

CONFIDENTIAL

**Independent System and Market Operator
Establishment Bill [B9-2012]:
Parliamentary Submission**

Submitted by:

EIUG

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1 KEY COMMENTS

*“To ensure reliable power supply, we have established an Inter-Ministerial Committee on Energy, to develop a 20-year integrated resource plan. Among other things, this will look at the participation of independent power producers, and protecting the poor from rising electricity prices. **We will establish an independent system operator, separate from Eskom Holdings.** Eskom will continue to build additional generation capacity and improve the maintenance of its power stations.”*

(President Zuma: 11 February, 2010 - State of the Nation Address)

The ISMO Bill was published for comment as Bill 9-2012, with the due date for comments to the Portfolio Committee on Energy being the 13th of April, 2012. At the request of the EIUG extension for submission of comments was provided by the Committee Secretariat until the 18th of April, 2012.

It is widely recognised that the creation of an Independent System Operator (ISO), is a key step in ensuring the development of a competitive, transparent market for Independent Power Producers (IPPs), in South Africa. In case of this Bill, it is also linked to purchasing and sales functions, and called an “Independent Systems and Market Operator (ISMO)¹”.

The establishment of the ISMO is welcomed by the EIUG and is seen as a prerequisite for the country to reach its targets regarding electricity generation expansion, localisation, job creation and the establishment of a “green” economy². The ISMO Bill would thus serve as a vital support underpinning the implementation of the Industrial Policy Action Plan (IPAP2), the New Growth Path (NGP) and the objectives of Presidential Infrastructure Co-ordinating Commission (PICC)

The ISMO Bill defines the first of three phases, needed to establish a fully-fledged ISMO. The three phases can be defined as:

1. Legislative Phase
2. Institutionalisation Phase
3. Operating Phase

¹ The “MO” aspect in the name not 100% correct is as no real “market” is foreseen with the proposed ISMO essentially performing a central-buyer function.

² As a mechanism to encourage the introduction of IPPs, the development of a local Renewable Energy industry and the enabling of South Africa’s Green Economy.

Phase 1 – Legislative Phase

This phase defines the boundaries of ISMO – the responsibilities, functions, processes, assets, governance structures and objectives of the organisation.

Phase 2 – Institutionalisation Phase

After the boundaries have been drawn, it will be necessary to (as efficiently as possible) populate ISMO with the assets, personnel and funding required in order to enable its effective and efficient operation. It is likely that Eskom will initially continue to manage certain functions and that these will be transferred to ISMO over time. It is vital during this phase that a clear outline of responsibilities and timelines for transfer are established and adhered to.

Phase 3 – Operating Phase

International best practice suggests that the ISMO operates as an independent state owned enterprise, managing or guiding the following functions:

1. Generation Planning
2. Systems Operations
3. Network Operation & Expansion
4. Procurement of New Generation
5. Central Buyer

In order to evaluate the ISMO Bill, it is necessary to establish if it enables successful implementation of all three the above phases. The EIUG believes it does go a long way towards achieving this, but that there are certain vital aspects that could be improved upon, with respect to the first three Objects of the Act, namely that the ISMO:

1. Is financially viable and that it will manage the system in an efficient manner
2. will act as a trader of electricity to ISMO Customers in line with Government policy
3. will prepare appropriate input into the planning of electricity supply and the transmission planning

There are certain areas of the Act, discussed below, that need further clarification in order to meet the objectives.

In order to keep comments brief and to the point the EIUG only highlighted key areas of concern, rather than approaching the total Bill on a section by section basis, on the understanding that individual sections would be given the necessary attention by the

Committee and the State Legal Advisers should the EIUG's broader comments be acceptable.

2 ISMO FUNCTIONS

The objectives and functions to be performed by ISMO, and the manner in which these will be performed, are key to the success of the organisation, and indeed the whole electricity supply industry.

Accordingly, the following areas were identified as requiring greater clarity:

ISMO Jurisdiction (Definitions section):

- It is not clear what the “integrated power system” is as this is not well defined. This goes to the core of ISMO as it would be performing system operation functions for the integrated power system.
- As it is, the Bill also includes integrated municipal systems that consist of interconnected generation, transmission and distribution systems (for example Kelvin Power Station and the Johannesburg system), whilst typically the system operator would not operate the Johannesburg system as such. This needs to be clarified to make sure that ISMO jurisdiction primarily pertains to the national grid, i.e. the transmission system presently owned and operated by Eskom.
- Similarly, the concepts of “system” as opposed to “integrated power system” is used inconsistently in the Bill, leading to uncertainty as to what transmission “systems” are actually subject to ISMO jurisdiction.

ISMO Customer’s (Definitions and Section 4):

- As a central buyer, ISMO would purchase electricity from generators and sell this to customers. However, “ISMO Customers” are not defined in the Bill and it is left to the Minister’s discretion to decide whom these ISMO customers will be³. This could be a serious gap as the ISMO concept already provides that some customers could purchase electricity directly from generators, but it is not clear who those customers are.
- In other words the ISMO will facilitate the introduction of new generation capacity and will coordinate the sale of electricity to ISMO customers, but its existence will not impinge or prevent a generator who wishes to sell for “own use” or to a “contestable customer”.
- Hence, it is suggested that “ISMO customers” are clearly defined in the Bill, and that definitions of “contestable customers” and “own use” are accordingly introduced to indicate which customers are not necessarily supplied by ISMO. This would link in directly with the purchasing functions of ISMO as already set out in the ISMO Bill

³ By regulation or government notice

whereby ISMO has to purchase electricity from generation licensees, with the exception of generators exempted by licence from selling to ISMO⁴. It would also serve to indicate where ISMO's exclusive responsibility of supply begins and ends.

- This is deemed to be one of the most critical aspects to be addressed in the ISMO Bill to ensure that ISMO's rights and obligations are clearly set out and that the eligibility criteria for bilateral transactions between generators and "contestable customers" are clarified. It is believed that if this is not addressed satisfactorily it could represent a fundamental obstacle for the establishment of an effective and efficient ISMO and to meeting its primary objectives, namely to facilitate the entry of IPPs while enhancing long term supply security and containing rising electricity prices.

ISMO Objectives (Section 2):

- The objectives of ISMO as set out in the Bill are not fully aligned to its functions, with most of the objectives seemingly couched at least partly as functions.
- It is suggested that ISMO's objective(s) could be a clear and simple mission statement, with the expansion thereon then contained in the sections dealing with its functions.

Transmission and Generation Expansion (Section 4):

- Whilst it is clear that ISMO provides input into the expansion of the transmission system in order to meet demand, ISMO's powers are limited and it cannot force the owner of the transmission system to either accept its inputs or to undertake the necessary transmission expansion proposed.
- It is expected that the ISMO will be charged with the responsibility to ensure South Africa's electricity supply security. As such the ISMO should have the necessary powers not only to call for the development of new generation assets but also to initiate the construction of new transmission assets if needed.
- Whilst it is not envisaged that ISMO assume full responsibility for procuring new Transmission assets, it may be prudent to allow them to commission new transmission should the need arise.

Transmission Ownership (Section 4):

- Whilst it is clear that ISMO will not own the transmission system, the rationale for this decision is unclear.
- It should be noted that system ownership would typically underlie an ISO as this links in to the key functions including system planning, system expansion⁵, maintenance,

⁴ And hence allowed to sell to other customers – that need to be defined

⁵ As noted in the point above

operation, scheduling and dispatch and 3rd party access to the grid. However, the current provisions of the Bill would *de facto* result in splitting accountability and responsibility between ISMO and Eskom. As such this could undermine the independence and functioning of ISMO, and raise arguments by IPPs that the playing field is still not level.

- Eskom will perform as transmission owner (including transmission assets planning, expansion and maintenance functions⁶) but would still control competing generation assets.
- Whilst it is accepted that this is a contentious issue, it is recommended that this door should not be fully closed, with the Bill providing the possibility that system ownership may in future be vested with ISMO. As a minimum, it is vital to ensure that IPPs get access to the grid on equitable terms to other generators.
- Within this context it is proposed that the Minister be given an enabling authority in the ISMO Bill to make regulations regarding conditions of access to the network, conditions of use, wheeling of power⁷, and transmission charges payable by ISMO and third parties. Whilst it may be argued that some of these issues are regulatory in nature, and hence should vest with NERSA⁸, it directly impacts on ISMO's activities.

Electricity Procurement (Section 4):

- ISMO's electricity procurement functions in terms of the ISMO Bill must be aligned with the integrated resource plan and done "...in terms of the procurement processes outlined in the Electricity Regulation Act...".
- Whilst it is understandable that procurement should be aligned to the integrated resource plan, ISMO should not be bound only to the section 34 procurement processes envisaged in the Electricity Regulation Act, as it would also need to purchase from and via other sources, for example from existing Eskom generation, from imports, or for balancing purposes.
- None of these aspects are covered under the procurement processes envisaged in the Electricity Regulation Act, and hence it is suggested that ISMO should rather procure "...in accordance with the processes envisaged in the Electricity Regulation Act *or its own procurement processes, as applicable in the circumstances*".

Tariffs (Section 4):

⁶ If the company is to be viable, it would be prudent to ensure a sound asset base

⁷ ISMO will also need to wheel power, depending on where electricity is bought, and hence wheeling charges would also apply to it

⁸ And the Grid Code

- In terms of the ISMO Bill, all of ISMO's energy supply tariffs must be approved by NERSA. The rationale for this is unclear as this could undermine ISMO's ability to negotiate tariffs on a willing buyer/ willing seller basis with larger clients⁹, and does not deal with existing supply agreements which would need to be honoured.
- However, it is understandable that tariffs to captive customers would need to be approved from a regulatory perspective, and hence the Bill should to be amended to make it clear that NERSA tariff approval only applies to captive customer categories.

Electricity Regulation Act Amendment (Section 4):

- The ISMO Bill makes reference to the Electricity Regulation Act is if that Act has already been amended. For example, it provides for procurement of electricity by ISMO "....from generation licensees...with the exception of licensees *exempted by licence from selling to ISMO in terms of the Electricity Regulation Act....*".
- Presently the Electricity Regulation Act has not been amended and has no provisions forcing the sale of electricity to ISMO, or for that matter from exempting anyone from selling electricity to ISMO. In fact, the Electricity Regulation Act presupposes the possibility of a competitive market with compulsory third party access to the national grid.
- Accordingly, this provision will be *pro non scripto* as no such licence can be issued. This demonstrates that the ISMO Bill should as far as possible "stand on its own feet", rather than rely on future changes to the Electricity Regulation Act that may or may not transpire.
- Hence it is necessary that references to the Electricity Regulation Act are carefully vetted by the State Law Advisers and where the ISMO Bill relies on future changes in other legislation that may or may not occur, these be replaced with substantive sections in the ISMO Bill. Examples include ISMO licensing¹⁰, Grid Code amendments and the status of the Grid Code as a binding instrument, electricity procurement and sales by ISMO, and formalisation of the central buyer concept¹¹.

ISMO Functions (Section 41):

- It is noted that at the outset some of the ISMO functions may need to be performed by Eskom until such time as ISMO is able to perform these, and in this regard provision is made that ISMO may enter into suitable arrangements with Eskom.
- However, the Bill should be clear that these are temporary arrangements as the wording is couched in such a manner that it could be a permanent arrangement. This

⁹ Who should be able to look after themselves

¹⁰ The Electricity Regulation Act has no dedicated ISMO licence possibility

¹¹ Which is absent from the Electricity Regulation Act

begs the question – if Eskom is going to perform the functions indefinitely, why establish ISMO at all?

3 ISMO GOVERNANCE

It is noted that the governance sections of ISMO are a mix of statutory-type “board” provisions and Company Law. It should be strived from the outset that ISMO be operated and governed in accordance with sound commercial principles and accepted governance guidelines, and that care should be taken that whilst well intentioned, some of the principles in the Bill are impracticable and/or counter-productive. In principle the EIUG believes that the Companies Act is sufficient in dealing with ISMO governance issues, as augmented by the provisions of the Public Finance Management Act. In this context the following more specific comments may be made:

ISMO Board Selection (Section 10):

- It is noted that the Board consists of nine members, with two as executive members. The rationale for having such a large Board is unclear, and care should be taken that the Board is not unwieldy. Interestingly, while it is clear from the ISMO Bill that the Minister appoints the Chairperson, it is not clear who appoints the remaining Board members – presumably this would be the Minister or the Chairperson, but this should be spelt out.

ISMO Board Mandate (Section 12):

- This section *inter alia* states that the Board “..takes decisions on behalf of ISMO and gives effect to those decisions..”. From this clause it is not clear whether the Board performs an executive role in the day to day decision making of ISMO and what the exact role of the Board vs that of management is. It is suggested that this be clarified, i.e. that the Board is responsible for policy direction, Board mandate and strategic plan, approvals of budget and business plan and oversight as opposed to the CEO that is responsible for the day to day operation and management of the entity.

ISMO Board Selection (Section 13):

- It is noted that the nomination committee for Board members should be “broadly representative of the various racial groups and geographic areas of the Republic”.
- Whilst this would be appropriate for a Board serving the larger public interest, such as the SABC, it must be noted that ISMO is a very specialised and narrowly focused entity and that such a broad definition could be counterproductive rather than helpful. It is suggested, rather, that only directly affected groups form part of the

nomination committee as these will be affected most by its activities, being the entities to whom ISMO provides system operator and related functions, buys from and sells to. This section also provides for the term of office of members, and it is noted that no staggering provisions for retirement are included. These are vital to ensure continuity on the Board.

ISMO Board Selection (Section 15):

- It is noted that non-South Africans may not be Board members of ISMO. There is no clear reason why a restriction simply on the basis of nationality should be included – ISMO is a specialist organization and hence it may be counterproductive to exclude foreign expertise *per se*.

Fiduciary Duties (Section 16):

- Fiduciary duties of directors are well covered in the Companies Act and there is no need to repeat these in the Bill.

Quorum (Section 17):

- It is noted that quorum requirements for the Board are very high. It is submitted that quorum (and decision making) requirements should be based on the type of decision required, and not simply apply to all decisions, as is already provided for in the Companies Act. Accordingly, it is suggested that the provisions of the Companies Act should apply and be incorporated in the Memorandum of Incorporation, rather than trying to govern these matters in the Bill itself.

Delegation of Decision Making (Section 18; Section 19):

- The Board should be able to delegate decision making powers to one of its committees. The current wording seems to indicate that this could only happen in special circumstances, which could be counterproductive to effective and efficient functioning of ISMO.
- The Board may only delegate its functions by a special vote of 75%. The Companies Act adequately deals with Board powers, duties and functions and it is not necessary to try and re-engineer these in the ISMO Bill, with the associated risk of unintended consequences. In any event these kinds of provisions should preferably be accommodated in the Memorandum of Incorporation, and not in the Act itself.
- It is, furthermore, not clear from this section what the inherent Board functions are, and hence what can and should be delegated to committees and the CEO or to other employees.

Appointment of the CEO (Section 20; Section 21):

- It is unclear why the Board must get the Minister's approval for appointment of the CEO, as opposed to getting Ministerial inputs. It should be the Board's responsibility to appoint the CEO and be accountable for it.
- The CEO may only be appointed for a maximum period of eight years. The rationale for this is unclear – if the person is doing a good job, why limit the term of office?

Conditions of Service (Section 27):

- It is noted that conditions of service (including remuneration) of personnel is determined by the Board, but only with the concurrence of the Minister of Energy and the Minister of Finance. In practice this means that all of these parties need to be in agreement, and if one is not, then salary increases or other changes would not be allowed. This could become highly impractical and it is suggested that "after consultation" is more appropriate in the circumstances.

Ministerial Intervention (Section 37):

- Whilst intervention by the Minister in exceptional circumstances is acceptable, care should be taken not to confuse ISMO functions with that of state entities that take discretionary administrative-law based decisions. ISMO is a commercial entity and enters into relationships on a contractual basis and not based on discretionary decision-making. Accordingly, equity and fairness principles should not come into play and subsection (1)(c) may be deleted. The State Law Advisers should take particular care that the Bill makes it clear that ISMO commercial decisions are not based on administrative law but are commercial in nature.

4 ISMO VIABILITY

Care needs to be taken to ensure that ISMO is a viable commercial entity, and that it can meet the obligations related to its functions. In this context it has been noted that Chapter 5 adequately provides for funding and financial accountability, and the provisions of that Chapter are generally conducive to ISMO viability.

However, a key aspect of ISMO viability will be determined by the definition of ISMO rights and obligations in respect of customers. At present the Bill is silent on how customers will be shared between Eskom and ISMO (if they will be shared) and who ISMO customers will be.

As this could have a serious impact on ISMO's viability, the Bill should ideally set out –

- the customer categories to whom ISMO must sell;

- the customer categories to whom ISMO may sell (and thus also which customers may also purchase directly from IPPs);
- how existing customers will be dealt with, e.g. will ISMO take over all of Eskom's customers, or only certain of Eskom's customers; and
- how existing contracts will be dealt with.

5 TRANSITIONAL PROVISIONS

Whilst provision is made for transitional provisions, these seem to be limited mostly to Eskom asset and staff transfers and does not really deal in detail with other issues related to ISMO establishment. For example, section 41 provides that "...ISMO must honour contracts transferred with functions..." without specifying whether ISMO substitutes Eskom or new contracts should be entered into. Similarly, the Bill provides that ISMO must within six months or such longer period as the Minister may allow apply for the necessary licences in terms of the Electricity Regulation Act, whilst the present Electricity Regulation act does not provide for a dedicated system operator licence.

To deal with possible shortcomings in the Act it is proposed that the Minister be given the powers to issue regulations dealing with transitional issues regarding the establishment and functioning of ISMO, and that clear enabling provisions to this extent be inserted in the regulation section.