

# Casting Forging and Machining Cluster

Casting, Forging and Machining Cluster of South Africa (NPC)  
Reg. No. 2018/054311/08



**"Changing the way that South Africa works in the metals industries"**

12 Spanner Road, Spartan, Kempton Park  
Tel: 061-2441234 | Internet: [www.cfmc.co.za](http://www.cfmc.co.za)  
High Energy Users Group  
Date: 09 April 2019

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## **Stakeholder comments on the NERSA Municipal Tariff Guideline dated 20 March 2020 ("Consultation Paper") with regards to the benchmarks and proposed timelines for the Municipal Tariff approval process for the 2020/21 Financial Year.**

### **1. Introduction to the Casting Forging and Machining Cluster**

The Casting, Forging, and Machining Cluster of South Africa NPC (CFMC) is a non-profit organisation with members, representing a spectrum of manufacturing businesses across Mogale City and South Africa. It is focused on increasing the level of manufacturing activity and job creation in South Africa, through competitiveness improvement and import replacement. The CFMC has an inclusive approach to membership that consists of small, medium and large manufacturing businesses and some national associations.

A key working group in the CFMC is the High Energy Industrial Users Group, which is currently focused on addressing the costs of electricity to industry.

The aim of the CFMC is to drive a localisation agenda that will deliver an increased level of locally manufactured products in South Africa, and to assist our members to get more work. This requires being competitive, working together to address challenges, and the connecting of local manufacturing businesses across supply chains. It is a partner with the government, and has the support of industry support structures to deal with the challenges in our path. The outcome of our activities is the stimulation of economic growth in local municipalities, in this instance Mogale City. Representation and strategic interventions are key focus activities to facilitate an enabling environment for manufacturing businesses.

The CFMC has actively been protecting manufacturing businesses' interests in relation to critical issues affecting the success of business in Mogale City. It has been particularly active in bringing together manufacturing business in the casting, forging, machining, and associated industries to provide inputs to government policy, to engage with industry stakeholders to find suitable recourse actions, to increase the competitiveness of manufacturers, to promote the increasing involvement of black businesses in manufacturing. The CFMC has an interest to protect manufacturing members rights and interests in relation to electricity tariffs and the reliability of the electricity supply.

Mogale City is one of the manufacturing hubs in South Africa, and is home to component manufacturers, steel merchants and fabricators, and some foundries, forges, and mills. The presence and success of these industries is crucial to the well-being of the local community. These plants are dependent on the affordable electricity supplied to them for their operations, and for them to be competitive. Other industries such as Mining, Pharmaceuticals and General Engineering, amongst others equally depend on a sustainable and competitively priced energy supply.

## **2. Municipal electricity usage and the impact of the municipal tariffs**

Municipalities purchased 41.9% of Eskom's electricity during the 2019 financial year.<sup>1</sup> Industrial users in the Municipalities consumed about half of this usage, equating to approximately 20% of Eskom's output. Including commercial usage, we estimate that municipal business consumes up to 26% of Eskom's usage. Key economic sectors reliant on using electricity supplied by Municipalities include: Automotive, Defence, and General Engineering. Industrial users are predominantly South African SMME's in manufacturing. In Automotive, for example, almost the entire automotive industry (all the OEM's and almost the entire supply base, use Municipal supplied electricity. Furthermore, a substantial portion of big industry, and almost all medium-sized industry in the country is subjected to municipal supply and tariffs. These industrial SMME users are a part of the core backbone of job retention and job creation in South Africa and add further value as a large percentage of them provide skilled jobs. As such, they are very important to the local Municipal economies and to the macroeconomic landscape in South Africa.

South African is part of the global economy, and accordingly many of the goods used in South Africa are imported at competitive prices, that provide a cost ceiling on cost increases, particularly for key important cost drivers, such as electricity. In order for South African manufacturers to retain their position in the market, they need an electricity supply that is reliable and itself cost competitive versus electricity price benchmarks. Alternative solutions such as self-generation through photovoltaic or wind are becoming more attractive and some of the lighter industries have installed such capacity. The foundries, die-casting shops, forges, machine shops, and steel engineering companies are, however, reliant on the Eskom base supply for the majority of their electricity needs. As such, municipal supplied electricity remains the main bulk power source for these industries, and the competitiveness of the municipal electricity tariffs are crucial for the wellbeing of industrial industry.

Electricity tariff increases have become problematic, and increases in the last 15 years have decreased competitiveness at ESKOM price levels. Municipal electricity tariffs have escalated at a rate faster than the ESKOM increases, and from 2008 onwards, municipal electricity tariffs have increased to the extent that electricity has become one of the key cost drivers, negatively impacting the sustainability of manufacturing in many sectors. Deloitte recognises this fact in a 2017 report<sup>2</sup> and confirms, "NERSA should review its approach to the regulation of municipal electricity tariffs as its current approach of providing guideline tariffs in terms of standard percentage price increases across all municipalities will only serve to amplify historical differences". Deloitte further states, "With Eskom tariffs set to continue to rise, it is questionable whether further increases in the already relatively high tariff charged by some municipalities can be justified."<sup>3</sup> Municipalities charge their users substantially more than Eskom would charge if they would

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<sup>1</sup> Eskom 2019 Integrated report

<sup>2</sup> 'An overview of electricity pricing and consumption in South Africa' Page 11 .Deloitte 2017

<sup>3</sup> 'An overview of electricity pricing and consumption in South Africa' Page 12 .Deloitte 2017

be the distributor in these areas. In other words, the Municipalities are abusing their position as licenced distributors of electricity by unnecessarily over-charging their users. NERSA's yearly municipal tariff guideline has been the methodology justifying this abuse.

Our research indicated that most municipal tariffs are at levels that cannot be justified as lawful in terms of the applicable regulatory framework. The tariff principles to be applied as regulated through the Electricity Regulation Act and the Electricity Pricing Policy determine that tariffs must reflect efficient cost per customer category. This does not appear to be the case, and simple benchmarks have identified to us that the trend lines associated with ESKOM Megaflex, and the municipal industrial tariffs are way out of sync. Furthermore, municipal tariffs vary from one municipality to the next, to the extent that it has become irrational. The vastly differing tariffs charged by the different licensees for exactly the same service are not only irrational, but are also discriminatory.

The Deloitte report further assists in evaluating the impact of these high electricity prices as it provides information regarding price elasticity of consumption. According to this report, excessive tariff increases will severely affect industrial usage and reduce consumption by an estimated 0.2% to 0.5% for every 1% increase in price above inflation.<sup>4</sup> Accordingly, municipal tariffs that rise faster than the ESKOM approved tariffs are causing disruption to ESKOM's ability to project future sales, and to estimate forward demand.

### **3. Historic Municipal Tariff Guideline Increase methodology**

Before we comment and make recommendations regarding the 2020 consultation paper, we need to reiterate our concerns with the process to-date.

The most relevant points of concern that we have were summarised in the Nelson Mandela Bay Business Chamber's 2019 **"Stakeholders comments on the NERSA consultation document of 27/3/2019 with regards to the Municipal Tariff Guideline Increase, Benchmarks and proposed timelines for the Municipal Tariff approval process for the 2019/20 Financial Year.**

In summary, their arguments against the 2019 guideline were as follows:

#### **3.1 The underlying problems with current municipal tariffs**

Specific underlying problems are inherent in the current municipal tariffs. NERSA's historic municipal tariff methodology allowed the continuation of these problems.

1. Firstly, municipalities often use the electricity function as a revenue raising mechanism to fund activities unrelated to the electricity distribution. This in essence, implies that the electricity user is paying (unlawful) hidden taxation through the electricity bills. It further allows municipalities to neglect its electricity infrastructure while funds are being siphoned out serving other purposes.

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<sup>4</sup> 'An overview of electricity pricing and consumption in South Africa' Page 7 .Deloitte 2017

2. Secondly, many municipalities run an inefficient distribution function and current tariffs include costs of inefficiencies. This does not provide incentives for municipalities to run their electricity distribution function efficiently. The main source of inefficiencies are electricity losses (mainly caused by electricity theft), poor metering, overstaffing and neglected infrastructure.
3. Lastly, municipalities tend to load industry and business with higher tariffs in order to subsidise (mainly) domestic tariffs and fund the inefficiencies in the domestic distribution sector. Other costs such as streetlights and municipal internal usage are often charged to the consumers.

### **3.2 The fit for all approach for tariff determination contravenes the regulatory framework:**

Section 15 of the Electricity Regulation Act (ERA) in combination with the Municipal Fiscal Powers and Functions Act (MFPFA) requires electricity tariffs for a specific licensee to reflect efficient costs + a reasonable return for this licensee. However, municipalities do not comply with their license conditions and do not compile audited information for the ring-fenced electricity business. Cost of Supply studies which should determine costs allocated per customer category are non-existing. Hence, NERSA does not receive the required information and is simply not in a position to determine a compliant tariff.

Instead, NERSA applied a fit for all approach by allowing a benchmark increase year on year, without verifying the base tariff on which this increase is levied. NERSA further added financial benchmarks to justify the tariffs they approved, but there is no way for NERSA to relate the applied benchmarks to the financial requirements per the EPP or the ERA. These financial benchmarks are furthermore so wide and poorly defined that they cannot be considered as a serious tool for tariff setting. Lastly, NERSA also added tariff benchmarks per customer category to their guideline. This benchmark was often meaningless and impractical, as e.g. for industrial customers, it only stated a R/KWh cost. For this customer category, TOU tariffs must be applied (EPP Policy Position # 31) and these tariff systems cannot simply be translated into R/KWh, rendering the tariff benchmark useless.

### **3.3 NERSA used flawed financial information to establish the guideline**

NERSA claimed in previous consultation documents that audited financial information from municipalities had been used to establish the municipal guidelines. We dispute that the financial information NERSA has used in the past was fully compliant with the requirements of the Act. NERSA claims it satisfied itself with partial information it received from the D-forms, despite these D-forms contain mostly unaudited and unverified information.

We suggest that it is not possible for NERSA to determine a compliant tariff (compliant with section 15(1)(a) of the Act), unless the municipalities provide them with financial information that has been correctly verified. The default position that would appear to have been applied when poorly motivated municipal increases were provided, was to assume that the benchmark percentages presented by NERSA in the annual guideline would be applied. In place of tempering increases, this practice has served to fuel the electricity

increases experienced by industrial users in recent years. Non-compliant reporting by municipalities was made acceptable. Compliance to the requirements set out in the legislative and policy frameworks has been by-passed, and the importance for the provision of reliable information relating to all costs accrued as a result of the municipality's electricity distribution activities has been down-played.

Any practices that serve to veil the electricity distribution activities of the municipality in secrecy, raise doubt and mistrust, and should be stopped. Industrial and business users have taken legal action aimed to force NERSA management to take corrective action, and with each new tariff increase approved, the number of challenges has increased.

Had NERSA forced municipal compliance, prior to their approving municipal electricity tariffs, there would have been more cost transparency in the public domain, and rather than forcing disclosure through legal actions, information would be available for more industry and government collaborative engagements. Furthermore, if the quality of information pertaining to the electricity account was publicly available, there would be no need for industry to take a more drastic legal route, which would save the public a lot of time and money.

Such action would also avoid the "unnecessary expenditure" cost incurred by NERSA to defend that which we suggest is undefendable, as it has been confirmed in court papers that municipal D-Forms were not fully compliant.

### **3.4 There was no efficiency test done on any of the costs NERSA uses to establish its guideline**

While NERSA might have claimed that some financial information was audited, it does not necessarily follow that the licensee runs its business efficiently or that the costs reflected in the D-Forms relied on by NERSA are efficiently incurred. Accordingly, there is no indication or proof that the benchmark used by NERSA would lead to tariffs reflecting *efficient costs* + a reasonable return. Accordingly, we dispute that the existing tariff structures reflect efficient costs. We assert that municipal electricity users largely pay tariffs well above the lawful tariffs intended by the regulatory framework. By their action, NERSA hereby either allows municipalities to be wasteful and inefficient, or allows municipalities to extract substantial income from the electricity function.

### **3.5 The benchmark does not ensure tariffs are cost reflective per customer category**

EPP Policy Position 2 states that electricity tariffs must reflect the efficient cost of rendering the electricity services, as accurately as practical. For this to be accurately reflected, the average level of all the tariff categories must be set. Furthermore, tariffs must be set to recover costs as follows:

- the energy costs for a particular customer category
- the network cost for a particular customer category
- the service cost associated with the above

EPP Policy Position 2 ensures that for every customer category, tariffs are set to recover the costs related to that specific customer category.

NERSA has not shown that its tariff determinations per customer category comply with this policy position. Accordingly, we assert that the previous tariff determinations do not comply with this policy and we contend that the benchmark tariffs per customer category are set in an arbitrary manner. As a result, certain customer categories (particularly industry and business) largely overpay for the rendered distribution services if compared to other customer categories (particularly the domestic sector).

### **3.6 The methodology creates large discrepancies between tariffs for the various municipalities**

NERSA's claim that the guideline was there to ensure there are no "vast" differences in tariffs between municipalities is baseless. The reality is that the differences in tariffs between municipalities are vast and unexplained. These irrational and unlawful differences are caused by and perpetuated by the Municipal Tariff Guideline. Tariff differences of up to 30% between the different municipalities for identical services are not uncommon. The NERSA approach to escalate tariffs without properly considering the base tariffs or the actual (efficient) cost is the main reason for the failure of the proposed methodology. Furthermore, the uncertainty and ambiguity created by providing benchmarks unrelated to cost, has contributed towards an irrational methodology.

## **4. The 2020/2021 Consultation Paper**

It is encouraging to note that for the 2020/2021 consultation paper, NERSA has seemingly taken a different approach to their determining of the municipal electricity tariffs.

This new approach to tariff benchmarks is better able to align municipal tariffs with Eskom direct tariffs. It is our view that this is a positive step forward and will in the end, lead to a different outcome during the determination of the electricity tariffs for each municipality. Nonetheless, we have experienced that the guideline document provided for comment, lacks sufficient clarity (i.e. in relation to the various benchmarks provided), is as a result potentially confusing, and appears to contain contradictions.

We will comment in detail on the document and explain our concerns where required.

The 2020/2021 Tariff Guideline needs to lead to the rectification of the existing tariff situation, allowing for correction and adjustment where necessary, in order for the municipal tariff reductions in the industry and business categories are implemented, thus enabling industry to revive, and turn around the current situation where the availability of jobs is being negatively impacted.

We are supportive of the regulations, in particular the ERA and the EPP and are very concerned that, if this document is not amended as per our recommendations below, process challenges and errors of interpretation could prolong the tariff approval process.

This situation would be untenable, as timelines would almost certainly be missed, and potential benefits to industry delayed.

We believe that the process to rectify tariffs will equally benefit industry and the municipalities, as it will stimulate the potential for microeconomic growth, as opposed to the “death cycle” currently experienced in numerous municipalities. Municipal electricity sales would increase with more users making use of more affordable electricity, and municipalities would be able to compete to attract customers, rather than pushing them away. The regulatory pressures brought to bear to enforce compliance will in due course benefit the municipalities and all the resident stakeholders in these municipalities.

As argued by our organisation and others during various public participation processes, it is equally important to note that rectifying municipal electricity tariffs will also benefit Eskom, as 42% of all Eskom’s electricity is sold through municipalities. A rectification of municipal electricity tariffs will inevitably help to stimulate Eskom’s sales and become a causal factor in turning around Eskom from their “death spiral”.

We recommend that the Consultation Paper is updated to provide more clarity as to how the guidelines and benchmarks should be interpreted, and request that annual Municipal submissions of D-Forms and CoS, as well as any Municipal correspondence with Nersa, and public information in general, are made more readily available to the public. Furthermore, we suggest that the veil of secrecy encountered thus far, needs to be abolished.

In what follows hereunder, we will follow the layout of the Consultation Paper and provide detailed comments accordingly.

**Page 5: Paragraph 2.3 and 2.4 (COS studies and the framework):**

Given the underlying legislation, it is clear Cost of Supply studies will need to be done per municipality and the outcome of these studies will impact the determination of the municipal tariffs.

We have reviewed the existing framework and are concerned that:

1. the application of a margin is inappropriate - municipalities are only allowed a “reasonable return”<sup>5</sup>
2. There is no clear methodology to define the regulatory asset base. Many municipalities have a dilapidated infrastructure, and income from electricity sales has been wasted or used for other matters not related to electricity.

There needs to be further engagements on this issue to find a workable way forward.

**Issue 1 - page 8: Submission of D-Form information and other information to establish municipal tariffs:**

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<sup>5</sup> MFPPFA Par 1.(1).(d)

We are pleased to note that NERSA is challenging the municipalities for full disclosure, and is intending to hold them accountable when supplying financial information. The concern is what happens once non-compliance is identified.

We do, however, have a concern with the D-forms that needs to be highlighted to you: the information provided in the D-form is unaudited and it has been noted that this information reflected may be incomplete, or reflect incorrect information. Similarly, we are concerned that the balance sheet reconciliations as they appear in the D-forms are often incorrect and this is problematic in judging assets values and historic funding of assets.

Hence, **we recommend** that

1. NERSA must also demand that all information mentioned under paragraph 4.1.4. of the Consultation Paper is supplied, as a mandatory requirement for any municipality to get tariff adjustments, different to the tariffs proposed in the tariff benchmarks.
2. NERSA must request that the ring-fenced electricity business must be audited and that a separate income statement and balance sheet should be produced. This requirement is part of the license condition.
3. We further request that NERSA requests a Cost of Supply study, in support of paragraph 3.3. Given a lack of cost of supply studies per NERSA's Cost of Supply procedure, we suggest municipalities must supply cost of supply per customer categories based on the cost information from the financial statements available to them. This will be a starting point to creating transparency in this regard.
4. We also suggest that municipalities that fail to submit D-forms and CoS studies should forfeit the right for automatic tariff increase. This mechanism should be used to force the municipal governing structures to comply with the process or eventually lose their license.

We would like to express our interest to work with and support municipalities in a manner similar to the work done by the Nelson Mandela Bay Business Chamber and their Municipality when they cooperated in previous years to establish costs per customer category.

#### **Issue 2 page 10: Guideline increase consultation paper**

We are in agreement with the approach taken to develop the guideline increase of 6.24%.

We note, however, that the application of this guideline increase is limited given the current economic state of affairs. We recommend that the benchmark is explicitly clarified in the Guideline, and that the following should apply:

1. The guideline increase of 6.24% can only be applied where 2020 tariffs fall within the benchmarks as listed in paragraph 5.
2. For tariffs requests higher than the maximum benchmarks listed in paragraph 5, the tariffs must be justified by supporting financial information and available Cost of Supply studies.
3. In the instance that credible information is not available, tariffs should be determined in-line with the NERSA proposed benchmarks in paragraph 5.



4. By applying these benchmarks as proposed in the Consultation Paper, it is highly possible that tariffs may be reduced substantially in some municipalities, which is good news for electricity users.

#### **Issue 3 Page 12: Draft tariff applications**

We recommend that draft applications are treated in a similar manner to D-forms, requiring that draft applications will be accompanied by all financial information listed under 4.1.4.

The requirements imposed on licensees is not new, and the guidelines published in recent years, have not in our view, empowered municipalities to be lax. Submission of a poorly motivated tariff application should not be condoned.

Licensees must be made aware of the new tariff benchmarks as listed in paragraph 5. Those municipalities that are not in a position to supply information in line with the requirements listed in paragraph 4, tariffs should be determined in-line with the NERSA proposed benchmarks in paragraph 5.

#### **Issue 4 Page 13: Above the guideline increases**

Although conditions are different, lack of information supplied is repeated information - we recommend that as this section is obsolete, it should be deleted.

Tariffs are to be awarded on the basis of a full and proper motivation, or they are not to be considered. Paragraph's 4 and 5 indicate the process and benchmarks to be applied in both instances.

#### **Issue 5 Page 15: Proposed Municipal Electricity tariff benchmarks for 2020/21**

##### **General comments on the renewed tariff benchmark approach:**

The proposal is credible as it deals with cost reflective municipal tariffs per customer category. Given prior abuse of position and a total lack of compliance by most municipalities, benchmark municipal tariffs against Eskom's distribution tariffs, is a necessity. It is also an important step towards the standardisation of tariffs across the country.

The proposed benchmark to Eskom tariffs is the correct way forward, and it is our recommendation that the Eskom tariff system and cost structures are applied across all municipalities. This will lead to improved transparency and process simplification.

Given the current proposal by NERSA regarding the benchmarks, we note that certain customer categories may have been left out. As an example, we recommend to NERSA that benchmarking must also be supplied for instances where more advanced tariff systems such as TOU are not available to users in a particular municipality (providing for EPP position 35 for MVA customers is being complied to).

#### **Issue 5 Page 15 Comments on domestic benchmarks**

Not relevant to our membership.

**Issue 6 Page 16 Comments on indigent tariffs**

Not relevant to our membership.

**Issue 7 and Issue 8 Page 22: Comments on Land Rate Tariffs**

Not relevant to our membership.

**Issue 9 Page 24: Comments on Resellers tariff**

Not relevant to our membership.

**Issue 10 Page 26: Time of use tariff for Urban customers**

We are in agreement with the benchmark principle applied for this customer category.

1. The benchmark can be refined per area/voltage in line with the valid Eskom's Megaflex tariffs.
2. Minimum KVA charges should be adjusted in line with Eskom's Megaflex KVA charges.

Note: One important consideration is that in certain municipalities (e.g. Madibeng) and contrary to the legislation, TOU tariffs are not available. Hence, the benchmark becomes meaningless in these municipalities, unless an alternative is provided. We recommend that NERSA should encourage all municipalities to have TOU facilities available , and to ensure that this requirement will be enforced from July 1, 2020. Alternatively, NERSA will need a temporary measure for municipalities which do not have TOU facilities for this customer category. In such an instance NERSA would need to supply a Maximum Demand benchmark.

**Issue 11 Page 27: The Financial Benchmarks**

We **do not agree** and strongly object to the financial benchmarks as listed in section 6 of this consultation document. We believe these benchmarks are a historic remnant of a flawed system and have no relevance going forward, and do not understand how NERSA can include such a statement which declares that “municipalities that operate within these benchmarks are considered to run a sustainable and efficient electricity business”, whilst at the same time accepting that there is no financial information from municipalities to show that this would be the case.

1. Tariffs should be as a result of financial information supplied as defined in paragraph 4 in combination with a Cost of Supply Study. Lacking such information, tariffs should follow the benchmarks defined in Paragraph 5.
2. As such, we do not understand the value of this benchmark. It is problematic and its current form is creating confusion.
3. We contend that the benchmark as stated is not compliant to the regulation. To illustrate this statement, we raise the example of the Net Profit Margin which is part of this benchmark: BUT is not allowed by legislation, that does not allow for a “profit margin” to be charged by municipalities. The **MFPFA is explicit regarding this issue** as it only allows municipalities to recover their cost + a reasonable return. In light of this, it is not understood how NERSA can set a 15% “net profit margin”, and make allowances for an increase up to 20%? It is absurd to think that tax-payers who are

themselves struggling to achieve single digit profit margins in difficult times, would ensure a double digit profit margin to a public services entity. **Benchmarks which potentially allow the municipalities to charge substantially higher tariffs without justification must be avoided.**

We can agree with methods, when it comes to details and the setting of benchmark parameters for specific cost items. For example, we would agree with benchmarks for technical losses, spending on maintenance, and collection rates.

Notes: With specific regard to:

1. Technical losses: we propose that NERSA benchmarks municipal technical losses against Eskom, to establish acceptable technical losses for the distribution function. We further recommend that these losses are benchmarked by customer category, as this will be very relevant when it comes to calculating tariffs per customer category.
2. Repairs and Maintenance: we suggest that NERSA will need to define what this cost line-item can include (e.g. is maintenance labour to be included/excluded).

### **Conclusions and way forward**

We are very pleased to observe that NERSA's "Municipal tariff guideline increases, benchmarks and proposed timelines for municipal tariff approval process for the 2020/21 financial year" appears to be a step in the right direction, and that it has the ability to rectify many of the current problems that are associated with the existing municipal electricity tariffs. We remain supportive of NERSA, and trust that the steps taken henceforth will serve to hold the municipalities to account.

The CFMC is encouraged by the approach and sees it as a crucial step to stop the decline of industry in municipal areas.

NERSA are still required to provide further clarity on certain aspects of the guideline, as discussed above in this letter, to ensure that all stakeholders are able to clearly understand and identify with the revised process, and the direction in which this approach is going to take us, without which there will be resistance and disruptions going forward.

We are excited and are looking forward to the changes, and to engaging with NERSA and our local municipalities during the next months, to find sustainable solutions for the 2020/2021 and future tariffs.

For the Casting, Forging, and Machining Cluster of South Africa  
High Energy Industrial Users Group



Steve Jardine  
7 April 2020

