


IN THE HIGH COURT OF SOUTH AFRICA
(GAUTENG DIVISION, PRETORIA)



Case No: 37296/2018

(1)	REPORTABLE:	No.
(2)	OF INTEREST TO OTHER JUDGES:	No.
		10/3/2020
N KOLLAPEN		DATE

In the matter between:

ESKOM HOLDINGS SOC LIMITED

Applicant

and

NATIONAL ENERGY REGULATOR OF SOUTH AFRICA

Respondent

JUDGMENT

KOLLAPEN, J

Introduction and the relief sought

[1] This is an application in which the applicant ("Eskom") seeks to have a decision taken by the respondent ("NERSA") on 15 December 2017, declared *ultra vires* in terms of section 15 of the Electricity Regulation Act¹ ("the ERA"), section 10(1) of the National Energy Regulator Act² ("the NERA") and the requirements of Multi-Year Price Determination Methodology 4 ("MYPDM4") and for the decision to be reviewed in terms of various provision of section 6 of the Promotion of Access to Justice Act³ ("PAJA").

[2] Eskom seeks the following relief:

- "1. The decision of the respondent ("NERSA") in relation to the Eskom application for tariff increases for the 2018/2019 year is reviewed and set aside.*
- 2. Paragraph 1 of this order does not affect the validity of the tariff increases that were implemented by Eskom in respect of the 2018/19 tariff year.*
- 3. Eskom is granted leave to apply to NERSA within 60 days of this Court's order or the final 2018/19 Regulatory Clearing Account ("RCA") decision, whichever is the later, to make a supplementary tariff determination granting Eskom any additional amounts which it has expended in the 2018/19 tariff year and to which it would have been entitled had the original tariff determination been made lawfully, in accordance with the principles established by this Court's judgment in the matter under the above-mentioned case number.*

¹ Act 4 of 2006.

² Act 40 of 2004.

³ Act 3 of 2000.

4. *Any additional amounts awarded by NERSA in terms of the process described in paragraph 3 above are to be added to the RCA balance and liquidated in accordance with additional tariff increases to be determined by NERSA in the process contemplated by paragraph 3.*
5. *NERSA is to pay Eskom's costs in this application, including the costs of two counsel."*

Background

- [3] In 2006, the Energy Regulatory Act⁴ ("ERA") was enacted establishing NERSA as well as a tariff regime which would apply to all electricity licensees (including Eskom). In accordance with this regime all electricity licensees will be entirely self-financing and will cover the reasonable cost of their licensed operations (including capital costs and a reasonable return on capital) through their tariffs. The ERA also set as one of its objectives the need to facilitate a fair balance between the interests of customers and end users, licensees, investors and the public.
- [4] Since 2006, Eskom tariffs have been determined by NERSA under a system of multi-year price determination ("MYPDs") governed by NERSA's own MYPD methodologies ("MYPDMs⁵"). The MYPDM provides for Eskom tariffs to be determined by NERSA at intervals of 3 to 5 years. A new cycle began on 1 April 2018 and was governed by MYPDM4. The decision relating to this application applies to the MYPDM4 determination made by NERSA for the 2018/2019 financial years. A single year price determination was made for 2018/2019 after Eskom applied to NERSA for permission to submit an

⁴ Act 4 of 2006.

⁵ The MYPDM is the methodology developed by NERSA to determine the allowable tariffs and tariff increases to be charged by licensees to consumers.

application for a single year determination; NERSA subsequently approved the single year application. The MYPDMs are discussed in more detail herein below.

- [5] Eskom applied to NERSA for allowable revenue of R219.514 billion for the 2018/2019 financial year which translated into an 18.91% average percentage price increase. NERSA approved allowable revenue of R190.348 billion, which translates into a 5.23% price increase. In short, NERSA's proposition in respect of its 2018/2019 decision is that Eskom can put itself in a position where, on a 5.23% tariff increase, it will be able to cover all of its costs and secure an additional return, by reducing its expenditure effectively.
- [6] NERSA made its decision on the basis that the R22.922 billion difference between a 5.23% increase and a 18.91% increase in standard tariffs, can be made up by Eskom in saved expenditure and Eskom was required to reduce its expenditure accordingly in the following areas :-
- 6.1 R11.099 billion in operating expenditure (approximately 19%);
 - 6.2 R10.777 billion savings on primary energy costs (approximately 19%);
 - 6.3 reduce depreciation by R4.237 billion;
 - 6.4 free up R511 million by abandoning its demand management programme entirely; and
 - 6.5 free up R533 million in respect of Independent Power Purchaser ("IPP") purchases over and above the R7 080 million that Eskom reflected in its revised application as the saving it could achieve in this regard.

The issue for determination

[7] The crisp issue for determination in this matter is whether NERSA's 2018/2019 determination was *ultra vires* section 15 of the ERA and whether the decision was made in accordance with the requirements of section 6 of PAJA.

The Regulatory Framework

[8] NERSA in terms of the National Electricity Regulatory Act⁶ ("NERA") has the mandate to *inter alia*, regulate the generation, transmission and distribution of electricity. NERSA's functions are set out in section 4 of the NERA and include the consideration of applications for licences and issuing of licences for the operation of generation, transmission or distribution facilities and the regulation of electricity prices and tariffs.

[9] The legal regime governing electricity prices and tariffs comprises the ERA, the Electricity Pricing Policy⁷ ("the EPP") and the MYPDMs. These three components operate within a clear legal hierarchy.

[10] ERA, which is the only Parliamentary legislation governing the determination of electricity tariffs is at the apex of the legal hierarchy. The EPP is a policy instrument and subordinate to ERA. The MYPDMs are instruments issued by NERSA setting out the methodology to be applied by NERSA in determining Eskom's tariffs and are subordinate to ERA and the EPP.

⁶ 40 of 2004.

⁷ Government Gazette 31741 of 19 December 2008.

[11] The MYPD methodology however provides that NERSA is not precluded from 'applying reasonable judgment on Eskom's revenue after due consideration of what may be in the best interest of the overall South African economy and the public.'

ERA

[12] Section 2 of the ERA sets the following objectives:

"2 Objects of Act

The objects of this Act are to-

- (a) achieve the efficient, effective, sustainable and orderly development and operation of electricity supply infrastructure in South Africa;*
 - (b) ensure that the interests and needs of present and future electricity customers and end users are safeguarded and met, having regard to the governance, efficiency, effectiveness and long-term sustainability of the electricity supply industry within the broader context of economic energy regulation in the Republic;*
 - (c) facilitate investment in the electricity supply industry;*
 - (d) facilitate universal access to electricity;*
 - (e) promote the use of diverse energy sources and energy efficiency;*
 - (f) promote competitiveness and customer and end user choice; and*
 - (g) facilitate a fair balance between the interests of customers and end users, licensees, investors in the electricity supply industry and the public."*
- (Emphasis added)

[13] The relevant part of section 14 of the ERA provides as follows:

14 Conditions of licence

(1) The Regulator may make any licence subject to conditions relating to-

- (d) the setting and approval of prices, charges, rates and tariffs charged by licensees;*
- (e) the methodology to be used in the determination of rates and tariffs which must be imposed by licensees;"*

[14] Section 15 of the ERA set out the "Tariff principles" as follows:

15 Tariff principles

(1) A licence condition determined under section 14 relating to the 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 continued improvement of the technical and economic efficiency with which services are to be provided;

...

(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." (Emphasis added).

NERA

[15] Section 10 of the NERA deals with decisions of NERSA and provides as follow:

"10 Decisions of Energy Regulator

(1) Every decision of the Energy Regulator must be in writing and be-

(a) consistent with the Constitution and all applicable laws;

(b) in the public interest;

(c) within the powers of the Energy Regulator, as set out in this Act, the Electricity Act, the Gas Act and the Petroleum Pipelines Act;

(d) taken within a procedurally fair process in which affected persons have the opportunity to submit their views and present relevant facts and evidence to the Energy Regulator;

(e) based on reasons, facts and evidence that must be summarised and recorded; and

(f) explained clearly as to its factual and legal basis and the reasons therefor.

....

(3) Any person may institute proceedings in the High Court for the judicial review of an administrative action by the Energy Regulator in accordance with the Promotion of Administrative Justice Act, 2000 (Act 3 of 2000).

...

The MYPDM

[16] The MYPDM is the methodology developed by NERSA to determine the allowable tariffs and tariff increases to be charged by licensees to consumers.

[17] MYPDM4 lists the following objectives in section 2.2:

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

2.2.1 to ensure Eskom's sustainability as a business and limit the risk of excess or inadequate returns; while providing incentives for new investment;

2.2.2 to ensure reasonable tariff stability and smoothed changes over time consistent with socio-economic objectives of the Government;

2.2.3 to appropriately allocate commercial risk between Eskom and its customers'

2.2.4 to provide efficiency incentives without leading to unintended consequences of regulation on performance;

2.2.5 to provide a systematic basis for revenue/tariff setting; and

2.2.6 to ensure consistency between price control periods."

[18] The MYPD methodology is intended to provide for a "cost plus" system of tariffs. The tariffs are to be set to recover Eskom's "allowable revenue" on the projected consumption of electricity. The formula in MYPDM4 for determining "allowable revenue" ("AR") is set out in section 5.2 of the MYPD methodology and provides as follows:

"The following formula must be used to determine the AR:

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

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)

D = Depreciation

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

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

SQI = Service Quality Incentives related to costs

<i>L&T=</i>	<i>Government imposed levies or taxes (not direct income taxes)</i>
<i>RCA=</i>	<i>The balance in the Regulatory Clearing Account (risk management devices of the MYPD)."</i>

[19] The MYPDM4 methodology in turn provides the details and content of how each one of these costs components and the projected sales volumes are to be determined so that there is a detailed system for projecting the total revenue upon which the tariffs will be based.

Regulatory Clearing Account

[20] The Regulatory Clearing Account ("RCA") is a crucial component in the methodology for determining Eskom tariffs. It is a risk management device ensuring that Eskom and consumers are protected against the consequences of projection-based tariffs that prove to be inadequate in the light of the actual experience. The RCA provides for allowable revenue to be adjusted *ex post facto* on the basis of a retrospective comparison of actual financial facts in respect of a particular financial year with the projections upon which the tariff for that year was determined.

PAJA

[21] It is Eskom's submission that the decision by NERSA is inconsistent with various provisions of section 6(1) of PAJA. Section 6(1) contains the following:

"6 Judicial review of administrative action

(1) Any person may institute proceedings in a court or a tribunal for the judicial review of an administrative action.

(2) A court or tribunal has the power to judicially review an administrative action if-

(a) the administrator who took it-

(i) was not authorised to do so by the empowering provision;

(ii) acted under a delegation of power which was not authorised by the empowering provision; or

(iii) was biased or reasonably suspected of bias;

(b) a mandatory and material procedure or condition prescribed by an empowering provision was not complied with;

- (c) the action was procedurally unfair;
- (d) the action was materially influenced by an error of law;
- (e) the action was taken-
 - (i) for a reason not authorised by the empowering provision;
 - (ii) for an ulterior purpose or motive;
 - (iii) because irrelevant considerations were taken into account or relevant considerations were not considered;
 - (iv) because of the unauthorised or unwarranted dictates of another person or body;
 - (v) in bad faith; or
 - (vi) arbitrarily or capriciously;
- (f) the action itself-
 - (i) contravenes a law or is not authorised by the empowering provision; or
 - (ii) is not rationally connected to-
 - (aa) the purpose for which it was taken;
 - (bb) the purpose of the empowering provision;
 - (cc) the information before the administrator; or
 - (dd) the reasons given for it by the administrator;
- (g) the action concerned consists of a failure to take a decision;
- (h) the exercise of the power or the performance of the function authorised by the empowering provision, in pursuance of which the administrative action was purportedly taken, is so unreasonable that no reasonable person could have so exercised the power or performed the function; or
- (i) the action is otherwise unconstitutional or unlawful.

...

(Own emphasis)

The case for the applicant

[22] In advancing its case for relief Eskom argues that electricity tariffs in South Africa remain historically low and that the tariffs approved by NERSA over the years have not enabled Eskom to recover the full cost of its licensed activities together with a reasonable return to which it argues it is entitled to by virtue of the provisions of section 15(1) of the ERA. To this end it contends that the impugned decision is *ultra vires* in that it does not, as it is required to, give effect to the mandatory provisions of section 15(1) of the ERA.

[23] It is also the case for Eskom that NERSA misdirected itself in applying the MYPDM4 alternatively, that if it departed from the MYPDM4 then it was required to allow Eskom the opportunity to make submissions as to whether such departures from the MYPDM4 were justified. To the extent that this was not done, it contends that its right to procedural fairness was violated rendering the decision reviewable on this basis as well.

[24] The starting point for determination of allowed revenue is the basic formula that is applied by energy regulators worldwide when regulating electricity prices in terms of a "cost-of-service" methodology:

"Allowed revenue = Primary energy costs⁸ + operating and maintenance costs⁹ + depreciation¹⁰ + return on capital¹¹".

[25] The average electricity tariff may then be calculated as:

"Average tariff per kWh = Allowed revenue + sales volumes (kWh)"

[26] Eskom contends that NERSA based its' decision of lowering Eskom's allowable revenue on the view that Eskom should cut down on its expenditure¹². This, according to NERSA, would make up the R22. 922 billion difference between the 5.23% increase and the 18.91% increase in standard tariffs.

[27] NERSA expects Eskom to save on operating costs, primary energy costs and to reduce depreciation, abandon its demand management programme entirely and to cut costs on Independent Power Purchaser ("IPP") purchases.

[28] Eskom contends that NERSA approached the decision as a whole with an assumption that Eskom's electricity prices are comparatively high and that Eskom

⁸ Provides for revenue with which to pay for the fuel – such as coal, diesel and uranium.

⁹ Provides for revenue with which to pay for the maintenance, employee costs, insurance costs and others operating expenditure.

¹⁰ Provides the revenue, in instalments spread over the full operational life of the assets.

¹¹ Represents the cost of debt and equity capital – such as interest expense.

¹² NERSA's Reasons for Decision – Founding Affidavit, Annexure 53 p 1302.

needs to reduce its tariffs in real terms to put itself in a "virtuous cycle". Eskom submits that this assumption was misconceived and in fact Eskom's electricity tariffs are among the lowest in Sub-Saharan Africa. Eskom contend that NERSA reverse-engineered its decision based on this assumption and this fundamental misunderstanding is sufficient for the decision to be reviewed and set aside.

[29] Eskom submits that NERSA failed to appreciate the profound impact of its decision on the country's finances. Eskom has been repeatedly down-graded because of inadequate tariff determination by NERSA, making Eskom's debt more expensive and making it impossible for Eskom to operate without incurring more debt. This has forced the government to step in and this is itself prejudicial to the country. NERSA in turn blames Eskom for operating inefficiently and while Eskom, admits to some operational inefficiencies it contends that the main cause of its dire financial situation is the inadequate tariffs approved by NERSA over time. On this basis Eskom submit that NERSA's decision is inconsistent with the objective of ERA to achieve sustainable electricity supply in South Africa and is also irrational and unreasonable.

[30] Beyond these conceptual flaws relating to the cost of electricity as well as the impact of NERSA's decision on the finances of South Africa, Eskom also relies on further specific grounds in NERSA's treatment of its allowable revenue in advancing the case for review. These are:-

a. Free Cash Flow

[31] While free cash flow is not an integral part of the exercise of determining allowable revenue, NERSA concluded that Eskom would have free cash flow of some R32 billion following the impugned decision. Eskom argues that, firstly the figures used by NERSA in arriving at this conclusion were wholly incorrect and that the free cash flow figure constantly changed in NERSA's calculations from about R7.1 billion in November 2017 to about R32 billion in December 2017 (after the impugned decision was taken) without there being any basis for the adjustment or indeed the final figure arrived at. It argues that this is evidence of both the irrational processes in the decision making cycle as well as what it describes as reverse

engineering on the part of NERSA - essentially to first arrive at a decision and then to seek justification for it by selective and sometimes inaccurate use of the numbers.

b. Coal Prices

[32] Eskom's claimed costs of R17.448 billion were adjusted by R3.532 billion using the prices approved in the 2013/2014 RCA. In respect of the short term coal contracts, Eskom's claimed costs of R1.372 billion was adjusted by R278 million also using the prices approved in the 2013/2014 RCA. Eskom challenges this approach taken by NERSA on the basis that it is inconsistent with and departs from the methodology in the MYPDM to determine coal process.

[33] Clauses 12.1 and 12.2 of the MYPDM4 provides as follows:-

"12 Primary Energy

Criteria for Allowing Primary Energy Costs

12.1 *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.*

12.2 Coal Costs

12.2.1 *The Energy Regulator will approve the coal benchmark price (i.e. average R/ton) per contract type (Cost Plus, Fixed Price, Medium-Term and Short-Term) and Alpha for each contract type in the final MYPD decision.*

12.2.2 *The R/ton coal price and R/ton/km transport cost (rail and road) shall be escalated using the formula in the contracts. Contract parameters (mining input costs like steel, labour, diesel, spare parts, rubber, electricity and tyres) in the indexation formula shall be adjusted using the industry accepted level of inflation available in the public domain.*

12.2.3 *Future coal procurement will be informed by the long-term coal procurement strategy that will be submitted to the Energy Regulator at the time of MYPD application. This strategy should demonstrate how Eskom will purchase least cost coal.*

12.2.4 *The forecasts indicated below shall be submitted together with the MYPD application:*

a) Coal volumes burnt per station, per contract type and per supplier.

- b) Coal volumes purchased per station, per contract type and per supplier.*
- c) Coal stockpiles tons per station.*
- d) Coal costs (R/ton delivered) per station, per contract type and per supplier.*
- e) Coal quality per station (CV, burn rate, ash content) and per supplier.*
- f) Road transport for each station: tons moved, kilometre travelled and payment rate.*
- g) Rail transport costs for each station: tons moved, kilometre travelled and payment rate.*
- h) Price escalations indices (electricity, diesel, mechanical spares, labour, tyre etc.) for mining and transport for each year of the MYPD.*
- i) Start date and expiry date of each coal contract per power station.¹³*

[34] NERSA did not follow this methodology but instead used the 2013/2014 coal price as a starting point for its benchmark. It sought to justify this by suggesting that there were serious governance problems regarding certain coal contracts signed after that period and that if those contracts were used it would provide an inflated starting point. Accordingly and in the light of those concerns, a conservative approach was warranted since only prudent and efficient costs could be approved.

[35] To this end Eskom also contends that NERSA's decision was procedurally unfair as NERSA did not give Eskom an opportunity to comment on its departure from the MYPDM4 and it is therefore reviewable under sections 6(2)(c) of PAJA. NERSA's decision was irrational and unreasonable and therefore reviewable under section 6(2)(b), 6(2)(d), 6(2)(e)(i), 6(2)(f)(bb), 6(2)(f)(dd) and 6(2)(h) of PAJA. The decision reflects reverse engineering to achieve an ulterior purpose of keeping tariffs as low as possible and is therefore reviewable under section 6(2)(e)(ii) of PAJA.

[36] Eskom's stance is that as there was no benchmarking against its existing contracts (as required by MYPDM4), NERSA did not have regard to factors specific to Eskom's situation such as existing contractual obligations, Eskom's procurement

¹³ Page 61, Volume 1.

policies and the global mining environment, all of which impact on the price Eskom can pay for coal.

c. The Regulatory Asset Base

[37] The Regulatory Asset Base ("the RAB") is a mechanism used by MYPDM4 to calculate depreciation and return on assets. It is a part of the formula in determining allowable revenue. MYPDM4 provides that the RAB must represent assets that are used and usable to provide regulated service by each of Eskom's business operation.¹⁴

[38] The Hendrina and Arnot power stations are currently being used by Eskom for electricity generation. NERSA decided that both of these power stations should be removed from the RAB because Eskom had surplus generating capacity. Eskom argues that this approach by NERSA contradicts the MYPDM4 as both of these power stations are currently used for electricity generating and they clearly constitute fixed assets as contemplated by MYPDM4.

[39] The exclusion of the Hendrina and Arnot power stations from the determination of the RAB impacts negatively on the ultimate allowable revenue that Eskom should be entitled to. Eskom says that this decision is both irrational and unreasonable and therefore supports the review grounds that it relies upon.

d. Disallowing Transmission Capital Costs

[40] In its decision NERSA disallowed R809 million in Transmission Capital on the basis that the amount for which Eskom applied translated to R2.8 million per kilometre of transmission line whereas the appropriate amount when measured against previous years' expenditure should be R2.5 million per kilometre. This, Eskom submits, are wrong as it is not clear from the Reasons of Decision where

¹⁴ Fixed assets must be used and useable which means that 'assets should be in a condition that makes it possible to supply demand in the short-term (within 12 months)'. Fixed assets that are not used and/or in a usable from must be excluded from the RAB.

NERSA obtained the figure of R2.5 million per kilometre and is far from the true figures. NERSA in turn blames Eskom for not providing it with the required figures.

e. Integrated demand management costs

[41] These are costs that relate to energy efficiency and demand reduction programmes that Eskom is obliged to formulate and is regarded as a prescribed component of allowable revenue. Eskom applied for R 511 million for integrated demand management costs and was allowed nothing, presumably on the basis that Eskom had excess capacity (which Eskom denies).

[42] NERSA's stance is that the RCA process is designed to deal with matters such as this but it appears for reasons that will follow that while the RCA process was designed to cater for unanticipated deviations from reasonable projections, it is not a mechanism to deal with conceptual errors in the calculation of what is acceptable allowable revenue.

f. Operational Costs (including employee costs and maintenance and other costs)

[43] In its decision NERSA disallowed some R 3.785 billion in employee costs. It did so, it appears, by using 2007/8 as a base year and calculated the ratio of staff to electricity output in 2007/2008 as 7.26 GWh per employee and using the 2018/2019 projection, it concluded that it translated into 5.3 GWh per employee. On this basis it then concluded that Eskom was overstaffed by 6232 employees and using inflation, adjusted the average rate of R0.608m per employee and came to a figure of R 3.785 billion which it disallowed from Eskom's allowable revenue.

[44] Eskom considers the decision to be both irrational and procedurally unfair and point out that:-

- a) The choice of 2007/8 was arbitrary and inappropriate in that that was the year when sales peaked and demand outstripped supply;

- b) There was no indications by NERSA that it would depart from MYPDM4 and use this approach rendering the decision procedurally unfair;
- c) The decision does not take into account that in the period 2007 to 2017, Eskom saw substantial changes to its business including, substantial construction projects that did not generate electricity but which required a substantial number of employees.

[45] NERSA's stance is that as the number of Eskom employees is decreasing, it serves to justify decreased employee costs and that it was entitled to exercise reasonable judgment in interrogating this aspect of Eskom's expenditure in the determination of allowable revenue.

g. Double counting errors

[46] NERSA disallowed all costs in respect of Network Use of System charges by IPP's. It appears it made this decision on the basis that it believed that Eskom recovered such costs whereas such costs were not recoverable and would ordinarily form part of the costs Eskom was entitled to recover through its tariffs.

[47] Eskom also takes issue with NERSA disallowing a portion of the Nuclear Fuel costs on the premise that these costs already formed part of capital expenditure when in fact it did not.

Preliminary issues

[48] Before dealing with the grounds of review there are two issues which require determination. They are:-

- i) The argument that the application is premature.
- ii) An application to strike out by NERSA.

i) Application is premature

[49] NERSA contends that this Court should not consider the relief sought on the basis that the application is premature. They argue that to the extent that this application is substantially about projected revenue that was disallowed in respect of financial year 2018/2019, the checking and balancing mechanism to resolve issues where there was a disallowance of projected costs, is the RCA and that in the context of this application the RCA process has reached an advanced stage with a decision on Eskom's RCA application for 2018/2019 likely to be made by about the 19 March 2020.

[50] This process they say will resolve much of the debate as to whether expenditure was properly allowed or not and that actual expenditure will clarify and render moot much of the disputes in these proceedings.

[51] While it is so that the RCA process is about reconciling projected costs with actual costs, it cannot be said that the existence and the operation of the RCA determination will therefore effectively insulate NERSA determinations until at the very least there is an RCA determination for the same year in question.

[52] What this Court is required to determine is whether the conduct of NERSA activates the review grounds advanced by Eskom. Whether it does or not, a Court called upon to make such a determination, should do just that. It is untenable to suggest that administrative action that is the subject of a PAJA review can be insulated from scrutiny on account of a process that does not fundamentally examine the correctness or otherwise of such action but is rather focussed on reconciling the numerical consequences of such action. That is precisely what will occur here.

[53] The RCA process will not review the correctness or otherwise of the NERSA decision. Rather it will serve to reconcile numerically any discrepancy between allowed projected revenue against actual revenue. A review and an RCA determination are essentially two separate and wholly different processes. The former is about ensuring the integrity of administrative action while the latter is about advancing accuracy and integrity in expenditure. The former is about ensuring that

the rule of law is promoted and entrenched whilst the latter is about ensuring accuracy in determining expenditure and revenue.

[54] For these reasons it cannot be said that the application is premature on account of a yet to be completed RCA determination. Of course, if Eskom is successful and the matter is remitted to NERSA for reconsideration then the outcome of the RCA process may well be factored into the process of re-determination. That however, does not conflate the two processes and the assertion that a party who makes out a case for review is entitled to appropriate relief by a Court must remain a fundamental tenet of the rule of law.

ii) The application to strike

[55] NERSA has brought an application to strike out:-

- a) What it describes as scandalous and vexatious allegations to the effect that NERSA either failed to apply its mind properly to the details of Eskom's application or reverse engineered its decisions in order to reach an outcome that it considers palatable.

[56] It says in support of this that Eskom has failed to identify instances where NERSA failed to apply its mind or where it intentionally manipulated the process to reach a pre-determined outcome.

[57] In addition, it seeks to strike out what it says is new matter, in the replying affidavit in the form of the expert reports/opinions of Mr Stephen Labson and Ms Kay Walsh.

[58] In opposing the application to strike out, Eskom contends that the application should be dismissed because it is procedurally flawed in that there was non-compliance with Rule 23(2) of the Uniform Rules of Court and on the merits it stands by the assertions that NERSA failed to apply its mind, alternatively engaged in reverse engineering.

[59] In respect of the new matter Eskom says that the reports attached to its replying affidavit are in response to what was raised in the answering affidavit.

[60] In the course of this matter there were strong positions advanced by Eskom in how it viewed NERSA's treatment of its projected expenditure and what would be the determination of its allowable revenue. It characterised the NERSA decision as being irrational, unreasonable and procedurally flawed and advanced grounds on which it could be suggested that it may have been entitled to conclude that there was reverse engineering – in particular in relation to the Free Cash Flow determination.

[61] Leaving aside compliance with Rule 23(2), I am of the view that the contentions made are neither scandalous nor vexatious but that in both instances the reading of the papers as a whole and the reasons advanced by Eskom would suggest that on their interpretation of the facts, they were entitled to make the assertions they did. Whether this is true or not is another matter – for now I am satisfied that there was at the very least a basis laid for the allegations made that are the subject of the strike out application.

[62] In respect of the new matter component of the application, my view is that while they do not advance Eskom's case, their inclusion is not offensive as in many respects this case is at the narrow end about deciding whether a tariff determination is reviewable or not. That is in essence the start and the end of the exercise. On the other hand the case has national and international ramifications which are tangential to the relief sought. In the light of its broad significance some degree of latitude may be necessary in order to ensure a proper ventilation of the issues. At the end of the day some of the material may have relevance and others not and in the particular context of this application an application to strike out may not be the relevant intervention to deal with such matter.

[63] I will accordingly in the exercise my discretion not strike out those parts of the replying affidavit. In any event I do not believe that they are directly relevant to the determination I am required to make so there can be no prejudice to NERSA nor is there any need to allow it the opportunity to respond to those reports.

[64] The application to strike is dismissed with no order as to costs.

Analysis

[65] In *National Energy Regulator of South Africa v Borbet SA (Pty) Ltd*¹⁵, the Supreme Court of Appeal summarised the legal regime governing NERSA in the determination of tariffs as follows :-

"[12] The provisions set out above create a situation where licensees are the ones empowered to charge a tariff for electricity consumption within parameters set by the Regulator. Licences, as can be seen from the provisions of ss 14(1)(d) and (e) of ERA, may contain conditions relating to the setting and approval of prices, charges, rates and tariffs to be charged by licensees. Licences may be made subject to conditions relating to the methodology to be used in the determination of rates and tariffs which must be imposed by licensees (s 14(1)(e)). NERSA is therefore responsible for determining whether a licence should be granted; the terms of the licence; the methodology by which tariffs and charges are to be determined and the imposition of that methodology on the licensee by way of a licence condition; and the tariffs and charges that the licensee may recover from its customer. All of these are embodied directly or indirectly in the licence and the obligation to adhere to them flows from the licence. "

[66] In *Borbet (supra)* the Court made also made reference to what it described as the balance to be struck between Eskoms' sustainability and the impact on the consumer and the South African economy and expressed itself as follows :-

"[3] Electricity tariff increases affect all South Africans. They impact the business world as well as domestic households. Thus, there is a statutory framework to ensure fairness so that tariff increases have the result that electricity infrastructure remains sustainable while at the same time ensuring that undue hardships are not imposed on consumers."

[67] This appears to be in line with the objectives of the ERA¹⁶ which provides for a fair balance to be struck amongst others between consumers and licensees. To

¹⁵ [2017] ZASCA 87; 2017 JDR 1121 (SCA).

that extent the tariff determination must also include considerations of affordability and impact on end users and consumers.

[68] While Section 15(1)(a) of the ERA provides that a license condition must enable an efficient licensee to recover the full cost of its licensed activities together with a reasonable return, the element of affordability and the need to avoid undue hardship on the consumer are all an integral part of the architecture in the tariff determination process.

[69] An obvious question that immediately arises is how then, are the competing interests of licensees and consumers to be reconciled or moderated as contemplated in section 2 of NERA which requires a fair balance to be struck. The answer may well be found in the MYPDM which allows the regulator to exercise what is described as reasonable judgment. Section 4.3 of the MYPD Methodology provides that NERSA 'may apply reasonable judgment on Eskom's revenue after due consideration of what may be in the best interest of Eskom, the overall South African economy and the public.'

[70] It is evident from section 4.3 above that reasonable judgment does not afford NERSA a license to use its discretion as it pleases but that when it does apply such judgment on Eskom's revenue it is bound to consider both Eskom's interests as well as those of the public. Consequently when NERSA seeks to place reliance on the exercise of reasonable judgment, as it does in these proceedings, it must be able to demonstrate both that the judgment exercised was reasonable and further that the reasonableness of the judgment was determined by taking into account amongst other factors, Eskom's interests.

[71] Where NERSA is unable to demonstrate this then the exercise of its judgment may well fall outside of the methodology that it is bound to apply and it may then fall short of constituting a 'reasonable judgment' with the consequence that its decision may then be susceptible to review.

¹⁶ Section 2(g).

[72] Similarly where NERSA seeks to depart from applying the MYPD such departure would have to constitute a 'reasonable judgment' and would require careful justification and may also activate *audi* rights on the part of Eskom both in respect of the intention to depart from the MYPD as well as the alternate mechanism NERSA would seek to follow other than the MYPD.

[73] This is not a constraint on the effective functioning of NERSA but rather a recognition that the ERA and the MYOPD seek to ensure that the process of determining an electricity tariff is fair to all parties including licensees. In particular, a licensee is entitled to assume that NERSA will follow the MYPD methodology and ordinarily would submit information on its projected expenditure and revenue based on that methodology. This is what Eskom did.

[74] When NERSA decides to depart from the MYPD methodology then it must follow, purely from a procedural fairness perspective at the very least that it is obliged to inform Eskom of such departure and the alternate methodology that it seeks to apply, to enable Eskom to both comment on the departure but more importantly, make input on the basis of the alternate methodology. In *Masetlha v President of the Republic of South Africa and Another*¹⁷ the Constitutional Court held the following in regard to procedural fairness in regard to administrative action:

"[183] The procedural aspect of the rule of law is generally expressed in the maxim audi alteram partem (the audi principle). This maxim provides that no one should be condemned unheard. It reflects a fundamental principle of fairness that underlies or ought to underlie any just and credible legal order. The maxim expresses a principle of natural justice. What underlies the maxim is the duty on the part of the decision-maker to act fairly. It provides an insurance against arbitrariness. Indeed, consultation prior to taking a decision ensures that the decision-maker has all the facts prior to making a decision. This is essential to rationality, the sworn enemy of arbitrariness. This principle is triggered whenever a statute empowers a public official to make a decision which prejudicially affects the property, liberty or existing right of an individual." (Footnote omitted.)

¹⁷ 2008 (1) SA 566 (CC).

[75] If this does not happen then it is inconceivable that Eskom can properly ensure that NERSA has all the information it requires to enable it to make decisions on Eskom's application. Indeed section 4.4 of the MYPD provides that 'NERSA shall from time to time and when necessary request Eskom to submit information and additional schedules in the manner considered suitable to allow to allow NERSA to analyse such information and schedules for the purpose of making decisions on Eskom's application'. In *Premier, Mpumalanga, and Another v Executive Committee, Association Of State-Aided Schools, Eastern Transvaal*¹⁸ the Constitutional Court held as follows:

"[41]... Citizens are entitled to expect that government policy will ordinarily not be altered in ways which would threaten or harm their rights or legitimate expectations without their being given reasonable notice of the proposed change or an opportunity to make representations to the decision-maker."

[76] Thus when NERSA departs from the MYPD and fails to inform Eskom about such a departure or invite it to submit information on the alternate methodology, then it must follow that such a decision taken as a result of it, is both in conflict with section 4.4 of the MYPD and would also violate Eskom's right to procedural fairness.

[77] Eskom submitted its application in terms of the MYDPM4 and therefore expected NERSA to determine its application in terms thereof. The unilateral departure by NERSA from the MYPDM4 and application of an alternate methodology without affording Eskom the opportunity to give an input, renders the impugned decision vulnerable to review in terms of PAJA.

[78] I proceed to apply against the above criteria and standards some of Eskom's specific complaints.

Coal Prices

[79] It is evident that NERSA did not use the formula specified in the MYPD. The MYPD states that the cost of coal shall be escalated using the formula in the

¹⁸ 1999 (2) SA 91 (CC).

contract. NERSA based the amount allowed for coal for 2018/2019 on the prices it approved in the 2013/2014 RCA decision and says it then escalated them by an industry composite index.

[80] What is problematic about the decision is that Eskom was never advised about the intended departure from MYPD and the alternate approach to be taken and never had the opportunity to give an input into the departure and alternate approach. In addition there is no evidence as to what composite industry index was used in the escalation of the coal price arrived at by NERSA.

[81] NERSA's stance that using the formula in the contract would have been unacceptable given serious governance problems about certain coal contracts may well on the face of it be a valid concern and conceivably could have justified a departure from the MYPD. That however, would have meant that NERSA was obliged to advise Eskom of the departure and the reasons for it, as well as the alternate method it chose to follow and allow Eskom to engage with it and to give input. Its failure to do so mean its determination of coal prices beyond being a departure from MYPD was also unilateral.

The Regulatory Asset Base (RAB)

[82] It does not appear to be in dispute that the Hendrina and Arnot power stations were intended to be used and were in fact used for electricity generation in 2018/2019 financial year. On that basis the MYPD to the extent that it provides that the RAB must represent assets that are used or usable, would have required their inclusion in the calculation of the RAB.

[83] NERSA's decision to exclude them from the RAB cannot be justifiable. These power stations were not decommissioned or mothballed and by definition were therefore available for power generation and accordingly should have been included in the RAB. The decision to exclude them is both irrational and unreasonable and advances the review grounds relied upon by Eskom.

Employee Costs

[84] NERSA reduced Eskom's employee costs by about R3.785 billion and based this on a comparison of Eskom's output and employee numbers in 2007. Again and while it does appear that Eskom is overstaffed, the approach taken by NERSA constituted a departure from MYPD about which Eskom was not informed. Secondly, the method by which the extent of the overstaffing was determined hardly appeared to constitute reasonable judgment. The choice of using employee numbers of 2007 as the benchmark year appears to have been arbitrary as little consideration was given to the fact that Eskom has seen substantial changes to its business model, including construction projects which did not generate electricity but required staff. This impacted on the GWh per employee calculation.

[85] While it must be contemplated that the exercise of reasonable judgment would have required a careful reconsideration of the amount Eskom advanced for employee costs, the method used by NERSA falls considerably short of such reasonable judgment.

Integrated Demand Management

[86] The total disallowance of this item appears to lack justification given that Eskom is obliged to formulate energy efficiency and demand reduction programs. It was disallowed because NERSA took the view that Eskom has excess capacity exacerbates the probe. Firstly, such programs are not dependent on the existence of capacity but are meant to advance energy efficiency and secondly, Eskom did not have excess capacity at the time which undermines the very basis for the disallowance of these costs.

[87] Some of the other complaints advanced by Eskom include disallowed transmission costs and double counting errors may well have been incorrect but do not in themselves constitute decisions which can be said to be unreasonable or irrational and can in any event be dealt with in the RCA process.

Summary

[88] NERSA's treatment of coal costs and employee costs resulted in the deduction of billions from Eskom's projected revenue and as demonstrated the decision arrived at and the rationale for them appear highly problematic. Not only do they constitute a departure from the MYPD of which Eskom was not informed but they also represent decisions taken by alternate methodologies that Eskom was not privy to nor invited to participate in.

[89] For these reasons the decisions taken were procedurally unfair, irrational and unreasonable and falls to be reviewed.

[90] I am accordingly satisfied that Eskom has advanced a case for the relief it seeks and the order I intend making takes into account the RCA process which I have dealt with in this judgment and provides some alignment between the remittal and the reconsideration NERSA is required to undertake as well as the RCA process in respect of the 2018/2019 financial year which may have an impact on some of the matters raised in this judgment as indicated.

Order

[91] I make the following order:

1. The decision of the respondent ("NERSA") in relation to the Eskom application for tariff increases for the 2018/2019 year is reviewed and set aside.
2. Paragraph 1 of this order does not affect the validity of the tariff increases that were implemented by Eskom in respect of the 2018/19 tariff year.

3. Eskom is granted leave to apply to NERSA within 60 days of this Court's order or the final 2018/19 Regulatory Clearing Account ("RCA") decision, whichever is the later, to make a supplementary tariff determination granting Eskom any additional amounts which it has expended in the 2018/19 tariff year and to which it would have been entitled had the original tariff determination been made lawfully, in accordance with the principles established by this Court's judgment in the matter under the above-mentioned case number.
4. Any additional amounts awarded by NERSA in terms of the process described in paragraph 3 above are to be added to the RCA balance and liquidated in accordance with additional tariff increases to be determined by NERSA in the process contemplated by paragraph 3.
5. NERSA is to pay Eskom's costs in this application, including the costs of two counsel.


N KOLLAPEN
JUDGE OF THE HIGH COURT

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:

Date of hearing

: 27 and 28 January 2020

Date of judgment

: March 2020