Conventional Three Phase – Low**

Table 29: Average benchmark for Commercial Three Phase – Low

Commercial - Low (5500 kWh)		
c/kWh		
142	-	148

- **Commercial Conventional Three Phase – Medium**

Table 30: Average benchmark for Commercial Three Phase – Medium

Commercial - Medium (11500 kWh)		
c/kWh		
135	-	141

- Commercial Conventional Three Phase – High

Table 31: Average benchmark for Commercial High

Commercial - High (22000 kWh)		
c/kWh		
132	-	138

7.3 Agriculture Benchmarks

- The agriculture tariffs for the 2015/16 benchmarks were increased by the municipal tariff guideline increase of 7.64%.

- Agriculture Low

Table 32: Average benchmark for Agriculture – Low

Agriculture - Low (2000 kWh)		
c/kWh		
194	-	200

- Agriculture Medium

Table 33 : Average benchmark for Agriculture – Medium

Agriculture - Medium (3000 kWh)		
c/kWh		
184	-	190

- Agriculture High

Table 34: Average benchmark for Agriculture – High

Agriculture - High (7000 kWh)		
c/kWh		
157	-	163

7.4 Industrial Benchmark

- The industrial tariffs for the 2015/16 benchmarks were increased by the municipal tariff guideline increase of 7.64%.

- **Industrial Low**

Table 35: Average benchmark for Industrial – Low

Industrial - Low (43 800 kWh)		
c/kWh		
163	-	171

- **Industrial Medium**

Table 36: Average benchmark for Industrial – Medium

Industrial - Medium (98 550 kWh)		
c/kWh		
160	-	166

- **Industrial High**

Table 37: Average benchmark for Industrial – High

Industrial - High (730 000kWh)		
c/kWh		
144	-	150

7.5 Industrial Time-of-Use

- The benchmarks for the municipalities that buy at Eskom's Megaflex tariff have been adjusted by the guideline increase of 7.64%.

Table 38: Average benchmarks for Industrial Time-Of Use (TOU) Megaflex

Industrial TOU (43 800 kWh) (Based on Eskom's Megaflex)		
c/kWh		
131	-	138

- The benchmarks for the municipalities that buy at Eskom's Nightsave tariff have been adjusted by the guideline increase of 7.64%.

Table 39: Average benchmarks for Industrial Time-Of Use (TOU) Nightsave

Industrial TOU (43 800 kWh) (Based on Eskom's Nightsave)		
c/kWh		
199	-	206

8. TIMELINES FOR MUNICIPAL TARIFF APPROVAL PROCESS AND GUIDELINE DETERMINATION

Municipalities are bound by among other legislation, the MFMA and Municipal Systems Act (MSA). According to the MFMA budgetary process, a budget circular to all municipalities is issued by National Treasury by the end of November annually. This circular takes into account NERSA's approved guideline increase.

It is anticipated that municipalities will compile and submit tariff applications for NERSA's consideration from April 2016. In line with the MFMA requirements stated below, NERSA will attempt to complete and finalise the municipal tariff approval process by 15 March 2015.

Section 43 of the MFMA states that:

- (1) If a national or provincial organ of state in terms of a power contained in any national or provincial legislation determines the upper limits of a municipal tax or tariff, such determination takes effect for municipalities on a date specified in the determination.*
- (2) Unless the Minister on good grounds approves otherwise, the date specified in a determination referred to in subsection (1) may -*
 - a) If the determination was promulgated on or before 15 March in a year, not be a date before 1 July in that year; or*
 - b) If the determination was promulgated after the 15 March in a year, not be a date before 1 July in the next year.*

The table below shows the timelines and processes leading to the approval of municipal electricity tariffs.

Table 40: Approval of the Municipal Tariff Guideline and Benchmarks

ACTIVITY/TASK	DATE
Modelling of municipal tariff guideline and benchmarks	Oct –Nov 15
Publishing of the municipal guideline, benchmarks and proposed timelines consultation paper on NERSA's website	08 March 16
Workshop and consultations with key stakeholders (NT, AMEU, SALGA)	March 16
Closing date for stakeholder comments	08 April 16
NERSA's decision of the municipal guideline increase, benchmarks and proposed timelines	April 16
Communicate approved guideline, benchmarks and proposed timelines to municipalities	April 16

Table 41: Municipal Tariff Review Process for the 2016/17 Financial Year

Municipalities compile and submit tariff applications for consideration by NERSA	April – May 16
NERSA's consideration and approval of tariff applications and communication of NERSA's decision to municipalities	April – Jun 16
Public Hearing ¹² for above guideline increase	May – Jun 16
Consideration and approval of applications above the guideline	May – Jun 16

¹² NERSA will hold two Public Hearings for the municipalities applying for above-guideline increases.

Communicate NERSA's decision to licensees	April – Jun 16
Receipt and analysis of tariff review (appeal) applications	April – Jun 16
Consideration and approval of review applications	April – Jun 16
Communicate NERSA's decision to licensees	April – Jun 16

Stakeholder Comment # 5

Stakeholders are invited to comment on the appropriateness of the municipal tariff approval process and timelines with regard to the MFMA prescribed budgetary process.

Reference: PTR 14/2/5

TO: THE MUNICIPAL MANAGERS
THE CHIEF FINANCIAL OFFICERS

MUNICIPAL ELECTRICITY TARIFF GUIDELINE INCREASE FOR 2016/17

Purpose

The purpose of this memorandum is to provide clarity and advice to municipalities on the municipal electricity tariff which should be applied in light of the recent NERSA Guidelines.

Background

The Energy Regulator, on an annual basis, approves a percentage guideline increase and reviews the municipal tariff benchmarks. On 10 November 2015 NERSA received Eskom's Regulatory Clearing Account (RCA) application for the first year (2013/14) of the third Multi-Year Price Determination (MYPD3) period. The Energy Regulator made its determination on Eskom's RCA on 1 March 2016. NERSA granted Eskom an average increase of 9.4 per cent to Eskom's RCA application for the first year (2013/14) of the MYPD3 control period. Furthermore, the Eskom Retail Tariff Structural Adjustment (ERTSA) application was approved on 7 March 2016, leading to a bulk increase of 7.86 per cent for municipalities. This is due to the Municipal Finance Management Act, 2003 (Act No. 56 of 2003) ('the MFMA') time lag (the municipalities' implementation date is 1 July whereas Eskom's financial year starts on 1 April).

NERSA Calculation for the Municipal Tariff Guideline

There are certain factors that need to be taken into account in determining the expected tariff increase for electricity in the municipal space. NERSA has developed a set of assumptions regarding certain cost item increases. These assumptions are as follows:

- The bulk purchases expected increase is provided in Eskom's standard tariff submission for the upcoming financial year (7.86%)¹;
- Consumer Price Index (CPI)- 6.6%;
- salary increases – CPI plus 1%²; and
- Repairs and maintenance, capital charges and other costs will increase by CPI³.

NERSA has developed a formula to determine the weighted average expected increase municipalities will incur in the provision of the service. From a sample analysis used by NERSA it was estimated that approximately 70 per cent of the municipal cost of providing electricity relates to bulk purchases. NERSA has implemented scenario 3 of their 2013 consultation paper.

NERSA, Scenario 3

Bulk purchases	Salaries & Wages	Repairs and Maintenance	Capital Charges	Other Costs⁴
70%	10%	6%	4%	10%

The formula for calculating the guideline:

$$\text{MG} = (\text{B} \times \text{BPI}) + (\text{S} \times \text{SI}) + (\text{R} \times \text{RI}) + (\text{C} \times \text{CCI}) + (\text{OC} \times \text{OCI})$$

Where:

- MG = % Municipal Guideline Increase
- B = % Bulk purchases
- BPI = % Bulk purchase increase
- S = % Salaries
- SI = % increase
- R = % Repairs
- RI = % Repairs increase
- C = % Capital charges
- CCI = % Capital charges increase
- OC = % Other costs
- OCI = % Other costs increase

¹ NERSA consultation paper 7 March 2016.

² As indicated in Circular No. 6/2012: Salary and Wage Collective Agreement.

³ NERSA consultation paper 2013.

⁴ Charges allocated from and to municipal departments, general expenses (costs related to the Municipal Electricity Department but not indicated on the D-forms).

Cost Item	Municipal % of Total Cost	Expected % increase	Weighted Average Increase
Bulk purchases	70%	7.86%	5.893%
Salaries	10%	7.6%	0.760%
Repairs and Maintenance	6%	6.6%	0.396%
Capital Charges	4%	6.6%	0.198%
Other Costs	10%	6.6%	0.396%
Municipal Electricity Increase			7.64%

Municipalities are therefore advised to apply municipal electricity tariff increases taking into account proportional cost of the above costs items in relation to the applicable weighted average increase.

In summary, the bulk tariff at which municipalities will buy electricity from Eskom is increased by 7.86 per cent and municipal guideline increase for consumers are 7.64 per cent.

Municipalities should to the extent where it is possible incorporate the above guidelines for the finalisation of the draft budgets, failing which it should be corrected prior to the adoption of the final budgets.

Kind regards



MR ML BOOYSEN

ACTING CHIEF DIRECTOR: PUBLIC POLICY SERVICES

DATE: 18 March 2016



MULTI-YEAR PRICE DETERMINATION (MYPD) METHODOLOGY REVISION

CONSULTATION PAPER

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Abbreviations and Acronyms

CECA	Capital Expenditure Clearing Account
DMP	Demand Market Participation
DSL	Demand Supply Loss Index
DSM	Demand Side Management
EAF	Energy Availability Factor
EEDSM	Energy Efficiency and Demand Side Management
ERTSA	Eskom's Retail Tariff Structural Adjustments
EUF	Energy Utilisation Factor
GLF	Generation Load Factor
GWh	Gigawatt hour
IDM	Integrated Demand Management
IPP	Independent Power Producer
IRP	Integrated Resources Plan
km	Kilometre
kWh	Kilowatt hour
MT	Medium Term
MTPPP	Medium Term Power Purchase Programme
MTRMS	Medium Term Risk Mitigation Strategy
MTSAO	Medium Term System Adequacy Outlook
MW	Megawatt
MWh	Megawatt hour
MYPD	Multi-Year Price Determination
NERSA	National Energy Regulator
OCGT	Open Cycle Gas Turbine
Opex	Operating expenditure
PAJA	Promotion of Administrative Justice Act
PCLF	Planned Capacity Load Factor
RAB	Regulatory Asset Base
RCA	Regulatory Clearing Account
REIPP	Renewable Energy Independent Power Producer
SADC	Southern African Development Community
SAE	Southern African Energy
SAIDI	System Average Interruption Duration Index
SAIFI	System Average Interruption Frequency Index
SALGA	South African Local Government Association
SAPP	Southern African Power Pool
SOC	State Owned Company
SPA	Special Pricing Agreement
SQI	Service Quality Incentive
ST	Short Term
STPPP	Short Term Power Purchase Programme
UAGS	Unplanned Automatic Grid Separation
UCLF	Unplanned Capacity Load factor
WEPS	Wholesale Electricity Pricing System

1 The Consultation Process

The National Energy Regulator (NERSA) is in the process of reviewing the Multi-Year Price Determination (MYPD) Methodology with the aim of finalising the review by 28 June 2016. However, prior to the decision, the Energy Regulator will embark on a due process involving stakeholder consultations. As part of this process, NERSA is requesting that stakeholders comment on the issues raised in this consultation paper. The consultation paper is broken down into sections relating to the key elements/components that make up the MYPD.

This consultation paper is structured as follows; each section starts with a section of the **current** methodology in a grey box, followed by the reasons for the revision of that section and the **proposed** new rules in a clear box. Lastly, questions are posed to the stakeholder to facilitate the consultation process.

NERSA will collate all comments received, which will be taken into consideration when the decision is made. NERSA will also hold a public hearing in 2016 wherein presentations may be made by interested and affected parties. The process for the consultation and decision-making is outlined in the table below:

DRAFT HIGH-LEVEL TIMELINES FOR APPROVAL OF THE MYPD METHODOLOGY	
ACTIVITY/TASK	DATE
Publication of draft the Methodology for stakeholder comments on the MYPD methodology	15 April 2016
Closing date for stakeholder comments on the MYPD Methodology	16 May 2016
Public Hearing	2 June 2016
Energy Regulator decision on the MYPD Methodology	28 June 2016
Publication of the MYPD Methodology on the NERSA website	30 June 2016

Stakeholders are requested to comment in writing on the MYPD Methodology Consultation Paper. Written comments can be forwarded to mypd@nersa.org.za; hand-delivered to Kulawula House, 526 Madiba Street, Arcadia, Pretoria, or posted to PO Box 40343, Arcadia, 0083, Pretoria, South Africa. The closing date for the submission of comments is 16 May 2016 at 16:00.

For more information and queries on the above, please contact Ms Lehuma Masike and Mr Dumisani Njezula at the National Energy Regulator of South Africa, Kulawula House, 526 Madiba Street, Arcadia, Pretoria.

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2 Introduction

After deliberations, NERSA, proposes to augment a number of key areas in the methodology including new rules in areas not covered before where conditions have changed. This is to achieve a high level of transparency (reliability), relevance and objective realignment. The Multi-Year Price Determination (MYPD) Methodology was developed for the regulation of Eskom's required revenues. It forms the basis on which NERSA will evaluate the price adjustment applications received from Eskom. The MYPD was first introduced in 2006 for implementation from 01 April 2006 to 31 March 2009. It is a cost-of-service-based methodology with incentives for cost savings and efficient and prudent procurement by the licensee (Eskom). The Methodology also provides for Services Quality Incentives (SQI) for Eskom. On an annual basis, the MYPD runs concurrently with Eskom's financial year(s). A second MYPD period started from 01 April 2010 to 31 March 2013, while the third started from 01 April 2013 and was to run until 31 March 2018¹.

In developing the MYPD Methodology, the following objectives were adopted:

¹ There was an interim price determination during the 2009/10 Eskom financial year due to unforeseen increases in fuel costs and Eskom's capital expansion programme.

1. to ensure Eskom's sustainability as a business and limit the risk of excess or inadequate returns; while providing incentives for new investment;
2. to ensure reasonable tariff stability and smoothed changes over time consistent with socio-economic objectives of the Government;
3. to appropriately allocate commercial risk between Eskom and its customers;
4. to provide efficiency incentives without leading to unintended consequences of regulation on performance;
5. to provide a systematic basis for revenue/tariff setting; and
6. to ensure consistency between price control periods.

3 Executive Summary

Given the current challenging South African macro-economic environment, such as the rising inflation, stagnation in Gross Domestic Product (GDP), stubborn unemployment rate, declining business confidence, potential sovereign credit down grade and the declining capacity of government and State Owned Entities (SOE's) to raise capital and funding as well as the ability of government to continue to support SOE's funding activities through credit guarantees. All these factors are pointing to a decline fiscal and monetary environment for South Africa "Incorporated".

Eskom is a vertically integrated monopoly responsible for generating, transmitting and distributing electricity. Although power generation has been widened to include Independent Power Producers (IPP's), Eskom is still responsible for 94% of the production of electricity in South Africa. The Energy Regulator has the responsibility of ensuring sustainability of the Electricity Industry Supply; this role is balanced with the need to ensure affordability of electricity. While it is the duty of Eskom to raise the capital to fund its capital programme and its operations, it is the duty of the Energy Regulator to enable Eskom to raise capital through a supportive regulatory environment that guarantees predictable electricity tariffs and the ability to pay its debts. This ensures a stable and dual price trajectory that enables the consumers of electricity to afford the rising costs.

As a basic and socio-economic commodity, electricity is also a major input cost to industry and manufacturing. In fact competitively priced electricity is in essence the corner stone on which economic growth is built. With South Africa only recently emerging from the scenario of constrained generation and extended load shedding of electricity, failure to invest by Eskom will continue to spur the environment of low economic growth even further.

Over the past eight years Eskom has been experiencing deterioration in its plant availability resulting in reduced energy sales. It has also been experiencing skills shortages as well as limited access to funding. This has resulted in it being unable to meet electricity demand, with load shedding being experienced from time to time since 2008 until 2015. The energy shortages have negatively impacted businesses aggravating the already weak macro-economic environment.

The experience gained in the current MYPD period has highlighted shortcomings in the current methodology and these need to be rectified in order to enhance the regulation of Eskom. The following issues have been identified as key risk areas that must be updated to be align with to the MYPD Methodology objectives:

- RAB rules are included to ensure Eskom's recovery of capital invested and a reasonable return.
- Operation & maintenance: a new section called Quality of Maintenance is included to align with the fourth objective which seeks to provide efficiency incentives without leading to unintended consequences.
- Primary Energy: additional rules are provided in this section to align with the third objective which seeks to appropriately allocate commercial risk between Eskom and its customers and ensure reasonable tariff stability and smoothed changes.
- IPPs: more rules have been included to ensure for the provision of a systematic basis for revenue setting.
- IDM: the revision of rules in this section to ensure Eskom's sustainability and provides efficiency incentives.

- For regulatory purposes a new section has been proposed namely, “*The ring fencing and reallocation of allowances*”.

NERSA invites all stakeholders to comment on the revised sections, as well as the rest of the Methodology.

4 Legal Basis

The legal basis for the MYPD Methodology lies in the Electricity Regulation Act, 2006 (Act No. 4 of 2006) (‘the Act’). Section 4 (a)(ii) of the Act states that ‘the Regulator must regulate prices and tariffs’. Further, section 15 (1) and (2) of the Act prescribes the following tariff principles:

- (1) *A license condition determined under section 14 relating to setting or approval of prices, charges and tariffs and the regulation of revenues –*
 - a) *Must enable an efficient licensee to recover the full cost of its licensed activities, including a reasonable margin or return;*
 - b) *Must provide for or prescribe incentives for the continued improvement of the technical and economic efficiency with which the services are to be provided;*
 - c) *Must give end users proper information regarding the costs that their consumption imposes on the licensee’s business;*
 - d) *Must avoid undue discrimination between customer categories; and may permit the cross subsidy of tariffs to certain classes of customers.*
- (2) *A licensee may not charge a customer any other tariff and make use of provisions in agreements other than that determined or approved by the Regulator as part of its licensing conditions.*

Apart from the Act, the Electricity Pricing Policy (*Electricity Pricing Policy GN 1398 of 19 December 2008*) (EPP) gives broad guidelines to the Energy Regulator in approving prices and tariffs for the electricity supply industry.

5 Allowable Revenue

- 5.1 The Allowable Revenue (AR) for Eskom for the MYPD period must be determined by applying the AR formula.
- 5.2 The following formula must be used to determine the AR:

$$AR = (RAB \times WACC) + E + PE + D + TNC + R\&D + IDM + SQI + L\&T \pm RCA$$

Where:

AR = Allowable Revenue

RAB = Regulatory Asset Base

WACC = Weighted Average Cost of Capital

E = Expenses (operating and maintenance costs)

PE = Primary Energy costs (inclusive of non-Eskom generation)

D = Depreciation

TNC = Transmission and Network Costs

R&D = Costs related to research and development programmes/projects

IDM = Integrated Demand Management costs (EEDSM, PCP, DMP, etc.)

SQI = Service Quality Incentives related costs

L&T = Government imposed levies or taxes (not direct income taxes)

RCA = the balance in the Regulatory Clearing Account (risk management devices of the MYPD)

- 5.3 Each functional division's (Generation, Transmission and Distribution) revenue will be calculated separately with the overall price/revenue determined at distribution level and communicated as such to customers.
- 5.4 The formula above must be applied to the three Eskom divisions by allocating the relevant costs to the division that incurred such costs.
- 5.5 Common costs will be allocated to the divisions according to an appropriate formula which will be subject to approval by the Energy Regulator.
- 5.6 Transmission revenues will be treated as pass-through costs at distribution level to avoid double-regulation.
- 5.7 Generation revenues will be treated as pass-through costs at distribution level to avoid double-regulation.

6 Applicability of MYPD Mechanism

- 6.1 The Methodology shall be used for the evaluation of Eskom's MYPD application.
- 6.2 In the application of the Methodology, the Energy Regulator shall not be precluded from applying reasonable judgement on Eskom's revenue after due consideration of what may be in the best interest of the overall South African economy and the public.

- 6.3 All expenses (that is operating and maintenance, primary energy, and research and development) are to be categorised in accordance with the guidelines on the Minimum Information Requirements for Electricity Tariff Applications² (MIRTA).

7 Weighted Average Cost of Capital

Current Rules

7.1 Formula

- 7.1.1 The Weighted Average Cost of Capital (WACC) is the weighted average of the expected cost of equity and cost of debt. The following formula must be used to determine the WACC:

$$WACC = K_d * g + [K_e / (1 - t_c)] * (1 - g)$$

Where:

WACC = pre-tax, real cost of capital

g = gearing

K_d = cost of capital

K_e = cost of equity

7.2 Gearing

- 7.2.1 The Energy Regulator strives to use the optimal gearing based on its actual calculations done on the application.
- 7.2.2 For purposes of regulation, the Energy Regulator will use a debt equity ratio of 65% as a capital structure used in the determination of the expected cost of capital.

7.3 Cost of Equity

- 7.3.1 The Cost of Equity (K_e) must be determined by the Capital Asset Pricing Model (CAPM) by applying the following formula:

$$K_e = [r_f + (\beta * MRP)] / (1 - t_c)$$

Where:

K_e = Pre-tax, real cost of equity. This is due to Eskom not getting an explicit tax allowance in the Allowable Revenue formula. The

² The Energy Regulator has approved minimum information requirements that will provide clarity on information needed for tariff applications and act as guidance to the applicant as to the type of information required by NERSA for tariff determination and decision-making.

revenue to pay for the tax is generated by specifying a pre-tax cost of equity.

r_f = Risk free interest rate. The average of the real monthly marked-to-market risk free rate for the preceding 300 months for all government bonds with at least a 10-year maturity as at 12 months before the commencement of the tariff period under review will be used.

β = The beta must be determined by proxy. As a proxy the average of at least six utilities companies listed in the stock exchange must be used. The methodology to be used to determine the beta is set out in Note 1. MRP = Market risk premium will be determined by using recent MRP studies conducted by credible entities both internationally and nationally over a period at least 25yrs. The Energy Regulator will use the proxy of Credit Suisse and/or Johannesburg Stock Exchange (JSE) All Share Total Index (ALSI) for the preceding (at least) 300 months for the calculation of the premium, whichever one is considered suitable.

7.4 **Cost of Debt**

7.4.1 The expected cost of debt consists of the expected risk free rate and the utility's debt premium.

7.4.2 The cost of debt is determined by using the following formula:

$$K_d = r_f + dP$$

Where:

K_d = pre-tax cost of debt measuring the average cost of debt for the contracted borrowing for the tariff period under review and taking into account the forward-looking view of expected interest rates yield curve.

R_f = Risk free interest rate. The average of the real monthly marked-to-market risk free rate for the preceding 300 months for all government bonds with at least a 10-year maturity as at 12 months before the commencement of the tariff period under review will be used.

dP : The debt premium will be determined as follows:

- The spread between the licensee bond rates and Government bond rates with the same maturity as well as other comparable international licensees with similar credit ratings and multi-year regulatory framework.
- Estimates of debt premium from financial institutions such as investment banks and credit rating agencies will also be considered.

Proposed Rules

There are no new proposals from NERSA to amend the WACC calculations. However stakeholders are requested to comment as follows:

Stakeholder Question 1:

- a) Stakeholders are requested to comment on the use of WACC to calculate the Eskom cost of capital.
- b) Given that beta is a measure of relative risk what would be the best way to estimate it?
- c) What is the reasonable rate of return on equity for state owned companies? How is this rate to be determined and what sources should NERSA use in determining this?
- d) In estimating the gearing ratio, what method should NERSA use?
- e) In estimating the various components of the WACC what period should NERSA use for estimation and what information sources should be considered?

8 Regulatory Asset Base

Current Rules

8.1.1 The Regulatory Asset Base (RAB) must represent assets used to provide regulated service by each of Eskom business operations of electricity generation, transmission and distribution.

- 8.1.2 The RAB of the regulated business operations must therefore only include assets necessary for the provision of regulated services based on the net depreciated value (residual value) of allowable fixed assets necessary to allow the utility reasonable return to be financially viable and sustainable while preventing unreasonable price volatility and excessive sustainability.
- 8.1.3 The RAB must consist of existing Fixed Assets in use, New Investments, Works Under Construction (WUC) excluding interest during construction, as well as making allowance for Net Working Capital to allow respective operations of Eskom to meet short-term obligations.
- 8.1.4 The allowance for Net Working Capital will be calculated in a way that it gives consideration to good practice targets to give incentives to Eskom to manage working capital optimally.
- 8.1.5 The RAB should, however, exclude any capital contributions by customers, though allowance will be made for electrification assets to allow for future replacement of such assets by Eskom at the end of their useful life.
- 8.1.6 Respective regulated operations of Eskom will be allowed to earn a rate on the RAB of the regulated operations based on the WACC.
- 8.1.7 Assets used partly for regulated revenues and of unregulated revenues will be proportionally allocated among these activities to avoid cross-subsidisation between regulated and unregulated businesses.
- 8.1.8 Only assets used in regulated operations and that meet the following criteria will be included in the RAB to allow the licensee to earn a reasonable return on assets as informed by an allowable return on assets:
- 8.1.8.1 Fixed assets must be long-term in nature and must be used and useable.
- 8.1.8.2 Fixed and other assets that are not in a used and useable form will therefore not be included in the RAB.
- 8.2 Criteria for including an asset in the asset base**
- 8.2.1 Used and useable means that assets should be in a condition that makes it possible to supply demand in the short-term (within 12 months).
- 8.2.2 Efficient working capital will be included in the RAB for the purposes of calculating the return.

- 8.2.3 The exception to the criteria is that the capital expenditure of expansionary nature, to create additional capacity (i.e. which is not used and usable) should be capitalised and included in the RAB as and when construction costs are incurred. Such capitalisation will however exclude interest during construction.

8.3 **The Basis for Valuation of the Regulatory Asset Base**

- 8.3.1 Policy position 1 (a) of the Electricity Pricing Policy (Electricity Pricing Policy GN 1398 of 19 December 2008) states that:

The revenue requirement for a regulated licensee must be set at a level which covers the full cost of production, including a reasonable risk adjusted margin or return on appropriate asset values. The regulator, after consultation with stakeholders, must adopt an asset valuation methodology that accurately reflects the replacement value of those assets such as to allow the electricity licensee to obtain reasonably priced funding for investment; to meet Government defined economic growth.

In addition, the regulatory methodology should anticipate investment cycles and other cost trends to prevent unreasonable price volatility and shocks while ensuring financial; viability, continuity, fundability and stability over the short, medium and long term assuming an efficient and prudent operator.

- 8.3.2 The Energy Regulator has adopted an asset valuation methodology whereby the current cost of replacing an asset with its modern equivalent asset is adjusted for physical deterioration and all relevant forms of obsolescence and optimisation to allow reasonable return on such RAB to ensure the financial viability and sustainability of Eskom while preventing unreasonable price volatility and excessive sustainability.

- 8.3.3 The methodology is also referred to as the Modern Equivalent Assets Value (MEAV) and is used as the basis for valuation of Eskom's RAB. Modern equivalent assets are similar to existing assets having equivalent productive capacity, however built using modern material, technology and design. The MEAV should be independently determined and verified by the Energy Regulator. The MEAV of the RAB should be adjusted for the associated

increased operational efficiency due to the use of modern technology. Efficiencies that can be extracted from operating expenditure must also be considered.

8.3.4 Depreciated Replacement Cost (DRC) will be used as the basis for estimating the cost of constructing a modern equivalent asset.

8.3.5 DRC will be derived from the modern equivalent asset value for the replacement of fixed assets that have been adjusted by accumulated depreciated taking into account the age and condition of the asset.

8.3.6 The MEAV focuses on valuing the cost of assets needed to provide the equivalent service provided by existing assets.

8.3.7 Valuation of the RAB should take the following criteria for valuation of assets into consideration:

8.3.7.1 All assumptions used in determining the starting value for the RAB must be clearly stated.

8.3.7.2 The assumptions underlying the MEAV must be transparent and predictable and also be made available to the users of electricity whenever necessary.

8.3.7.3 The value must be based on delivering the current level of service using the MEAV, in accordance with good international regulatory practice.

8.3.7.4 The MEAV must be determined objectively and be verifiable to optimise the impact of revaluated RAB on the allowed return to the utility.

8.4 Depreciation and Return on Assets

8.4.1 Regulatory depreciation and return on the RAB provides the regulatory mechanisms under which capital investment cost are recovered on a cost reflective basis over the course of its economic/regulatory useful life.

8.4.2 In line with the EPP, full cost reflectivity³ with respect to depreciation and return on assets cost recovery will be implemented over a reasonable period to allow Eskom reasonably priced funding for investment.

³ The pricing method to reflect the full economic cost of supplying electricity to a customer

8.4.3 The Energy Regulator will, however, apply reasonable regulatory judgment in balancing between the need to smooth price increases, allowing the licensee a reasonably cost reflective return on investment, and preventing excessive returns.

8.5 Depreciation on Regulatory Asset Base

Calculation of Depreciation

Annual Depreciation will be calculated by deducting the Accumulated Depreciation of the previous year (year-1) from the Accumulated Depreciation the current year (year 0) using the following formula:

$$D = AC_{y0} - AC_{y-1}$$

D = Depreciation and amortisation of Replacement cost adjustment

$$AC_{y0} = MEAV * (\text{remaining useful life year 0} / \text{total useful life})$$

$$AC_{y-1} = MEAV * (\text{remaining useful life year -1} / \text{total useful life})$$

8.5.1 The depreciating period will vary according to the economic useful life of various asset classes or groups of asset classes in the respective regulated operations of the licensee.

8.5.2 The RAB to be used for the depreciation of the assets will be the RAB as approved by NERSA. The RAB is the DRC. The DRC is arrived at, for each regulated asset, by the following steps:

8.5.2.1 **Step One:** Revalue the asset to obtain a MEAV value. NERSA will consider the MEAV study conducted by Eskom and approve what it considers to be an appropriate MEAV value.

8.5.2.2 **Step Two:** This MEAV value is then depreciated (according to the expired useful life and remaining useful life of the asset) to arrive at the DRC. Formulae $DRC = MEAV * (\text{remaining useful life} / \text{total useful life})$.

8.5.2.3 **Step Three:** Phase in the DRC over a number of years. (The first DRC value was being phased in over 5 financial years and commenced in 2010/11 in accordance with the MYPD2 NERSA decision. The MYPD3 phase in will be on a straight line basis over five financial years commencing in 2013/14. NERSA may adjust the

period in the light of Eskom's progress in implementing its investment programme).

8.5.3 Each year the MEAV value will change. Because it is not practical to conduct an entire MEAV study every year, the value from the last year studied will be increased by the Producer Price Index, each year, until the next MEAV study is carried out, after which the process will repeat itself.

8.5.4 All assets in the indexed historic asset base will be depreciated over a period in line with the accounting policies of the licensee years.

8.5.5 Useful lives ranging from 10 to 80 years will be used to depreciate all used or useable network assets.

8.5.6 WUC will be excluded from RAB for the purposes of depreciation.

8.6 Net Working Capital

8.6.1 Net working capital refers to trade receivables, trade inventory, reasonably incurred future fuels less trade payables reasonably required for the operation of the regulated business.

8.6.2 Trade receivable represents current assets due to the utility due to sale of electricity on credit. A maximum of 45 days sale of electricity by the regulated operations will be included in the RAB to the extent that such trade receivables do not attract interest in the hands of the utility.

8.6.3 Inventory refers to coal, nuclear fuel, maintenance spares and consumables held in efficiently operation of the regulated business.

8.6.4 Trade payables refer to current liabilities for which the amount to be settled is usually with respect to the normal operations of the utility and excludes provisions. A minimum of trade payable turnover of 60 days of trade purchases from suppliers will be included in the RAB to the extent that such payables do not attract interest payments.

8.7 Works Under Construction

8.7.1 Capital WUC are qualifying construction costs incurred with respect to projects with a long construction period (longer than 12 months).

- 8.7.2 Capital WUC should be stated at cost consisting of the cost of material and direct labour and any cost directly attributable to bringing it to its present location and condition.
- 8.7.3 To the extent that the assets are financed by borrowing, such borrowing costs attributable to construction of qualifying assets will not be capitalised as part of these assets over the period of construction.
- 8.7.4 The criteria for allowing inclusion of WUC as part of the RAB are as follows:
- 8.7.4.1 The WUC projects to be included in RAB are with respect to the creation of additional generation, transmission and distribution capacity.
 - 8.7.4.2 The WUC projects for additional electricity generation undertaken must be evaluated against the Integrated Resource Plan (IRP) of the National Government of South Africa; the Energy Regulator must be able to evaluate and compare such a project with similar projects that Eskom has undertaken in the past.
 - 8.7.4.3 The WUC must not necessarily be based on least-cost model of the IRP; however, the least cost model should be seen as an indication of the costs.
 - 8.7.4.4 Costs in the WUC programme must be disaggregated with full details on the activities undertaken.
 - 8.7.4.5 All WUC allowed must be subject to reviews and audits and any amounts identified to be imprudent must not be allowed in the risk management device on an annual basis.
- 8.8 **Works Under Construction Cost Variance Mechanism**
- 8.8.1 Aspects of the WUC will have to be forecasted at the beginning of the MYPD cycle. Therefore, the costs of WUC will change/deviate from the forecast in line with global market factors such as exchange rates, availability and costs of financing, and costs of key inputs.
- 8.8.2 To accommodate the unstable environment in which the WUC cost will be undertaken, the approach for adjusting works under construction for cost and timing variances will be as follows:

- 8.8.2.1 Eskom will annually report to the Energy Regulator on its capital expenditure programme, providing information on timing and cost variances.
- 8.8.2.2 At the end of each financial year, Eskom will provide the Energy Regulator with a final reconciliation report of the actual works under construction incurred.
- 8.8.2.3 On receipt, the Energy Regulator will record all efficient works under construction above or below the approved amount on the works under construction carryover account (CECA) and quantify Eskom's exposure.
- 8.8.3 Balances on the CECA will be adjusted as follows in the Regulatory Clearing Account (RCA) as follows:
- 8.8.3.1 At the end of the financial year, if there is any under-expenditure compared to forecasted works under construction, the value of the RAB will be adjusted downwards for works under construction not undertaken and the revenues for the subsequent financial year adjusted to compensate for the return earned on unused funds in the previous MYPD. For any over-expenditure approved by the Energy Regulator compared to forecasted works under construction, the balance will be added to the RAB and Eskom will be allowed additional returns on the CECA balance to recover the costs of the over-expenditure for that year. This approach will effectively minimise any potential windfall losses or gains should the approved capital expenditure differ from the actual expenditure.

Proposed Rules

It is proposed that the calculation of the Depreciation on the regulatory asset base be included in the Methodology.

Depreciation on Regulatory Asset Base

- 8.8.4 Straight-line method which allocates equal amounts of depreciation to each accounting period of the asset life will be used in depreciating the regulatory asset base.
- 8.8.5 The depreciating period will vary according to the economic useful life of various asset classes or groups of asset classes in the respective regulated operations of the licensee.
- 8.8.6 Useful lives ranging from 10 to 80 years will be used to depreciate all used or useable network assets.
- 8.8.7 WUC will be excluded from RAB for the purposes of depreciation.

Stakeholder Question 2:

- a) Stakeholders are requested to comment on the principles followed in determining the building blocks of the Eskom Regulatory Asset Base.
- b) Stakeholders are requested to comment on the appropriateness of the principle of the local user paying for assets used in generating and supplying electricity to regional state utilities and whether the regulatory asset base should be adjusted accordingly to compensate for the proportional use.
- c) Stakeholders are asked to comment on allowing a return on assets that are not performing at required capacity as determined by the Regulator and whether the return should be allowed on achieved Energy Utilisation Factor (EAF) or other means of performance measurement.
- d) Stakeholders are requested to comment on the appropriateness of using the MEAV in determining Eskom's assets replacement costs
- e) If the MEAV is an appropriate method to determine the Depreciated Replacement Cost (DRC), what criteria and assumptions must be made in calculating the DRC using the MEAV.
- f) Stakeholders are requested to comment on whether the return on assets should be limited to the extent that it enables the licensee to obtain reasonably priced funding for investment as anticipated by the Electricity Pricing Policy. Stakeholders are requested to comment on the appropriateness of revaluing the RAB at regular intervals as well as indexing it between valuations.

- g) Stakeholders are requested to comment on whether or not present customers should pay for new asset creation.
- h) Stakeholders are requested to comment on whether or not the licensee should be compelled to preserve some of the annual depreciation for future new asset creation.

9 Expenses – Operating and Maintenance

Current Rules

9.1 Section 15(1)(a) of the Electricity Regulation Act, 2006 (Act No. 40 of 2006) states that:

A license condition determined under section 15 relating to setting or approval of prices, charges and tariffs and the regulation of revenues –

a) Must enable an efficient licensee to recover the full cost of its licensed activities, including a reasonable margin or return;

9.2 The EPP position 1(a) further states that:

b) The revenue requirement for a regulated licensee must be set at a level which covers the full cost of production, including a reasonable risk adjusted margin or return on appropriate asset values.

9.3 Costs related to Operating and Maintenance (O&M) will be allowed. The reasonableness of such expenses will, subject to paragraph 7.4, be determined by the Energy Regulator on a case-by-case basis.

9.4 These costs are to be categorised in accordance with the Regulatory Reporting Manuals RRM.

9.5 The fully allocated cost attribution approach for the allocation of costs is used. This approach is as per the methodology contemplated in the RRM (as contained in the Energy Regulator-approved Cost Allocation Manual).

9.6 Principles regarding expenses

- 9.6.1 Allowable expenses relate to all expenses that are incurred in the production and supply of electricity. These costs include normal operating expenditures, maintenance (excluding refurbishment costs that must be capitalised), manpower or labour costs, and overheads (centrally administrative and general expenses allocated) that are normally recovered within one financial year.
- 9.6.2 Expenses must be incurred in the normal operations and supply of electricity, including an acceptable level of repairs and maintenance costs.
- 9.6.3 Expenses must be prudently and efficiently incurred and must be at arm's length transaction. Eskom must have a competitive procurement policy and demonstrate to the Energy Regulator that it has been strictly adhered to in its procurement processes.
- 9.6.4 For any expenses incurred under abnormal or extraordinary circumstances, consideration shall be given to spreading such expenses over a number of years. This consideration may also apply to particular types of expenditure within management's control only for purposes of tariff smoothing and once the Energy Regulator is satisfied that those expenses have been prudently and efficiently incurred.
- 9.6.5 Allowance for the human resources costs should be at reasonable levels. The Energy Regulator may require access to wage settlement documents to verify the reasonability of these costs.
- 9.6.6 Costs relating to corporate social investment, expenses on charitable donations and broad social development activities cannot be included as qualifying (regulated) expenses unless it can be shown that these costs benefit tariff paying customers.
- 9.6.7 Other expenses that are not related to the core business of supplying electricity will also be disallowed.

9.7 Efficiency of operating costs

- 9.7.1 In classifying operating costs further into controllable or non-controllable elements, the Energy Regulator will decide on incentives to Eskom to

minimise costs that are under its control as well as encourage it to reduce some of the costs that are not under its control.

Proposed Rules

Due to poor plant maintenance over the past 5 years, Eskom's coal fleet performance has deteriorated by more than 10%. A new section has been included named quality of maintenance, as previously there was no rule relating to quality and efficiency of maintenance implementation.

9.8 New Rules: Quality of maintenance for Generation assets

- 9.8.1 Eskom must provide their maintenance plan, highlighting the Philosophy / Proactive maintenance as well as the reactive maintenance to be implemented in the MYPD period.
- 9.8.2 Revisions to the maintenance plans should to be submitted to NERSA within 15 days after they are approved by Eskom management. Eskom must on a quarterly basis demonstrate improvements in the form of post outage reports for every completed maintenance project.
- 9.8.3 Eskom must demonstrate high quality and efficiency in the execution of the maintenance by demonstrating that work was implemented as planned within the planned time as well as within the budget allocated.
- 9.8.4 The Regulator will perform a prudence / efficiency assessment regarding the execution of maintenance and determine costs to be allowed.

Stakeholder Question 3:

- a) Stakeholders are requested to comment on the approach used by NERSA in the separation and allocation of costs for regulatory purposes.
- b) Stakeholders are requested to comment on the approach to oversee the implementation of maintenance and the impact thereof.
- c) Stakeholders are requested to comment on the adequacy of the proposed rules in ensuring that Eskom is only allowed costs that are prudently incurred.
- d) Stakeholders are requested to comment on the proposed new rules on quality of maintenance of Generation Assets.

10 Primary Energy

It became obvious during the RCA process that the rules around Primary Energy were inadequate for the current situation. Therefore a number of changes have been proposed that make the rules more relevant to today's reality. Part of that is the removal of the IPPs from the Primary Energy consideration as these do not form part of Eskom and are governed by separate contracts and prices not determined by Eskom.

Also in previous MYPD periods most of the coal was purchased from tied collieries which were either fixed cost or cost plus mines. However problems with coal quality and availability have meant that Eskom is looking for alternative and new sources of coal. These are not tied mines and in some cases are quite a distance away from the power station.

Matching the correct coal quality to the power stations is also an issue. While these challenges cannot be resolved overnight, the Energy Regulator needs to assure itself of a number of effects in evaluating coal costs.

Firstly, has Eskom properly planned to ensure that there will be sufficient coal of the right quality? Secondly, has Eskom been efficient and prudent in the procurement process? Thirdly, is the coal of the right quality being delivered i.e. Is Eskom performing adequate checks at the delivery point?

NERSA believes what has been missing from the current rules is the ability to address the changing supply regime, therefore the decision has been made to remove the provision that all coal will be treated as one cost centre so that the various supplies can be interrogated separately.

Eskom also sought clarity on the rules related to Open Cycle gas Turbines (OCGTs) and because of the high value of this item the rules have been completely rewritten. Other Primary Energy costs were also inadequately dealt with in hindsight based upon the experience gained during the RCA process. These areas have been separated and expanded.

Current Rules

10.1 Criteria for Allowing Primary Energy Costs

10.1.1 All rules applicable to operating expenditure shall apply to the primary energy costs.

10.1.2 In considering the allowable primary energy costs, the Energy Regulator will consider the most appropriate generation mix that can be achieved practically to the best interest of both the customer and the supplier.

10.2 Coal Costs

10.2.1 Coal will be treated as a single cost centre without differentiating between the various coal sources (for example cost plus contracts, fixed price contracts, short-term contracts and long-term contracts).

10.2.2 The Energy Regulator will determine and approve the coal benchmark cost (i.e. an average cost of coal R/ton), and Alpha for each year will be determined as part of the MYPD3 final decision.

10.2.3 The coal benchmark price is determined by the Energy Regulator in order to be used in comparison with the actual coal cost for the purpose of determining pass-through costs.

10.2.4 The coal benchmark price will be compared to Eskom's actual cost of coal burn (R/ton) using a Performance Based Regulation (PBR) formula. The PBR formula is the maximum amount to be allowed for pass-through, calculated by applying the following formula:

$$\text{PBR cost (Rand)} = (\text{Alpha} \times \text{Actual Unit Cost of Coal Burn} + (1 - \text{Alpha}) \times \text{Coal burn Benchmark price}) \times \text{Actual Coal Burn Volume}$$

Where:

Actual Cost = Actual unit cost of coal burn in a particular financial year

Benchmark Price = Allowed coal burn cost/coal burn volume (R/ton)

Actual Coal Burn Volume = Actual ton of coal burn in a particular financial year

Alpha = Alpha is the factor that determines the ratio in which risks in coal burn expenditure is divided: i.e. those that are passed through to the customers, and

those that must be carried by Eskom. Any number of the alpha between 0 and 1, set to share the risk of the coal cost variance between licensees and its customers.

10.2.5 The pass-through component of the coal burn cost is equal to the coal burn volume variance plus Alpha times the coal burn cost variance:

Pass through coal burn cost = PBR cost (Rand) minus Allowed Coal burn cost (Rand)

= Coal burn Volume variance + Alpha x (Coal burn cost Variance)

Where:

Coal burn Volume variance (Rand) = (Actual coal burn volume minus projected coal burn volume) x Benchmark coal cost

Coal burn cost variance (Rand) = (Actual coal burn cost minus Benchmark coal cost) x Actual coal burn volume

10.2.6 The coal benchmark price will be used to determine the resulting allowed actual coal burn cost (R/ton) and transferred to the RCA. The amount transferred to the RCA will therefore be calculated as the difference between the PBR amount and the amount forecast/allowed in the MYPD decision.

10.2.7 The coal stock level (stock days) will be reviewed by the Energy Regulator when necessary.

10.3 Gas Turbine Generation Costs

10.3.1 Gas turbine generation [Open Cycle Gas Turbine (OCGT)] costs will be allowed as a full pass-through cost, but limited conditional to volumes allowed by the Energy Regulator, except where such use is necessary to ensure security of supply. This is only applicable to Eskom's OCGT.

10.3.2 Capacity constraints shall be mitigated by gas turbine generation as a last resort. For avoidance of doubt, gas turbine generation should be employed before implementation of load shedding activities.

10.3.3 In cases where there are any variances in the operation of the gas turbine, the reasonableness of such expenses will be subject to review by the Energy Regulator

to determine the efficiency and prudence review in which Eskom has to demonstrate that it has maximised the availability and utilisation of cheaper resources such as Integrated Demand Management (IDM) and Demand Market Participation (DMP).

10.3.4 The pass-through cost must be equal to the gas turbine production volumes (energy sent out) of electricity in the MYPD production plan, converted to litres of fuel oil/gas consumed using the fuel efficiency of the gas turbine, and multiplied by the difference between the actual unit price of fuel (R/litre) and the MYPD unit price of fuel (R/litre).

10.3.5 A full pass-through cost shall be allowed where there are variances as a result of fluctuations in the unit cost of fuel.

10.3.6 The variances (i.e. difference between MYPD allowed costs and actual incurred costs) together with reasons shall be presented to the Energy Regulator for the full financial year (audited financial statements). These variances shall be based on actual costs for the full financial year.

10.3.7 After approval by the Energy Regulator, the variance shall be debited or credited to the RCA.

10.4 Other Primary Energy Costs

10.4.1 Other primary energy costs such as nuclear, hydro, and sorbent, will be allowed as pass-through costs.

10.4.2 Primary energy costs at the coal-fired power stations, for example water treatment, start-up fuel and coal handling costs will be allowed as a pass-through and will be reviewed by the Energy Regulator based on the percentage cost increase (inflation forecast).

10.5 Road Repairs and Maintenance

10.5.1 Government and the relevant road authority will be responsible for road repairs and maintenance. Eskom will pay a toll fee (Shadow toll) to SANRAL based on the beneficial use of the roads for coal haulage.

10.5.2 Eskom will be allowed a full pass-through cost for the toll fees to be paid to the relevant road authority.

10.5.3 For Eskom's own roads, it will be allowed to pass through cost for repairs and maintenance

Coal

The current rules did not provide for full interrogation of contracts as well as recognition of previous cost trends and forward projections, they furthermore allowed for inefficient procurement of coal. New rules are therefore being proposed to mitigate the information asymmetry risk.

10.6 Coal Costs

- 10.6.1 Coal must be procured according to the principles above (paragraph 9.6) for the optimum long term least cost. Coal procured from short and medium term supplies must be properly monitored on delivery to ensure that invoiced quantities are delivered and that it is the correct quality.
- 10.6.2 The application must specify on a per power station basis the annual expected deliveries and the associated cost per supplier together with the contract quality specification. The associated RCA application will contain the matching actuals.
- 10.6.3 In evaluating the coal costs due consideration will be given to the industry accepted level of inflation of mining costs as a reference. In the case of delivered coal, the transport inflation for the applicable year will also be considered. Eskom will have to motivate variances larger than expected based upon historical trends over the previous 5 years..
- 10.6.4 The Energy Regulator will determine and approve the coal benchmark cost (i.e. an average cost of coal R/ton) and alpha for each year as part of the MYPD final decision. The benchmark cost will be the approved average cost implicit in the decision.
- 10.6.5 The coal benchmark cost determined by the Energy Regulator will be used for comparison with the actual coal cost for determining pass-through costs for the RCA.
- 10.6.6 The allowed coal cost for the RCA purposes will be determined by comparing the coal benchmark with Eskom's actual cost of coal (R/ton cost) using a Performance Based Regulation (PBR formula). The allowed actual total cost is calculated by applying the following formula:

$$\text{Allowed actual cost (Rand)} = [\text{Alpha} \times \text{Actual Unit Cost of Coal Burn} + (1 - \text{Alpha}) \times \text{Benchmark Unit Cost Burn}] \times \text{Actual Coal Burn Volume}$$

Where:

Actual Cost = Actual unit cost of coal burn in a particular financial year

Benchmark Cost = Allowed coal burn cost/coal burn volume coal burn (R/ton)

Actual Coal Burn Volume = Actual ton of coal burn in a particular financial year

Alpha = Alpha is the factor that determines the ratio in which risks in coal burn expenditure is divided: i.e. those that are passed through to the customers, and those that must be carried by Eskom. Any number of the alpha between 0 and 1, set to share the risk of the coal cost variance between licensees and its customers.

- 10.6.7 The coal stock level (stock days) will be reviewed by the Energy Regulator when necessary.
- 10.6.8 Eskom bears the sole risk of ensuring that the Coal Suppliers meet their obligations in terms of the Coal Supply contract so that the power station has sufficient coal for the duration of the Coal Supply contract.
- 10.6.9 Eskom should submit coal a procurement plan linked to the production plan with the MYPD application.
- 10.6.10 Eskom must obtain confirmation of 100% availability of required coal quantities, unit cost (R/ton), coal quality including calorific value and the supply thereof and regimes to manage any shortfalls in respect of such quantities. These quantities must be confirmed at least three (or equal to MYPD period and production plan for the period) years ahead of actual usage.
- 10.6.11 No coal shall be procured without a signed contract so as to avoid additional costs related to coal spot purchases.
- 10.6.12 The Energy Regulator will determine the coal benchmark price (i.e. average R/ton) per contract type (Cost Plus, Fixed Price and Short term) and Alpha for each year will be determined as part of the MYPD final decision.
- 10.6.13 If Eskom is aware of or anticipates occurrence of any force majeure event or unforeseeable conduct in respect of coal supply this shall be included in the MYPD application with all information reasonably available to Eskom in respect of such anticipated event. In the application Eskom should include measures in place to mitigate the impact of such events and also provide the financial impact of such events. However Eskom shall only pass through the cost as and when such events happen. *Force majeure* and unforeseeable conduct shall be as defined in the coal

contracts for the affected power station. In the absence of such definitions the Energy Regulator shall use definitions in the final PPA under the DoE Coal IPP programme Bid Window 1.

- 10.6.14 Long Term contracts (Cost Plus and Fixed Price contracts) have a duration longer than 10 years. Coal from long term contracts is transported by conveyor belt.
- 10.6.15 Short Term (ST) contracts are contracts with a duration of 1-10 years. Coal from ST mines is typically further away from the power station than coal on long term contracts. The coal from ST contracts is transported by road or rail and sometimes a combination of the two.
- 10.6.16 In the case of ST purchases under *force majeure* operational events or spot market, Eskom must provide reports for such purchases within 30 days to the Energy Regulator.
- 10.6.17 Coal price in Cost Plus (CP) contracts shall be adjusted using the formula provided in the contracts. Under CP contracts Eskom has influence on volumes, costs, strategies and capital. Eskom is therefore expected to make accurate forecasts on coal price because they are part owners of the mines thus price variance in favour of Eskom shall not be allowed unless Eskom can prove it was beyond their control. Cost Plus contract parameters (mining input costs like steel, labour, diesel, spare parts, rubber, and electricity) in the indexation formula shall be adjusted using the lower of either publicly available information or Eskom internal forecasts. As a prudent operator Eskom shall be required to re-negotiate the contract terms on an on-going basis to minimise costs to Eskom in the long run.
- 10.6.18 Coal price in Fixed Price (FP) and Short Term (ST) contracts shall be adjusted using the formula in the contracts. Under FP contracts the price risk lies with the mining house, so Eskom is not involved in the planning processes of the mine. However Eskom does review the mining plans at high level to reduce the risk exposure to the organisation. As a prudent operator Eskom shall be required to re-negotiate the contract terms on an on-going basis to minimise costs to Eskom in the long run.
- 10.6.19 Any variations of the FP and ST contracts should be submitted to the ER in 30 days after the event occurred.
- 10.6.20 Increase in R/ton unit cost arising from reduced production at the mines shall not be recovered from the electricity customer for the first 2-years of MYPD period

unless the volumes reduction is caused by events beyond the control of Eskom or the mine such as reduced energy demand, force majeure and unforeseeable conduct (definitions). Unforeseeable Conduct refers to any action taken by a Responsible Authority (government or regulatory departments) in terms of applicable Law (including the introduction, application or Change in Law) that has a material impact on the availability or pricing of coal. Eskom and the Coal Supplier may agree, for operational reasons from time to time to decrease the volumes of required coal and such agreements should be submitted to the ER within 30 days of the event .Eskom coal burn volume forecasts must be 100% accurate for at least the first two years of the MYPD period. Revised forecasts, if incurred, for the subsequent years should be submitted to the ER within 30 days of the incurred revision.

- 10.6.21 If a coal supplier fails to deliver coal of the required quality then Eskom shall apply penalty mechanisms in the coal contract to recover additional costs incurred in implementing remedies to arrive at the desired coal quality, no such additional costs will be recovered from the electricity consumer.
- 10.6.22 Transport costs (R/ton/km) shall be escalated using formula in the transport contracts. The parameters (transport input costs like diesel, mechanical spares and tyres) in the indexation formula shall be adjusted using publicly available information. Transport is most sensitive to diesel price and diesel price escalation shall be a pass through after prudency review of the route optimisation.
- 10.6.23 Conveyor belt costs shall be adjusted based on the mechanical spares and escalation index derived from the lower of either publicly available information or Eskom internal forecasts. Rail transport costs shall be escalated as per contract with the service provider.
- 10.6.24 Additional road transport costs caused by failure to meet the migration deadlines from road to rail use shall be subject to prudency review. If the delay in commissioning of railway infrastructure is caused by the contractor then Eskom shall recover such costs from that contractor using the penalty clauses in the rail construction contract. If the delay in commissioning of railway infrastructure is caused by Eskom then additional road transport costs shall be charged at the cost of rail transport which should have be in operational at that time.

- 10.6.25 Additional costs resulting from failure of coal handling equipment and facilities (e.g. conveyor belt systems, silos) to deliver coal to the boiler shall not be a pass through cost unless the event was beyond the control of Eskom. Eskom shall demonstrate that all measures were implemented to minimise the impact of the disruptive events such as adhering to maintenance schedules of all equipment and facilities.
- 10.6.26 Flooding of mines under Cost Plus contracts due to heavy rains shall be a pass through cost provided Eskom can demonstrate they had adequate measures to channel the rainfall away from the shafts/pits. For any other contract types additional costs arising from mine flooding shall be recovered using mechanisms in the coal contracts.
- 10.6.27 Additional costs arising from the non-delivery of coal to the power stations due to strikes, lockouts and other industrial action by employees of Eskom service providers (mining houses, transporters) shall not be treated as a pass through, Eskom should invoke the penalty mechanisms in the contracts with their service providers to recover these costs. However Eskom shall be allowed to recover from the electricity customers additional costs arising from industrial action by employees of Eskom service providers if such an action is part of any wider industrial action involving a significant section of the public sector, the public administration, the construction industry or the electricity supply sector.

Stakeholder Question 4:

- a) Should the Energy Regulator approve revision of existing coal contracts and new coal contracts with a view to ensure cost effective coal procurement thus eventually minimising increases in coal costs?
- b) Should Eskom be allowed to recover additional costs incurred due to variations between the actuals and forecasts of coal volumes, transport costs, coal costs etc. What should be the suitable percentage deviation of the actuals from the forecasts?
- c) What should be the most suitable value of Alpha which will encourage Eskom to better manage coal costs?

OCGTs

In the recent past OCGT utilisation has increased by up to three times more than planned. This has led to escalation of primary energy costs that can be passed on to the electricity consumer.

The problem with the current methodology is that it is not comprehensive enough in defining the prudent use of OCGTs and there are no explicit guidelines for the dispatch of OCGTs in relation to other cheaper options. It is furthermore not explicit in the handling of exports, imports, pumping water for pumped storage plants, demand market participation as well as maintenance strategies that treat their generation as available generation and not emergency generation.

10.7 Gas Turbine Generation (OCGTs)

10.7.1 Subject to the conditions set out in this methodology Gas turbine generation cost will be allowed as a full pass-through cost but limited to volumes allowed by the Regulator, except where such use is necessary to ensure security of supply due to *Force Majeure* events. This is applicable to Eskom OCGTs as well as the stations procured under the Department of Energy (DoE) “Peaker Programme” (Dedisa and Avon) .

10.7.2 Price variances due to higher than projected diesel prices will be allowed as a pass-through but limited to the allowed volumes based on allowed energies, according to the equation below;

$$\begin{aligned} \text{Allowed Volumes (l)} \\ &= \text{Allowed Energies}_{\text{Per Station}} (\text{MWh}) \\ &\quad * \text{Efficiency}_{\text{Per Station}} \left(\frac{\text{l}}{\text{MWh}} \right) \end{aligned}$$

And

Price Variance

$$= (Allowed\ Volumes\ (l) * Average\ Diesel\ Price_{Actual} \left(\frac{R}{l}\right)) \\ - Allowed\ Diesel\ Cost\ (R)$$

10.7.3 A full pass-through cost shall be allowed where there are variances as a result of fluctuations in the unit cost of fuel.

10.7.4 OCGT plant utilisation is directly dependant on the performance of the rest of the Eskom fleet (coal fleet, nuclear plant and other Peaking plants). For this reason the MYPD determination will be made after full consideration of the production plan for the period under consideration.

10.7.5 Eskom will with their application provide NERSA with the following in Excel format.

10.7.5.1 The summary production plan (per station) in annual terms for the period under review showing capacity, standard daily burn, Heat rate, burn rate and expected fuel CV. Also the annual availabilities (EAF, PCLF, UCLF, OCLF), total expected coal burn, energy sent out, the Generator load factor (GLF), Energy Utilisation Factor (EUF), Energy Availability Factor (EAF) and Total Energy Produced.

10.7.5.2 With regard to the production plan above (also in Excel format) the financial and commercial information per station needs to be supplied. That is the power station with the planned fuel consumption with associated cost. Planned purchases per supplier in quantity and price. Planned additions or offtakes from stockpiles and starting stocks.

10.7.5.3 Detail hourly planned production with the details as shown in Appendix 1 must also be submitted.

10.8 During the RCA process, in assessing the prudence of OCGT operation beyond the allowed amount, consideration will be given as to how the circumstances arose that

required such operation. Specifically situations that arise solely out of management decisions such as running OCGTs in place of plant taken out of service as an operational philosophy will be excluded.

10.8.1 The following should be fully dispatched, in the least cost dispatch order, before OCGTs can be used

10.8.1.1 The full available baseload fleet (coal and nuclear)

10.8.1.2 The full available PS and Hydro, dependent on water restrictions as defined by DWARF

10.8.1.3 The full available DMP (Supplementary) and Demand Response where applicable

10.8.1.4 All contracted Load reduction measures

10.8.1.5 All available contracted IPPs;

10.8.1.6 MTPPP

10.8.1.7 STPPP

10.8.1.8 Imports (increase thereof) / Exports (decrease thereof)

10.8.1.9 WEPS

10.8.1.10 DoE Peaker

10.9 The following are conditions under which OCGTs should ordinarily not be used;

No.	Duration	Notes
1	Weekends (Saturdays and Sundays)	Quantify (MWh)
2	Week days, Off-peak (09:00 am – 16:00 pm, 22:00 pm – 05:00 am)	Quantify (MWh)
3	Use of OCGTs for pumping (Pumped Storage plants)	Quantify abnormally high OCGT generation while pumping
4	Use of OCGTs to maintain reserve margin of 2000MW	Quantify increase in OCGTs generation responding to reserve margin deterioration

5	Use of OCGTs to maintain exports	Quantify increase / high OCGTs generation to maintain export during constrained supply.
6	Use of OCGTs to create room for maintenance	Quantify increase / high OCGTs generation incidental with high maintenance losses.

10.9.1 It must be quantified / indicated upfront by Eskom how much OCGT generation is allowed to ensure quick response of the generators in case of emergency i.e. running the OCGTs at minimum stable level.

10.9.2 Using OCGTs under the conditions defined in the table above would have to be explained demonstrating the prudence and efficiency of doing so. It must be demonstrated by the generator that all available cheaper sources have been exhausted.

10.9.3 Eskom must ensure that plant performance projections are as accurate as possible. Deterioration in plant performance will result in penalties relative to the revenue that would have been generated from the lost energy.

Stakeholder Question 5:

- a) Stakeholders are requested to comment on the proposed rules for considering the gas turbine generation costs.
- b) Stakeholders are requested to comment on whether recouping the excess OCGT generation at coal cost appropriate.
- c) Stakeholders are requested to comment on whether the prudence criteria defined in 10.9 is sufficient.
- d) Stakeholders are requested to comment on whether the proposed penalty method for managing plant performance is appropriate.

Other Primary Energy

The current methodology does not specify water usage particularly in coal fired power stations, it also did not link water usage to any plant performance criteria as well as water treatment costs. Coal handling costs are not explicitly dealt with. Start-up oil and gas costs were also not linked to any plant performance criteria. No rule was provided for both nuclear decommissioning and fuel procurement cost.

10.10 Other Primary Energy Costs

10.10.1 Water costs

10.10.1.1 The water quantity allowed is calculated at 1.34 litres per unit sent out (L/USO) and will be further adjusted to 1.20 L/USO when the Medupi and Kusile Power Stations come online

10.10.1.2 Water unit costs (Rands / Litre) will be the actual costs incurred

10.10.2 Coal handling

10.10.2.1 Coal handling costs will be allowed at a reasonable level. However Eskom should provide the following breakdown on a per station basis.

- Costs incurred building stockpiles
- Costs incurred recovering from stockpiles
- Costs incurred handling coal delivered by road
- Extra costs incurred due to *Force Majeure* events

10.10.2.2 Specifically, records of costs incurred due to wet coal issues and mine shutdowns must be kept.

10.10.2.3 In evaluating the costs, the reasonableness and past history will be factors considered.

10.10.3 Water Treatment

10.10.3.1 Water treatment costs are based on ESKOM's previous performance and will be evaluated on L/USO and actual cost incurred.

10.10.4 Start-up Oil & Gas

10.10.4.1 Start-up Oil & Gas costs are based on ESKOM's previous performance and will be evaluated on the following criteria:-

- International Fuel Price

- Rand / Dollar exchange Rate
- Capacity Loss Factor

10.10.5 Fuel procurement

10.10.5.1 The cost will be allowed provided that Eskom submits detailed disclosures of how these costs are incurred.

10.10.5.2 Other primary energy costs such as nuclear, hydro, and sorbent, will be allowed as pass-through costs.

10.10.5.3 Primary energy costs at the coal-fired power stations, for example water treatment, start-up fuel and coal handling costs will be allowed as a pass-through and will be reviewed by the Energy Regulator based on the percentage cost increase (inflation forecast).

10.11 Road Repairs and Maintenance

10.11.1 Government and the relevant road authority will be responsible for road repairs and maintenance. Eskom will pay a toll fee (Shadow toll) to SANRAL based on the beneficial use of the roads for coal haulage.

10.11.2 Eskom will be allowed a full pass-through cost for the toll fees to be paid to the relevant road authority.

10.11.3 For Eskom's own roads, it will be allowed to pass through costs for repairs and maintenance.

10.12 Nuclear

10.12.1 Spent fuel decommissioning provision is to be ring-fenced from any other costs.

10.12.2 Applications for a revision in the spent fuel decommissioning provision should be aligned with the engineering study to determine the adequacy of the provision.

10.12.3 Any allowed spent fuel decommissioning provision should be recovered over the remaining useful life of the nuclear plant as per the licence

Stakeholder Question 6:

- a) Stakeholders are requested to comment on the proposed rules for considering other primary energy costs.
- b) Stakeholders are requested to provide views on how the volatility in the cost of fuel can be managed.

11 Purchases from Independent Power Producers

Current Rules

- 11.1 In accordance with the provisions of Section 14(f) of the Electricity Regulation Act, the Energy Regulator shall, as a condition of licence, review power purchase agreements (PPAs) entered into by licensees before signature. This also includes all PPAs considered under the Ministerial Determination by the Department of Energy (DoE). In evaluating the MYPD, the cost associated with the Independent Power Producers (IPPs) will be done based on the conditions of the respective PPAs.
- 11.2 The Energy Regulator will review the efficiency and prudence of the IPP before and after PPA contracts are concluded.
- 11.3 Purchases or procurement of energy and capacity from IPPs, including capacity payments, energy payments and any other payments as set out in the PPA, will be allowed as a full pass-through cost.
- 11.4 Use-of-system charges incurred by the buyer in line with the PPA from IPPs will be allowed as a full pass-through cost.
- 11.5 Energy output (deemed payments) that would otherwise be available to the buyer but due to a System Event or a Compensation Event (e.g. system unavailability) was not incurred in accordance with provisions of power purchase agreements reviewed by the Energy Regulator, will be allowed as full pass-through costs.
- 11.6 Termination amounts payable by the buyer, designated pursuant to New Generation Capacity regulations, in accordance with provisions of PPAs reviewed by the Energy Regulator, will be allowed as full pass-through costs.

- 11.7 Administration costs of the PPAs will be reviewed by the Energy Regulator to determine the efficiency and prudence with which the costs will be allowed as a pass-through cost.
- 11.8 Hedging costs to hedge against exposure to risks allocated to the buyer in the PPAs will be allowed as a pass-through cost.
- 11.9 Each pass-through cost will be reviewed by the Energy Regulator to determine the efficiency and prudence with which pass-through costs have been incurred above.
- 11.10 The variances (i.e. difference between MYPD allowed costs and actual incurred costs) together with reasons shall be presented to the Energy Regulator. After the review, the variance will be debited/credited to the RCA.
- 11.11 Over and above the MYPD allowance, pass-through costs shall be reviewed by the Energy Regulator to determine the efficiency and prudence under which they have been incurred.

The current methodology allows IPP costs to be pass through costs. Eskom can reasonably forecast the volumes to be generated by IPPs and the total costs from the tariff and capacity factors in the PPAs. However, currently Eskom is under-forecasting the IPP costs. Eskom would then apply to recover IPP costs in the RCA, adding to the already approved tariffs. The under-forecasting is not only limited to IPPs costs but to even its own generation volumes from its generation plants. Whilst Eskom can recover the shortfalls due to under forecasting through the RCA, the consumers, especially industry, does not have any mechanism of absorbing the additional tariff increase due to RCA increases caused by Eskom's under-forecasting.

Proposed Rules

- 11.12 Eskom should provide detailed demand, energy and cost forecasts of the IPP purchases per plant and technology (renewable and conventional), including the STPPA and MTPPA together with the generation production plan for the regulatory period under consideration.
- 11.13 Any cost variances between the forecasts and Eskom's actual IPP cost greater than 5% should be subject to regulatory prudence and efficiency tests.

Stakeholder Question 7:

- a) What percentage variance from applied IPP forecasted cost would be reasonable for Eskom?
- b) If Eskom's actual cost is outside the allowed variance percentage, should it also be penalised to encourage Eskom to forecast more correctly?
- c) If Eskom should be penalised, how would the penalty be calculated?

12 Research & Development

Current Rules

- 12.1 The Energy Regulator shall consider the core research and development (R&D) activities based on the following criteria:
- 12.1.1 The purpose and goal of R&D should be clear.
 - 12.1.2 The development costs will be capitalised when the projects indicate that future economic benefits will flow into the entity, and when they are technically feasible and their expenditures can be reliably measured. Eskom will provide the details around the readiness of the projects.
- 12.2 The following criteria gives guidance with regard to which projects are acceptable:
- 12.2.1 those which will result in improved efficiency;
 - 12.2.2 those which will result in extended plant life;
 - 12.2.3 those which will result in lower operating costs;
 - 12.2.4 those which will result in a better load factor or power factor;
 - 12.2.5 those which will result in a better understanding of load behaviour; and
 - 12.2.6 those which relate to the design, construction, selection and operation of projects in the build plan or demo plant of those technologies which might form part of a future build plan.
- 12.3 In addition, the following environmental projects are allowed:
- 12.3.1 those related to developing, designing, selecting and operating renewable energy sources;

- 12.3.2 those related to better usage of water, less pollution and less global warming; and
- 12.3.3 climatology projects related to environmental impact or forecasting of availability of natural resources and weather patterns.
- 12.4 Further considerations will be:
 - 12.4.1 The costs undertaken by Eskom will be allowed if they are likely to benefit customers. The licensee will have to justify the expenses incurred in the R&D activities.
 - 12.4.2 The costs in the R&D should be prudently incurred.
 - 12.4.3 There must be proper governance procedures in place with industry input in terms of project selection and review.

Proposed Rules

There are no proposals from NERSA to amend the Research and Development section.

Stakeholder Question 8:

Stakeholders are requested to comment on the current rules concerning Research and Development.

13 Integrated Demand Management (IDM) Costs

Current Rules

13.1 Energy Efficiency and Demand Side Management

- 13.1.1 The Energy Efficiency and Demand Side Management (EEDSM) revenue requirement will be calculated as follows:

$$\text{Revenue Requirement (RREEDSM)} = \text{Projects cost or programme cost} + \text{Operating cost} + \text{Measurement \& Verification (M\&V) cost}$$

- 13.1.1.1 Eskom shall submit a full breakdown of all EEDSM programmes/technologies with their estimated costs, demand and energy savings to the Energy Regulator with the MYPD application.
- 13.1.1.2 The projects' costs will be benchmarked with the cost of peaking, base-load or mid-merit power stations where applicable and the funding will be on the basis of the life cycle cost of the project compared with the avoided cost of supply.
- 13.1.1.3 EEDSM programmes/projects that are funded by other stakeholders, e.g. Treasury/DoE should be excluded from the required revenue.
- 13.1.1.4 IDM operating cost will have to be in line with the operation and functions of IDM including labour, marketing and overheads. The energy targets shall be evaluated on the basis of the energy efficiency targets of the DoE and Eskom's contribution to the EEDSM in the IRP2010.
- 13.1.1.5 Ideally, the overall EEDSM programmes will be evaluated using the lifecycle cost of the programme and be compared to the avoided cost of supply based on the Long Run Marginal Cost (LRMC). If the life cycle cost of the programme is greater than the avoided cost of supply the programme will be rejected. The avoided cost of supply shall be determined using the annual average long run marginal cost of
- 13.1.1.6 Generation, for a period equal to the life cycle of the EEDSM programme, seasonally, weekly, and hourly differentiated and adjusted for network costs and losses based on the Wholesale Electricity Price System (WEPS).
- 13.1.1.7 The M&V costs shall be limited to a benchmark of 5% of the total project cost.
- 13.1.1.8 The EEDSM funds shall be approved subject to the above and on the condition that Eskom shall submit performance reports quarterly and annually reflecting expenditure (Rm), energy (GWh) and demand savings (MW) per programme and per project and the Energy Regulator shall have the final decision in allowing or disallowing the EEDSM programmes.
- 13.1.1.9 IDM will incur penalties for under achieving their targets. In case of non-performance, the penalty will be calculated as follows:
- $$\begin{aligned}\text{Penalty(R)} &= \text{total allowed revenue /projected MW target X MW Unserved} \\ &= \text{R/MW X MW unsaved}\end{aligned}$$
- 13.1.1.10 In terms of reporting demand savings, the following rules will apply:

- a) Where the measured and verified evening peak demand saving is the highest daily demand saving achieved by the project, the evening demand saving will be reported.
- b) Where the measured and verified morning peak demand saving is more than the measured and verified evening peak demand saving, the recognised demand savings will be equal to the measured and verified evening peak demand savings plus a factor multiplied by the difference between the measured and verified morning and evening peak demand savings.
- c) The factor will rate the importance of the morning peak vs. the evening peak.
- d) The factor will be calculated as the average of the ratios of the system daily morning peak demands and the system daily evening peak demands for the preceding calendar year.
- e) The formula for recognised demand savings where the morning peak demand savings are higher than the evening peak demand savings is as follows:

$$\text{Recognised demand savings} = \text{PE} + \text{factor}^4 \times (\text{PM} - \text{PE})$$

Where:

PE = Measured and Verified Evening peak demand savings

PM = Measured and Verified Morning peak demand savings

$$\text{Factor} = 1/249 \sum_{i=1}^{249} \frac{\text{Pmi}}{\text{Pei}},$$

Where:

Pmi = the system daily morning peak demand

Pei = the system daily evening peak demand

13.1.1.11 Recognised demand savings exclude weekends and public holidays.

13.1.1.12 If the evening peak demand savings are equal to or higher than the morning peak demand savings, then the recognised demand savings are:

$$\text{Recognised savings} = \text{PE}$$

⁴ Factor is an average of the ratio of system daily morning peak demand/ system daily evening peak demand of the preceding calendar year period.

13.1.1.13 The morning peak is considered to be from 07:00 to 10:00 and the evening peak is considered to be from 18:00 to 20:00 Monday to Friday or any other deviation in the peak hours that is caused by the changes in the daily load profile.

13.2 Principles of the avoided cost determination

13.2.1.1 The avoided generation cost will be determined on the basis of the annual average long run marginal cost of generation derived from the IRP applicable at the time.

13.2.1.2 The avoided transmission cost infrastructure charge will be based on the WEPS network charge.

13.2.1.3 The avoided distribution cost shall be calculated on the basis of the WEPS network charge variable according to voltage supply level.

13.3 Demand Market Participation

DMP cost = tariff (R/MWh) x MWh + programme administration costs

13.3.1 The DMP will be evaluated using the available data on customers that previously participated and the response of those customers, to estimate the market potential of several types of demand response programmes. The process of estimating large and small aggregated customer demand response market potential in an Eskom supply areas will involve the following steps:

13.3.1.1 Projecting the targets based on the projected economic dispatch and any potential short fall of energy or capacity.

13.3.1.2 Considering types of demand response options by using available data to estimate customers' participation in voluntary programmes and those with contractual obligations.

13.3.1.3 Determining the appropriate price/tariff below the price of peaking station.

13.3.1.4 The tariff/price should benchmark at the cost of OCGT (including capital, operating and fuel costs) applicable at the time as a base and will be escalated with the Consumer Price Index (CPI) annually. OCGT is used for supplying peak demand; therefore DMP will then be used to provide a flexible and cheaper alternative to OCGT.

13.4 Power Conservation Programme

13.4.1 The Power Conservation Programme (PCP) Regulations and Regulatory Framework has not yet been finalised, therefore the PCP/Energy Conservation Schemes (ECS) rules for the MYPD3 will be finalised as soon as these frameworks have been concluded.

13.5 PCP/ECS Safety Net Programmes

13.5.1 In the absence of any electricity shortfall, the ECS shall be implemented on a voluntary basis.

13.5.2 The mandatory implementation will be implemented at no cost to Eskom with zero penalties, until the promulgation of the ECS policy, to be developed by the DoE.

13.5.3 In the event of an electricity shortage, the ECS funded through electricity tariffs shall come into operation after considering all possible Demand Side Management Programmes such as EEDSM DMP and OCGT, which would only be activated during times of crisis.

Proposed Rules

The need to change this section of the methodology was prompted by information obtained from the following documents: the IDM Audit, IDM Performance, the RCA and the MYPD. The analysis of these documents revealed the following shortcomings:

- Eskom underspent and underachieved DMP and EEDSM demand and energy savings targets whilst using the OCGT's in excess of the allowed volumes (GWh).
- There is no evidence of ring-fencing of IDM funds because some IDM funds were "reallocated" to other Eskom functional areas outside IDM.
- Eskom suspended IDM programmes without approval by the Energy Regulator
- Classification of IDM programmes is not in line with the best international practices. In some instances the Eskom reports show no evidence of IDM targets alignment with IRP, Medium Term System Adequacy Outlook (MTSAO) and Generation production plan in order to achieve the economic efficiency.

- 13.5.4 Eskom should develop and submit a 5-year demand resource potential assessment including technical potential and estimated achievable potential. The 5-year plan should be updated annually.
- 13.5.5 Levelised cost of IDM resources should be based on the Total Resource Cost (TRC) and should be provided upon application for implementation of existing as well as new demand side resources.
- 13.5.6 The IDM programmes considered in the rules are classified as follows:
- 13.5.7 **Energy Conservation (EC)**
- 13.5.7.1.1 Energy Efficiency (EE) programmes effecting energy savings during daily hours of working days with a duration of more than 1600 hours per financial year.
- 13.5.7.2 **Demand Reduction (DR)**
- 13.5.7.2.1 Demand response, demand reduction, demand curtailment, demand market participation, and demand response aggregation programme are programmes aiming to reduce the demand during peak hours.

13.6 Integrated Demand Management Revenue

13.6.1 The IDM revenue requirement will be calculated as follows:

$RR_{IDM} = RR_{ec} + RR_{dr}$, where

RR_{ec} is the revenue requirement for the EC programme;

RR_{dr} – the revenue requirement for the DR programme.

The revenue requirement per programme will be calculated as follows

$RR_{pr} = (PC) + OC + M\&V$, where

RR_{pr} is the revenue requirement for the programmes above;

PC – programme cost;

OC – operating cost of the programme;

M&V – measurement and verification cost of the programme.

The revenue requirement for the EC programme will be determined as follows:

$PC_{ec} = AC_{base} \times Target$, where

PC_{ec} is the programme cost of the EC programme, R;

AC_{base} – avoided cost of supply of base load generation, R/MWh;

Target – demand savings of the programme, MWh.

13.6.2 The energy efficiency savings should be achieved for at least 1600 hours during working days per annum.

13.6.3 The revenue requirement for the DR programme will be determined as follows:

$PC_{dr} = AC_{peak} \times Target$, where

PC_{dr} is the programme cost of the DR programme, R;

AC_{peak} – avoided cost of supply for peak generation, R/MW;

Target – energy savings of the programme, MW.

13.6.4 The demand savings under DR programme should be measured and verified only during peak hours of the working days, or in total the demand savings should be achieved over 1560 peak hours during working days. The annual reduced demand should be measured as the average of the MW reduction over the peaking hours of the year.

13.6.5 Eskom shall submit a full breakdown of all IDM programmes/technologies with their estimated costs, demand and energy savings to the Energy Regulator with the MYPD application.

- 13.6.6 The projects' capital costs (R/kW) will be benchmarked with the capital cost (R/kW) of peaking and base load power stations where applicable.
- 13.6.7 The funding will be on the basis of the life cycle cost of the project compared with the avoided cost of supply calculated for the life of the project. IDM programmes/projects that are funded by other stakeholders, e.g. Treasury/DoE should be excluded from the required revenue.
- 13.6.8 The IDM projects and costs shall be aligned with the applicable at the time IRP, the MTSAO and production plan of generation.
- 13.6.9 The overall IDM project costs will be evaluated using the life cycle cost of the project and should be less than the relevant (baseload and peak) avoided cost of supply calculated for the life of a project. The avoided cost of supply shall be determined using the annual average marginal cost of generation, for a period equal to the life cycle of the project, seasonally, weekly, and hourly differentiated and adjusted for network costs and losses based on the Wholesale Electricity Price System (WEPS).
- 13.6.10 Based on international best practices, M&V costs range from 5% to 10% of the total project cost. Considering the specific local conditions and previous experience the M&V costs shall be limited to 8% of the total project cost.
- 13.6.11 In order to minimise costs M&V shall not be implemented after the expiry of the contract between Eskom and the customer, i.e. M& V costs shall only be allowed for projects still under contract.
- 13.6.12 The IDM funds shall be approved subject to the above and on the condition that Eskom shall submit performance reports quarterly and annually reflecting expenditure (R), energy (GWh) and demand savings (MW) per project and the Energy Regulator shall have the final decision in allowing or disallowing the IDM programmes.
- 13.6.13 IDM will incur penalties for underachieving the targets..
- 13.6.14 In case of non-performance, the penalty will be calculated as follows:
- Penalty_{ec}(R) = allowed revenue /projected MWh target x MWh unsaved or,
R/MWh X MWh unsaved
- Penalty_{dr}(R) = allowed revenue /projected MW target x MW unsaved or, R/MW
X MW unsaved

- 13.6.15 In terms of reporting demand/energy savings, the following rules will apply:
- 13.6.16 The savings should be reported for the actual period for which the project was implemented, i.e. demand/energy savings and period for which they have been achieved. Annualising of the energy and demand savings will be disallowed. Recognised demand/energy savings exclude off-peak hours, weekends and public holidays.
- 13.6.17 The system peak hours are considered the hours when the system experiences maximum loading. The peak hours in morning peak is considered to be from 06:00 to 12:00 and the evening peak from 18:00 until 21:00 during working days of the summer months (September to April); and from 06:00 until 09:00 and from 17:00 until 20:00 during working days of the winter (May, June, July and August) or may as changed by notice of one month provided by Eskom to the Energy regulator.

13.7 Principles of the avoided cost of supply determination

- 13.7.1 The avoided cost of supply include the avoided generation, transmission and distribution costs.
- 13.7.2 The avoided generation cost will be determined on the basis of the annual average marginal cost of generation for the life of the programme aligned with the IRP, the MTSAO and generation production plans applicable at the time.
- 13.7.3 The avoided transmission cost infrastructure charge will be based on the WEPS network charge.
- 13.7.4 The avoided distribution cost shall be calculated on the basis of the WEPS network charge variable according to voltage supply level.

Stakeholder Question 9:

- a) Stakeholders are requested to comment on the calculation of the marginal cost of generation, transmission and distribution.
- b) Stakeholders are requested to comment on the principles to be followed in determining the avoided cost.

13.8 Demand Reduction (DR) Programmes

- 13.8.1 Eskom should submit an annual update of the market potential of the DR programmes and the associated costs.
- 13.8.2 The System Operator should submit monthly reports on the DR programmes' cost and performance to the Energy Regulator.
- 13.8.3 The System Operator should submit the methodology and models for calculating the ceiling costs of the DR programmes and ancillary services for consideration by the Energy Regulator.
- 13.8.4 The System Operator should submit annual plans and targets for the DR programmes and ancillary services.
- 13.8.5 The cost of EC projects should be benchmarked at the cost of baseload plant, including capital, operating and fuel costs applicable at the time.
- 13.8.6 The cost of DR projects should be benchmarked against the cost of peaking plant (OCGT), including capital, operating and fuel costs applicable at the time.
- 13.8.7 Demand response aggregation programmes will be subject to the same rules.

Stakeholder Question 10:

Stakeholders are requested to comment on the demand reduction proposed rules.

13.9 Power Conservation Programme

13.9.1 The Power Conservation Programme (PCP) Regulations and Regulatory Framework have not yet been finalised. The PCP/Energy Conservation Schemes (ECS) rules for the MYPD will be finalised as soon as these frameworks have been concluded.

13.10 PCP/ECS Safety Net Programmes

13.10.1 In the absence of any electricity shortfall, the ECS shall be implemented on a voluntary basis.

13.10.2 The mandatory implementation will be implemented at no cost to Eskom with zero penalties, until the DoE promulgates the ECS policy.,

13.10.3 In the event of an electricity shortage, the ECS funded through electricity tariffs shall come into operation after considering all possible Demand Side Management Programmes such as EEDSM, DMP and OCGT, which would only be activated during times of crisis.

Stakeholder Question 11:

Stakeholders are requested to comment on whether PCP should be implemented without regulations or should be used only as a safety net.

14 Service Quality Incentives (SQI)

Current Rules

- 14.1 The SQI are used as a measure to encourage Eskom to improve their reliability of supply. A portion of Eskom's allowable revenue will be channelled towards the SQI schemes. The performance review and setting of new targets for Eskom Transmission and Distribution will be done at the end of each MYPD control period. The performance results are used to adjust the revenue requirements for the next control period; rewards/penalties are applied according to the performance achieved by Eskom on the parameters set in the schemes.
- 14.2 The SQI scheme has the following measures: system minutes < 1 , system minutes ≥ 1 , line faults/100km and System Average Interruption Duration Index (SAIDI). These measures and the reward/penalty targets are clearly specified in the SQI scheme.
- 14.3 The objective of the service quality incentives is to ensure that the provision of good quality of supply (QoS) is rewarded, and poor QoS is penalised. Eskom should not achieve reduced expenditure at the expense of deterioration in the QoS to customers.

Proposed Rules

The proposed new methodology includes setting targets at the beginning of each financial year to cater for the current state of the network. Generation is now included in SQI.

- 14.3.1 The Service Quality Incentive (SQI) is used as a measure to encourage Eskom to improve the quality of service it provides to its customers. A portion of Eskom's allowable revenue will be channelled towards the SQI schemes. The performance review and setting of new targets for Eskom Generation, Transmission and Distribution will be done at the beginning of each financial year. The performance results will be used to adjust the revenue requirements for each financial year according to the Regulatory Clearing Account (RCA). The rewards/penalties are applied according to the performance achieved by Eskom on the parameters set in the schemes.
- 14.3.2 The SQI scheme has the following measures: Unit Capability Factor (UCF) for Generation, System minutes and line faults/100km for Transmission, System Average Interruption Duration Index (SAIDI), System Average Interruption Frequency Index (SAIFI) and Distribution Supply Loss Index (DSLI) for Distribution. These measures and the reward/penalty targets are clearly specified in the SQI scheme.
- 14.3.3 The objective of the service quality incentives is to ensure that the provision of good quality of service is rewarded, and poor service penalised. Eskom should not achieve reduced expenditure at the expense of deterioration in the quality of service it provides to customers.

Stakeholder Question 12

- a) Stakeholders are requested to comment on whether the setting of performance targets should be done at the beginning of each financial year or the current setting of targets for the duration of the MYPD control period should be continued. The current scheme does not cater for the current state of the network as performance targets are set at the beginning of the MYPD control and are locked for the entire period.
- b) Stakeholders are requested to comment on whether the allocation of 1% of the allowable revenue towards the SQI is acceptable or not.

15 Taxes and Levies (not income taxes)

- 15.1 The Government imposes certain taxes and levies that are payable by Eskom.
- 15.2 Levies are any charges that the Government may impose and payable by Eskom arising from its licensed activity.
- 15.3 Taxes are any amount arising from an enacted legislation that the Government may require Eskom to pay which amount will be calculated in terms of such legislation.
- 15.4 Principles regarding taxes and levies**
 - 15.4.1 The taxes and levies are exogenous and will be treated as a pass-through cost in the MYPD.
 - 15.4.2 Taxes and levies will be treated as a separate account in the Eskom revenue determination.
 - 15.4.3 Eskom must ensure that the cost of the taxes and levies is specified and that the calculation thereof is clear and concise.
 - 15.4.4 The amount provided for the taxes and levies must be ring-fenced and any over or under-recovery will be recorded in the RCA.

Proposed Rules

There are no proposals from NERSA to amend the Tax and Levies section

16 Risk Management Control & Pass-Through Mechanisms

16.1 Risk Management Device

16.1.1 The risk of excess or inadequate returns is managed in terms of the RCA. The RCA is an account in which all potential adjustments to Eskom's allowed revenue which has been approved by the Energy Regulator is accumulated and is managed as follows:

16.1.1.1 The nominal estimates of the regulated entity will be managed by adjusting for changes in the inflation rate.

16.1.1.2 Allowing the pass-through of prudently incurred primary energy costs as per Section 8 of the Methodology.

16.1.1.3 Adjusting capital expenditure forecasts for cost and timing variances as per Section 6 of the Methodology.

16.1.1.4 Adjusting for prudently incurred under-expenditure on controllable operating costs as may be determined by the Energy Regulator.

16.1.1.5 Adjusting for other costs⁵ and revenue variances where the variance of total actual revenue differs from the total allowed revenue. In addition, a last resort mechanism is put in place to trigger a re-opener of the price determination when there are significant variances in the assumptions made in the price determination.

16.2 The Regulatory Clearing Account

16.2.1 The RCA is used to debit/credit all the aforementioned potential adjustments to Eskom's allowed revenue and must be used as follows:

16.2.1.1 The RCA will be created at the beginning of the financial year and continuously monitored. The evaluation of the account (for the purpose of determining the pass-through and/or claw-back) will be done with actuals for the full financial year.

16.2.1.2 This account must be updated quarterly so as to use it for regular alerts to customers of any possible adjustment in the coming year. Eskom must therefore submit actual financial data on a quarterly basis.

16.2.1.3 The RCA balance will be measured as a percentage of total allowed revenue and will act as a trigger for a re-opener as follows:

⁵ Includes but not limited to taxes and levies (as defined), sales volumes and customer number variances.

- 16.2.1.3.1 If the RCA balance is less than or equal to 2% of the allowable revenue, then there will be no immediate pass-through adjustment, but the RCA balance will be carried over to the next financial year.
- 16.2.1.3.2 If the RCA balance is between 2% and 10%, the amount is allowed as a pass-through in the next financial year without the need for a full stakeholder consultation process.
- 16.2.1.3.3 If the balance is greater than 10% of the allowable revenue, there will be a full stakeholder consultation process before any pass-through is allowed.
- 16.2.2 The adjustments to be included in the RCA and balance of the RCA will be approved by the Energy Regulator in terms of the MYPD Methodology. The Energy Regulator will only have to determine the timing of when it should be passed through or clawed-back.
- 16.2.3 Eskom will, on a quarterly basis, present the Energy Regulator with possible adjustments based on the Methodology, the costs to date and the projections to year-end.
- 16.2.4 The Energy Regulator will then review Eskom's submission and make a preliminary assessment of any adjustments required in the subsequent financial year's tariff adjustment.
- 16.2.5 The review will be performed on receipt of audited statements from Eskom.

Proposed Rules

Propose to remove rule 16.2.1.2 for practicality reasons.

Stakeholder Question 13:

- a) Stakeholders are requested to comment on the appropriateness and adequacy of the aforementioned RCA mechanism.
- b) Stakeholders are requested to comment on whether RCA should only consider primary energy and eliminate the rest of the costs.
- c) Stakeholder are requested to comment on whether rule 16.2.1.2 enhances the RCA process and the removal thereof.

17 Ring Fencing and the Reallocation of Allowances

The rules arose from the need to ensure that funds are applied as per the MYPD application and the resulting MYPD decision.

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| <p>17.1 The Eskom application in terms of costs, revenues and capital items must be done on the basis of ring fenced divisions and the determined amounts for each division may not be reallocated between divisions without the Energy Regulator's approval.</p> <p>17.2 The determination is done on the basis of an application done in good faith and based upon the approved Corporate Plan and Corporate Strategy for the period of the application. Therefore it is expected that the specific items dealt with in the determination will be implemented according to the determination and that targets and assumptions that form part of the application and the determination will remain for the period of the determination.</p> <p>17.3 Specifically where the impact of reallocation is not upon Eskom alone but has significant impact on other industry stakeholders then the approved plans implicit in the determination need to be honoured unless approval is obtained from the Energy Regulator to deviate from them.</p> <p>17.4 Eskom is expected to generate a Transmission Development Plan which will see Eskom meeting its Grid Code obligations and obligations in terms of the known Integrated Resources Plan thus the approved capital allocations and implementation of the forecast projects needs to be honoured.</p> <p>17.5 The principles above also apply to loan covenants, generation project and approved amounts for improving the efficiency of Eskom.</p> |
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Stakeholder Question 14:

Stakeholders are requested to comment on the appropriateness and adequacy of the aforementioned rules around ring fencing and reallocation of funds.

18 Tariff Design

- 18.1 The Energy Regulator will consider the approval of tariff designs and structures after due consideration of the legal and policy frameworks in place.
- 18.2 The tariff design principles must meet the objectives as set out in the EPP. The following, among others, are the key objectives that should be considered:
 - 18.2.1 Tariffs should be affordable.
 - 18.2.2 Tariffs should be equitable and fair.
 - 18.2.3 Tariffs should be easy to understand and apply.
 - 18.2.4 Tariff levels and structures should accommodate social programmes.
 - 18.2.5 Tariffs should be transparent.
- 18.3 Revenue from tariffs should reflect the full cost (including a reasonable risk adjusted margin or return) to supply electricity and ensure that the industry is economically viable, stable and fundable in the short, medium and long term.
- 18.4 In designing the tariffs, the following should be considered:
- 18.5 Costs must be functionalised into the different unbundled services to which they relate (i.e. Generation, Transmission and Distribution).
- 18.6 Cost of Service: Eskom must determine its cost of service as contemplated in the EPP for each of the ring-fenced licensed entities.
- 18.7 Customer class definitions: customer classes must be identified and properly defined.
- 18.8 Class revenue allocation: revenues must be allocated (either on embedded cost or marginal cost basis) to be collected from the defined customer classes. The revenue to be collected from each customer category is before adjustments for cross subsidies (as stated below) to ensure that the cost structure can be tracked (cost-reflective).
- 18.9 Tariff design for each class:
 - 18.9.1 Tariff design objectives that achieve a reasonable balance between the various EPP positions must be maintained.
 - 18.9.2 Tariff structure should ideally follow the cost structure – to the extent feasible given metering, customer understanding, and acceptable bill impact.
 - 18.9.3 Furthermore, the tariffs must give end users proper information regarding the costs that that their consumption imposes on the licensees' business

and must permit the cross-subsidy of tariffs to certain categories of customers.

18.10 Bill and consumption impact analysis: understanding the impact of the rates designed on the typical customer. This requires that after the design of new tariff structures or restructuring of an existing tariff structure, the licensee should consider the impact of such changes to a typical customer based on historical data (consumption patterns etc.).

18.11 Adjustment of revenues/cross-subsidies between customer classes to address certain socio/political/environmental needs:

18.11.1 Adjustment to tariffs to provide for cross-subsidies between customer classes to address certain socio/political/environmental needs will be allowed.

18.11.2 The licensee may propose adjustments to tariff structures/principles (that are in place to address the aforementioned issues) if such adjustments will enhance effective targeting of such programmes to benefit the intended customers groups.

18.11.3 Adjustments of revenue between customer classes must be done so that the cross-subsidies are quantified transparently while at the same time ensuring simplicity and transparency of rates.

18.11.4 Final Retail Tariffs: the licensee must ensure that final tariff levels proposed enables the allowable revenue, based on the approved sales forecast, to be recovered.

Proposed Rules

NERSA has developed a new tariff design methodology, the document will be titled “*Eskom Retail Tariff and Structural Adjustment Methodology*” which is due for publication in May 2016. It is proposed that the tariff design section be removed from this document and replaced by *Eskom Retail Tariff and Structural Adjustment Methodology*

19 Sales Volumes

19.1 Principles of sales volume forecast

- 19.1.1 The sales forecast must be based on all customer categories.
- 19.1.2 The loss factor must be calculated based on the historical pattern and must be at all main transmission and distribution substations.
- 19.1.3 The customer consumption categories must include seasonal patterns.
- 19.1.4 The load forecast must include the assumptions regarding energy conservation programmes.
- 19.1.5 Eskom must furnish the Energy Regulator with the projected sales which support the ten-year forward-looking price path as per the EPP.
- 19.1.6 In order to verify the load forecast, the Energy Regulator requires the energy wheel, which includes all the details on energy demand, supply, imports, export, losses, own use and sales.

Proposed rules

In previous applications there was no incentive for Eskom to give an accurate sales forecast. The sales forecast is a critical element in the whole price determination as it is the denominator in the price equation. Therefore inaccurate forecasts can result in large RCA claims. These rules try and provide an incentive to forecast correctly.

- 19.1.7 The sales forecast must be based on all customer categories
- 19.1.8 The methodology for calculation of the loss factor should be submitted together with the MYPD application
- 19.1.9 The load forecast must include assumptions regarding the IDM programmes, customer distributed generation and electricity price elasticity
- 19.1.10 Eskom must furnish the Energy Regulator with the projected sales aligned with the applicable IRP, MTSAO and generation production plan at the time.
- 19.1.11 The accuracy of the sales volumes forecast should be within 5%.
- 19.1.12 Variances between the forecast and actual sales higher than 5% should be allowed provided that they result from external economic factors. However

variances above 5% associated with operational and management risks within Eskom's control should be disallowed.

20 Review and Modification of the MYPD Methodology

20.1.1 The Energy Regulator will conduct a review of the MYPD Methodology as and when required to ensure that the contents of the Methodology reflect the current regulatory circumstances. The Energy Regulator also recognises that special circumstances may arise that may necessitate changes to be effected to the Methodology. The Energy Regulator will continuously incorporate justifiable changes that are considered necessary to immediately capture clarity, transparency and regulatory efficiency benefits.

20.1.2 The Energy Regulator will make decisions on the interpretation of the various clauses of the Methodology, but any party will be entitled at any stage to take decisions of the Energy Regulator on review or appeal as contemplated in the enabling legislation.

Proposed Rules

There are no proposals from NERSA to amend the Review and Modification section.

21 Other Comments

Stakeholder Question 15:

Stakeholders are requested to state any other comments on issues relating to the MYPD Methodology, not addressed elsewhere in this consultation paper.

Stakeholders are requested to comment in writing on the MYPD Methodology Consultation Paper. Written comments can be forwarded to mypd@nersa.org.za; hand-delivered to Kulawula House, 526 Madiba Street, Arcadia, Pretoria or posted to PO Box 40343, Arcadia, 0083, Pretoria, South Africa. The closing date

for comments is 16 May 2016 at 16:00.

For more information and queries on the above, please contact Ms Lehuma Masike and Mr Dumisani Njezula at the National Energy Regulator of South Africa, Kulawula House, 526 Madiba Street, Arcadia, Pretoria.

Tel: 012 401 4600

Fax: 012 401 4700

End.