FUTUREGROWTH
/ASSET MANAGEMENT

# 2023 BUDGET: OUR VIEWS ON THE ESKOM DEBT RELIEF PROPOSAL

**Author: Olga Constantatos, Head of Credit**
**Published: 23 February 2023**

**In Tuesday's note, we outlined our hopes for the long-awaited details of the proposed solution to the Eskom debt problem in the 2023 Budget Speech presented on Wednesday afternoon by Minister Godongwana.**

## What we said on Tuesday before the Budget speech:

*We will publish a follow-up article after the Budget, in which we will assess the proposed solution as against these questions:*

a. *Is a clear commitment to treating all creditors fairly contained in the proposal?*

b. *Is it clear that the proposal will not trigger any of the ratings agencies' or loan agreements' definitions of a default or a debt restructure?*

c. *After implementation of the solution, will the level of debt on Eskom's balance sheet be sustainable, given Eskom's cashflows and operating environment?*

d. *Has the required level of detail been provided on any conditions that may be imposed, together with the consequences and/or concomitant actions following any non-compliance with the proposed conditions?*

e. *Is the relief immediate or staggered, and is the profile such that it ensures that Eskom does indeed return to standalone financial sustainability?*

f. *Do we have clarity on Eskom's future funding needs, the likely sources of this funding, and does this plan ensure Eskom's standalone financial sustainability over the medium- to longer-term?*

*We will also need to assess the actions of the various stakeholders in the coming weeks on the other matters integral to a solution, namely: tariffs, costs and municipal debt.*

*Delays, half-measures and "kicking the can down the road" are not going to get the results the nation needs. Bold, urgent and integrated intervention on Eskom is extremely overdue. This is what we are looking for when the Minister rises to speak at 14h00 on Wednesday.*

FUTUREGROWTH
/ ASSET MANAGEMENT

We've assessed the Eskom Debt Relief Plan as presented by the Minister on Wednesday as against the six criteria we outlined in our previous note in the table below, together with some brief commentary.

*Budget documentation are all available here: https://www.treasury.gov.za/documents/National%20Budget/2023/
** Scoring system: "yes" = 1, "mixed" = 0.5 and "no" = 0

| Questions posed in our pre-Budget note | Achieved: yes, no or mixed | Futuregrowth comment | Reference to Budget documentation* | Score |
|---|---|---|---|---|
| 1. Is a clear commitment to treat all creditors fairly contained in the proposal? | yes | The annexures available on National Treasury's website, and subsequent engagements with the National Treasury team indicate a commitment to treat all creditors fairly in the proposal. | Annexure W3, p1: "With these factors in mind, the National Treasury worked with Eskom and others to develop a debt-relief arrangement that is **equitable and fair to all stakeholders.**" | 1 |
| 2. Is it clear that the proposal will not trigger any of the ratings agencies or loan agreements' definitions of a default or a debt restructure? | yes | The proposed mechanism indicates the government will provide a subordinated loan to Eskom that is enough to allow them to pay the interest and capital payments when they fall due the upcoming three fiscal years (FY23/24, FY24/25, FY25/26), and, while the full details and mechanism is still to be confirmed, our preliminary understanding is that this does not trigger any adverse responses from a loan or ratings agencies perspective. | Annexure W3, p2: "The advance of funds will take the form of an **interest-free subordinated loan, to be settled in Eskom shares rather than cash**, allowing Eskom to better manage its liquidity position." | 1 |
| 3. After implementation of the solution, will the level of debt on Eskom's balance sheet be sustainable, given Eskom's cashflows and operating environment? | mixed | While we do not (yet?) have sight of the ratios and benchmarks used in arriving at the numbers proposed in the solution, it appears that substantial consideration was given to what level of debt would be considered sustainable, as well as a recognition that different actions are needed than those taken previously to ensure an outcome that results in a standalone financially sustainable Eskom. The actualisation of this plan will rest on successful and timely implementation of the plan, including Eskom's compliance with the conditions for the support, | 2023 Budget Review, p3: "Eskom's **operational failures are intertwined with its untenable financial position**. Since 2008/09, government has provided the utility with R263.4 billion in bailouts. These **allocations have failed to stem the collapse** of Eskom's balance sheet and operations. The utility imposes an enormous drain on the economy and its debt stands at an **unsustainable R423 billion.**" | 0.5 |

| | | | | |
|---|---|---|---|---|
| | | appropriate implementation of the agreed tariff and a successful outcome of the municipal debt proposals. | | |
| 4. Has the required level of detail been provided on any conditions that may be imposed, together with the consequences and/or concomitant actions following any non-compliance with the proposed conditions? | yes | This is outlined in the text of the speech as well as the annexures that are available on National Treasury's website. There are some unknowns that may pose some downside risk, specifically the condition that Eskom must implement the operational recommendations of the international consortium that National Treasury has appointed to perform a review and advise on operational improvements on Eskom's coal-fired fleet. | W3 Annexure, p2: "**Strict conditions have been developed** to safeguard public money." "A **failure by Eskom to achieve and/or adhere to specific conditions** will cause the loan amount from that quarter to be repaid to the National Revenue Fund at market rates. Prior to such repayment, government will meet with Eskom to determine the cause of and timing to rectify non-compliance." | 1 |
| 5. Is the relief immediate or staggered, and is the profile such that it ensures that Eskom does indeed return to standalone financial sustainability? | mixed | The timing of the relief is mixed and achieves a balance between providing immediate relief to release cashflows for maintenance, as well as providing an ability for National Treasury to impose conditions on Eskom in order for them to qualify for further relief in the outer years of the plan. It is important that Eskom sensibly utilises the cashflow that is freed (by the government taking over its interest and capital obligations in the next three years) on the expenditure items that will assist in returning Eskom to operational sustainability. | W3 Annexure, p1: "This will take the form of advances of **R78 billion in 2023/24, R66 billion in 2024/25 and R40 billion in 2025/26**. These amounts represent Eskom's full debt settlement requirement over the next three years. Additionally, in **2025/26**, government will **directly take over up to R70 billion of Eskom's loan portfolio**." | 0.5 |
| 6. Do we have clarity on Eskom's future funding needs, the likely sources of this funding, and does this plan ensure Eskom's standalone financial sustainability over the medium- to longer-term? | mixed | Together with the debt proposal, there was some detail provided on the specific steps on tariffs ("implementation of the recent tariff increase"), some concrete (and overdue!) steps to start resolving the municipal debt problem and the condition that Eskom may not implement "remuneration adjustments that negatively affect its overall financial position and sustainability", which should allow for some cost containment on | W3 Annexure, p1: "Eskom and the National Treasury developed their own financial models covering various debt relief scenarios. These models also examined the effect of a range of variables on Eskom's long-term financial position, including tariffs, operational efficiencies, disposal of non-core assets, capital investment and maintenance requirements. The results informed the proposed | 0.5 |

| | | | | |
|---|---|---|---|---|
| | | remuneration at least. It is worth noting that other cost items - the diesel spend on the Open Cycle Gas Turbines specifically - were not mentioned and could pose downside risk to the efficient usage of the cashflow relief, which may impact the eventual outcome. | debt-relief quantum and the package of associated measures. The **modelling exercise included an assessment of financial benchmarks that would enable Eskom to operate sustainably, without continued transfers from the national budget.** In developing these financial benchmarks, the National Treasury consulted World Bank studies examining similar utilities in other countries, and engaged with Eskom's finance team and external legal and financial advisors for their input." | |
| | | | **Score (out of a possible 6)** | **4.5** |
| | | | **% score** | **75%** |

On a balanced score, the proposals seem to meet most of the criteria we outlined in our Tuesday note. While there is some execution risk, we believe it is a credible plan that can provide Eskom with a path to return to financial and operational sustainability if executed with ruthless focus and urgency.

## What we consider positive about the plan:

- It seems to signal a **recognition that a new approach to Eskom is needed** and that previous shareholder actions as regards Eskom – specifically allocating sizeable amounts to Eskom over a considerable period of time without appropriate controls/conditions/oversight and without additional action on the other pressing challenges Eskom faces - have clearly not achieved the intended result.
- The proposal **includes interventions on more than just Eskom's debt.** Mention is made of the **need for Eskom to implement the stipulated tariff,** it outlines a plan to address the **municipal debt problem** and it **limits Eskom's ability to implement remuneration increases** that "negatively affect its overall financial position and sustainability[1]" (all of which have challenges and will require political will to execute). We view these as positive and critical to the achievement of the stated goal "to strengthen the utility's balance sheet[2]," and it affirms our previously stated view that a "bold, urgent and integrated" intervention is needed.

[1] Annexure W3, p3
[2] Annexure W3, p1,

- The amount and timing of the financial support indicate **a balance between immediate cashflow relief** to Eskom and **the imposition of conditions** to "safeguard public money[3]" and ensure Eskom's financial position is sustainable and does not need further bailouts.

## What we still need further clarity on:

- The **outcome of the international consortium's review of Eskom's coal-fleet plant** is unknown at this stage and will only become clear when that report is finalised, reportedly in mid-2023. It is unclear whether this report will be made publicly available, although it appears that some of the outcomes may find their way to Eskom's Corporate Plan and the Shareholders Compact, which should provide some needed public disclosure. We would like to understand specifically **what the recommendations are**, **how they will be funded**, the **timelines** for implementation and whether, indeed, it is a **realistic plan** that Eskom's aged coal fleet can be "resuscitated to original equipment manufacturer's standards[4]". We also have **questions about the plan to concession** these power stations, specifically:
    - how this fits in with the government's Integrated Resource Plan, which anticipates the decommissioning of Eskom's coal fleet over a particular timeframe;
    - whether this plan aligns with government's COP commitments and the Just Energy Transition financing possibilities; and
    - whether there is demand for such assets, particularly with banks and institutional funders increasingly committed to decarbonising their funding books and plans to achieve "net zero" by specified dates.
- The **plan for Eskom to address its long outstanding (and ballooning) municipal debt problem requires further scrutiny**. The Minister highlighted that municipal debt at Eskom currently stands at R56.3bn. We understand the plan for this intervention will be published at the end of March 2023, with the implementation of the plan commencing on 1 April 2023. We await the details of the plan but do have some initial concerns that it will **require significant political will to implement**, as well as **require meaningful take-up by historically recalcitrant municipalities** who need to agree to participate in the plan (in exchange for having some/all of their outstanding debt to Eskom written off). We also believe it may **take time for the anticipated change in behaviour** to take root**,** namely municipalities paying for services received, and result in better cashflows to Eskom. We believe this poses **some**

[3] Annexure W3, p1
[4] Budget Review 2023, p22

**degree of execution risk,** which may risk the ultimate successful implementation of the overall relief plan.

– We need to understand the **mechanism of the proposed R70 billion** of Eskom's loan portfolio that the "government will directly take over[5]" in 2025/26.

In conclusion, and perhaps of particular significance, are these two sentences from page 22 of the Budget Review Document: **"Since 2008/09, government has provided the utility with R263.4 billion in bailouts. These allocations have failed to stem the collapse of Eskom's balance sheet and operations."** This seems to indicate a recognition from the shareholder that a different approach to that undertaken since 2008 is needed, which is a positive step if the political will to deliver on this intention is found.

The real test will come in the execution of this debt relief plan, which is where the shareholder has previously stumbled. We hope that this time is, indeed, different.



[5] Budget Review 2023, p4