Chamber of Mines response to NERSA regarding MYPD3 re-opener

23 June 2015

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CHAMBER OF MINES OF SOUTH AFRICA
Putting South Africa First

Chamber of Mines response

The imposition of the multi-year 24% increase in electricity tariffs would severely jeopardise the sustainability of the mining industry

- Chamber committed to the **sustainable growth** and transformation of South Africa's economy. Chamber supports the views expressed by BUSA, EIUG and individual member mining companies.
- Eskom's need for extra funding is noted, as well as the various initiatives to address the crisis. However, the **underlying cause** we believe is principally due to delays in commissioning of new power stations, necessitating the increased usage of OCGTs and increased maintenance requirements.
- Chamber does not support the proposed funding **mechanism through a tariff hike**, specifically given the mining industry current crisis situation as sustainability of the majority of the sector is in question:
  - Industry has absorbed a third of cost increases through energy efficiency initiatives and installing back-up emergency generation capacity over the last decade; and
  - Majority of operations are loss-making, with the drivers continuing to deteriorate.
- A further increase, **jeopardises the profitability of more mining operations** and companies' ability to make investment decisions, amidst already poor investor returns and an unpredictable operational environment (due to electricity supply curtailments).
- Alternate funding mechanisms required to address negative economic impact trade-offs, such as through traditional shareholder recapitalisation methods.

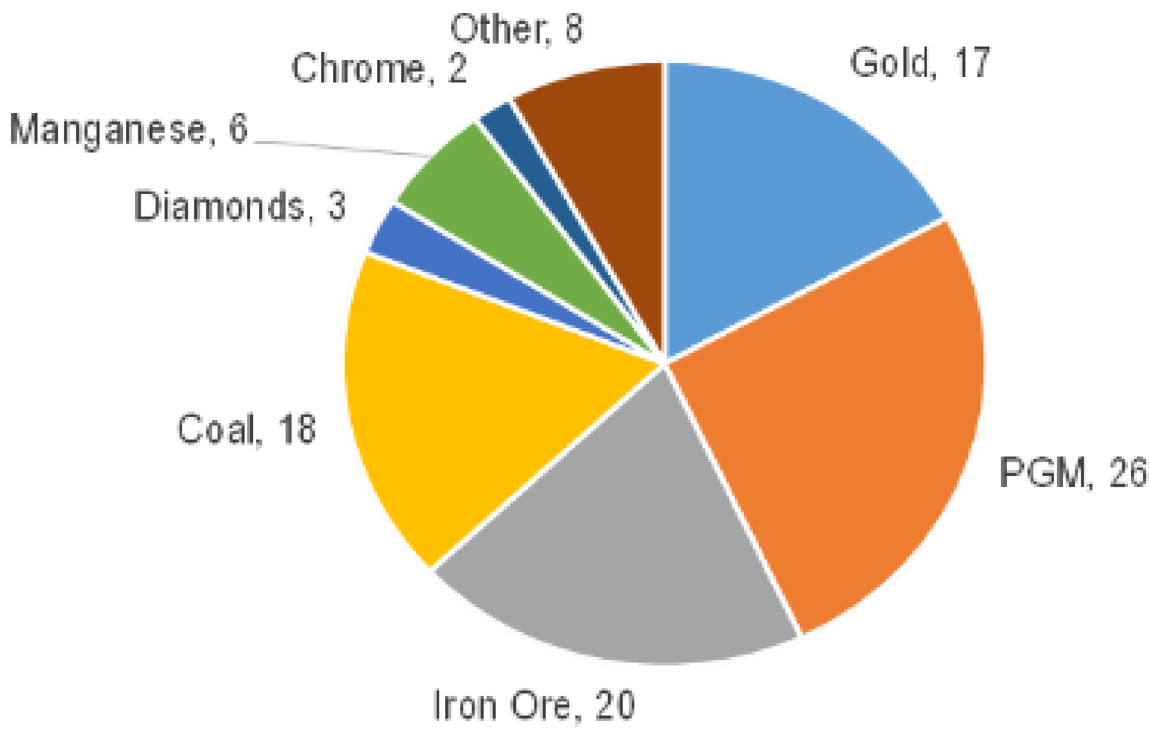
Mining sector contribution significant

Key points

Mining sector contributes (2014):
- ***7.6% to GDP***
- ***26% of merchandise exports***
- ***18.7% JSE market capitalisation***
- ***14% to FDI in 2013***
- ***495 thousand jobs directly***
- ***1.3 million jobs directly and indirectly***
- ***Consumes 15% of total SA electricity consumptions***

Together, Gold and PGM contributes:
- ***43% to mineral exports***
- ***62% to mining employment***

Sector contributions to mining minerals exports in SA



Source: Chamber of Mines estimates; StatsSA

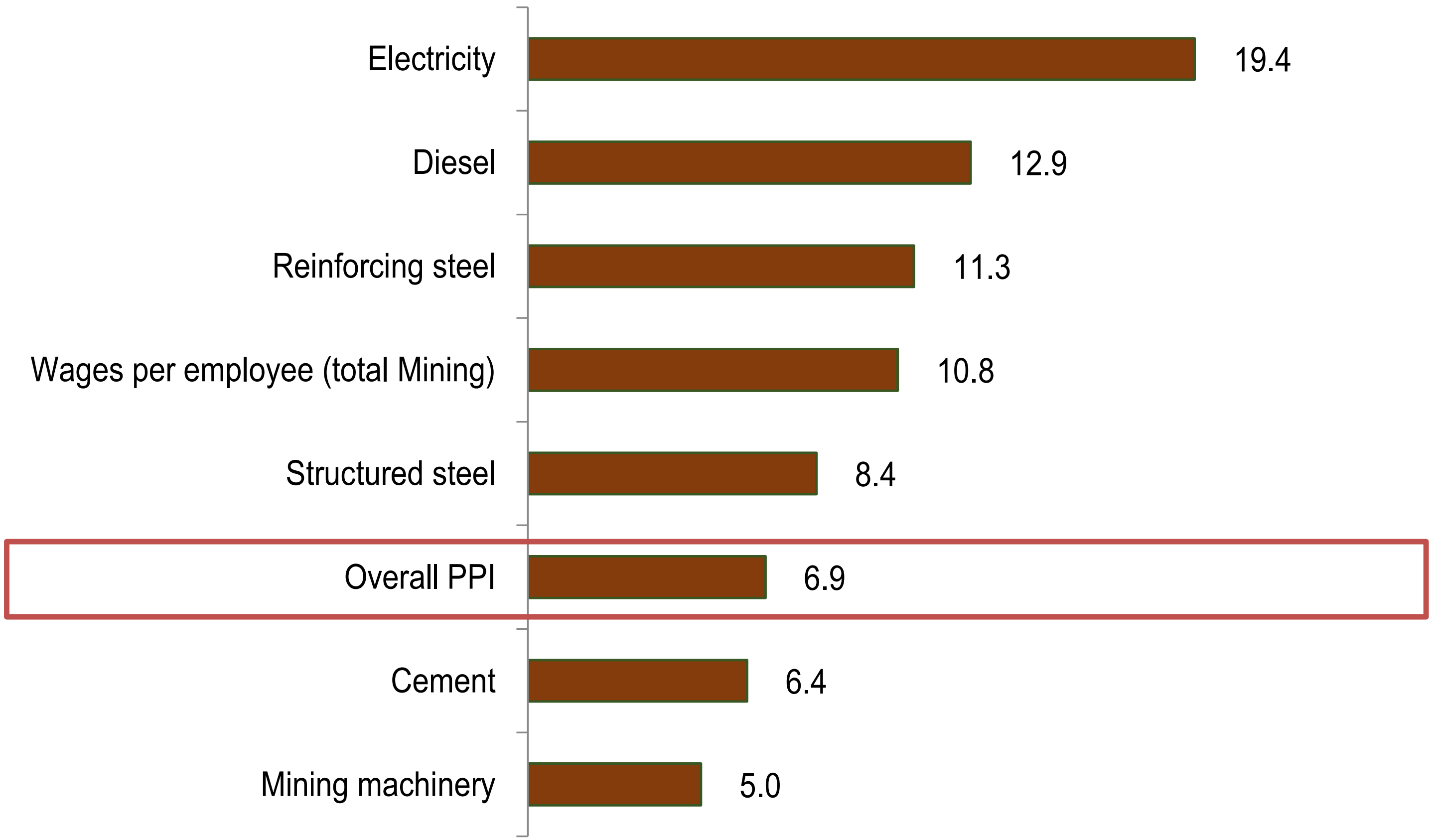
Mining cost has exceeded revenue growth

Key points

Significant cost inflation, with electricity the highest across the various cost components

Especially significant for more electricity intensive users such as Gold and PGM sectors

Cost inflation affecting the mining sector (Annual average increase 2008 to 2014)



Source: CoM EAU

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Capital spend ability is also severely compromised

Key points

Companies' ability to spend capital is severely compromised in the context of:

- ***Negative equity returns over the last 5 years***
- ***Raising net debt levels***
- ***Limited production growth opportunities***

Due to this, shareholders have carried the responsibility of recapitalising struggling mining operations

SA mining companies' net debt and debt cover ratios

JSE listed mining companies	FY 2014	FY 2008
Total Net debt (R million)	1 201	270
Total Net debt excluding AAL, BIL, GLN (R million)	93	40
Total Net debt/EBITDA (x)	2.2	0.62
Total Net debt/EBITDA (excluding AAL, BIL, GLN) (x)	1.4	0.47
No. of companies with Net debt	35	19
% of companies with Net debt	61%	33%

Source: Chamber of Mines, JP Morgan

Capital and production costs: Gold

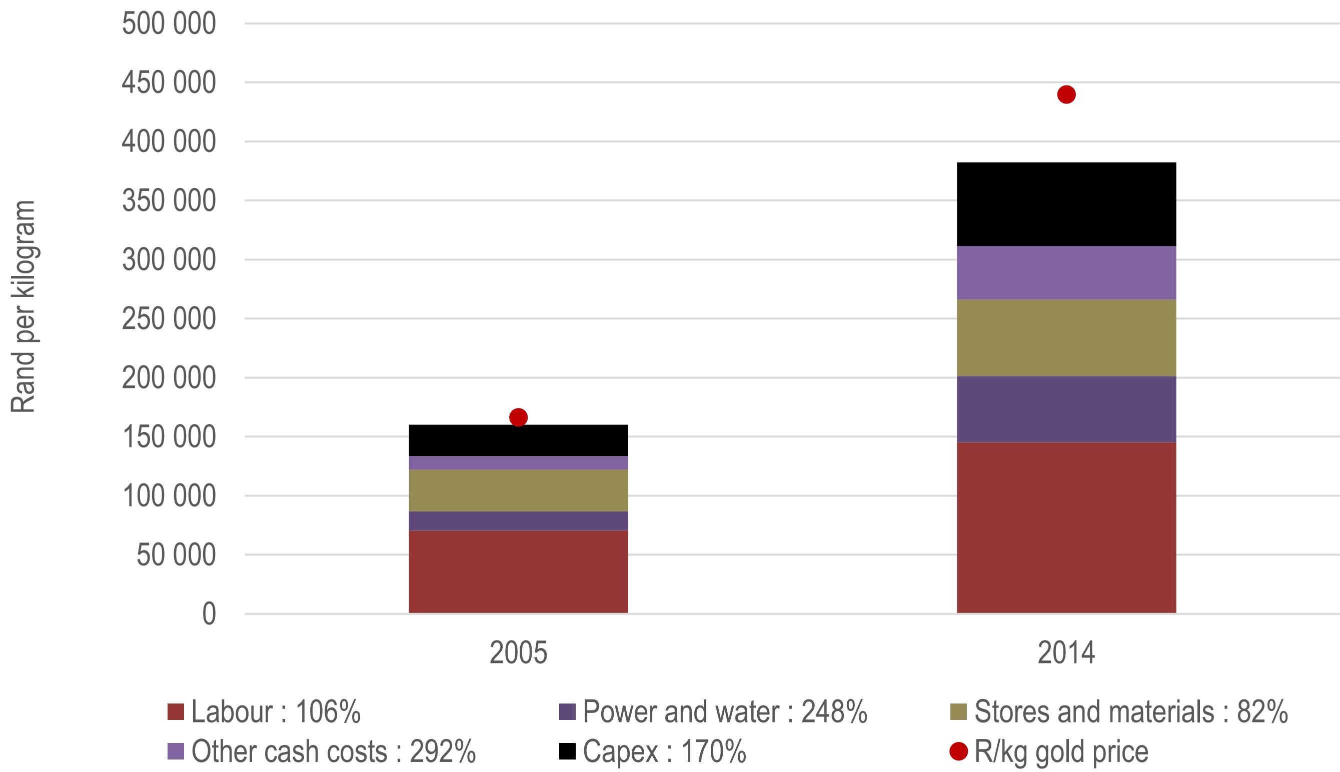
Key points

Unit operating costs have more than doubled over the last decade

Capital cost increases place significant pressure on cash flow and growth opportunities

Power and Water has increased 248%

Cost of producing one kg of gold, real terms



Source: Chamber of Mines member estimates

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Capital and production costs: PGM

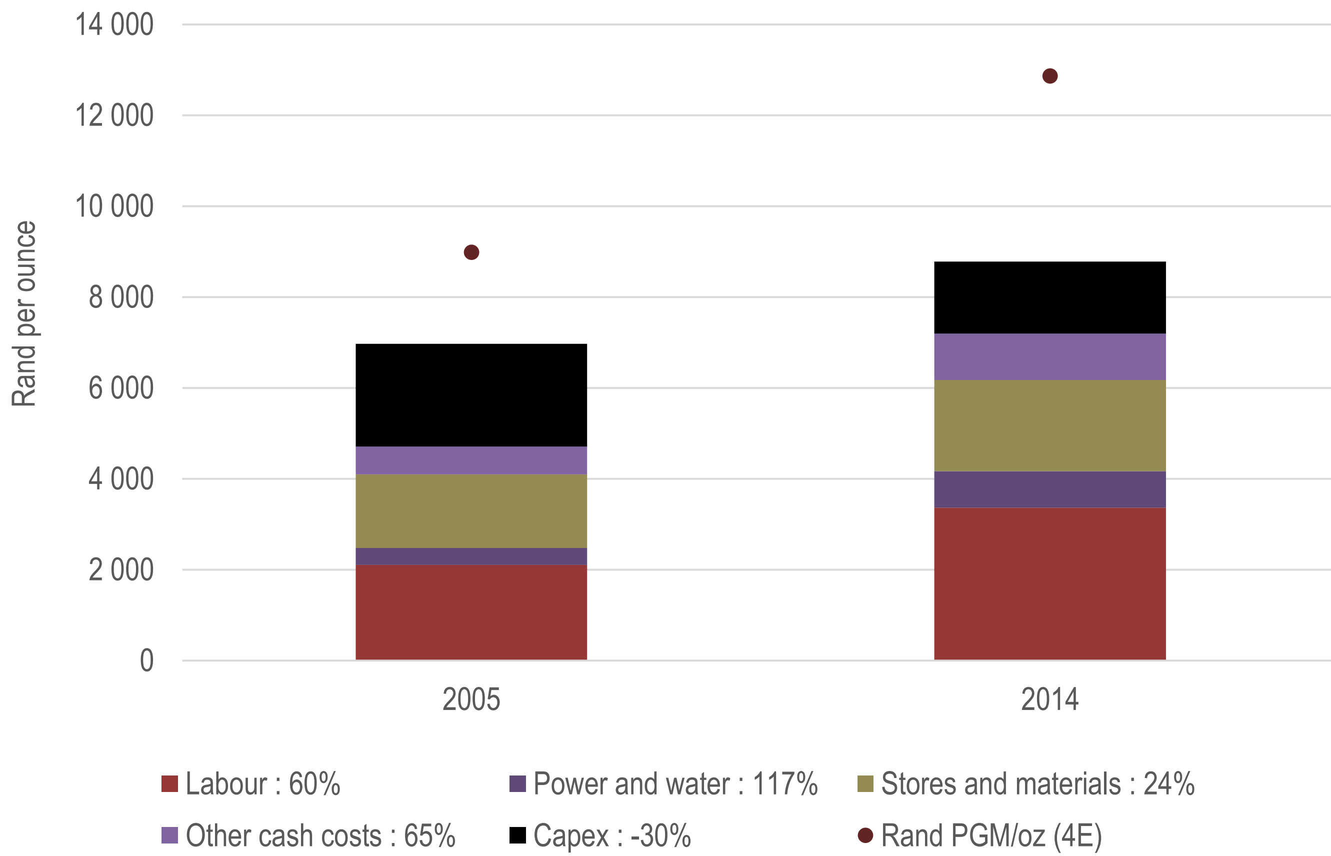
Key points

Reduction in capex a function of reduced production and growth potential

Partially due to lack of electricity availability

Power and water largest cost increases at 117%

Cost of producing one ounce of PGM, real terms



Source: Chamber of Mines member estimates

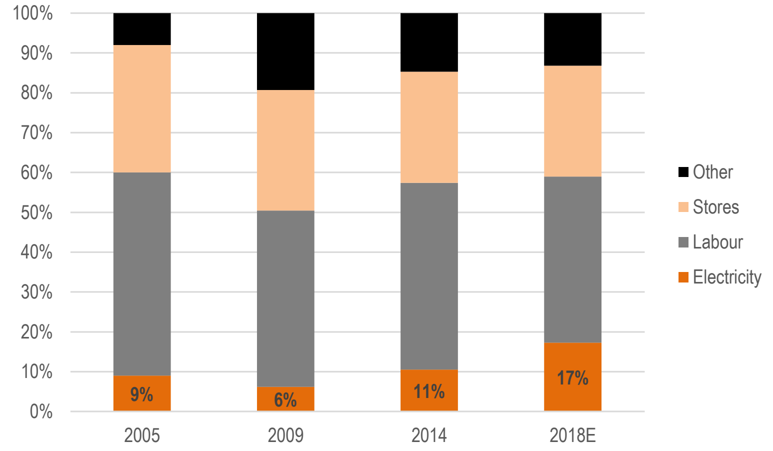
Electricity in relation to total costs

Key points

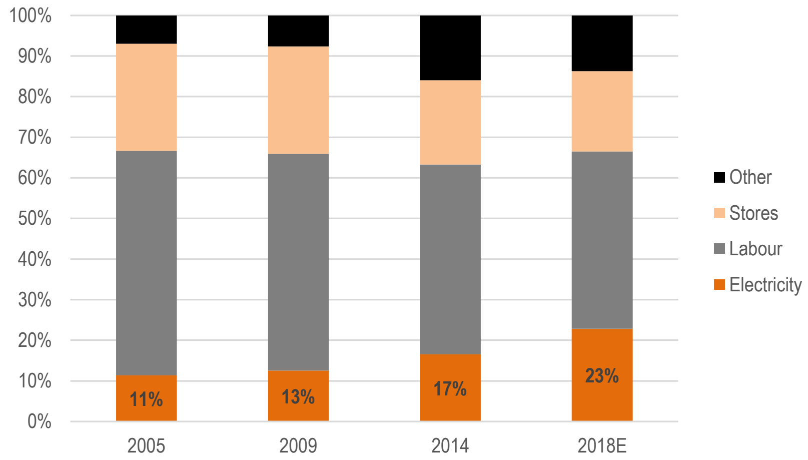
Given the rapid rise in electricity costs in relation to other costs, it is becoming an increasingly important driver of sustainability for the industry

- ***PGM has grown from 6% to an expected 17%***
- ***Gold has grown from 11% to an expected 23%***

Cost components for the PGM sector



Cost components for the Gold sector



Source: Chamber of mines member estimates, *PGM sector proxy represented by 80% of production, ^Chamber members

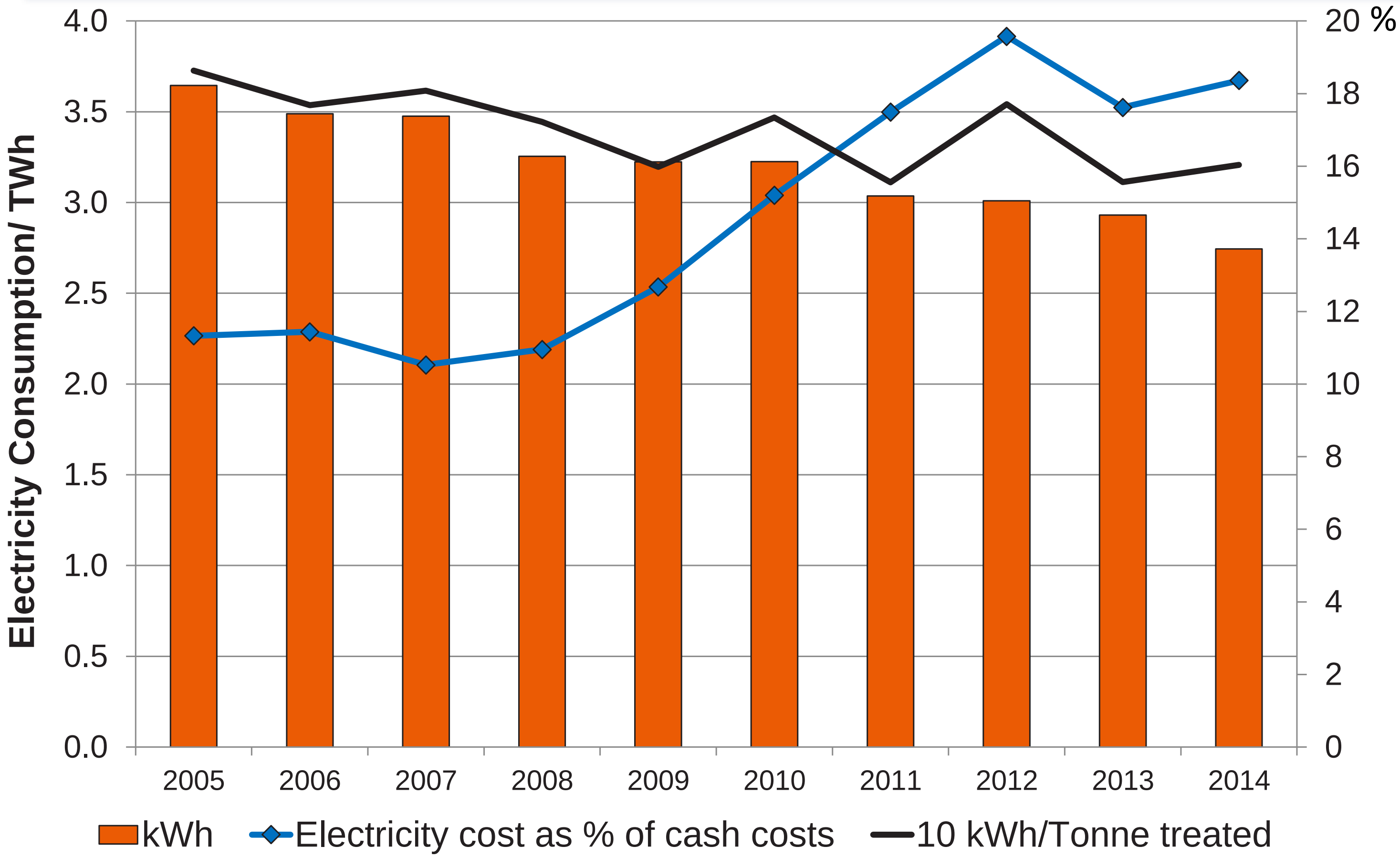
Electricity in relation to total costs: example

Key points

Companies have initiated various energy saving initiatives to reduce consumption by 10% (from 2008)

Despite this, cost increases have more that off-set utilisation reductions

AngloGold Ashanti electricity utilisation and cost implications



Source: AngloGold Ashanti

Profitability and sustainability implications

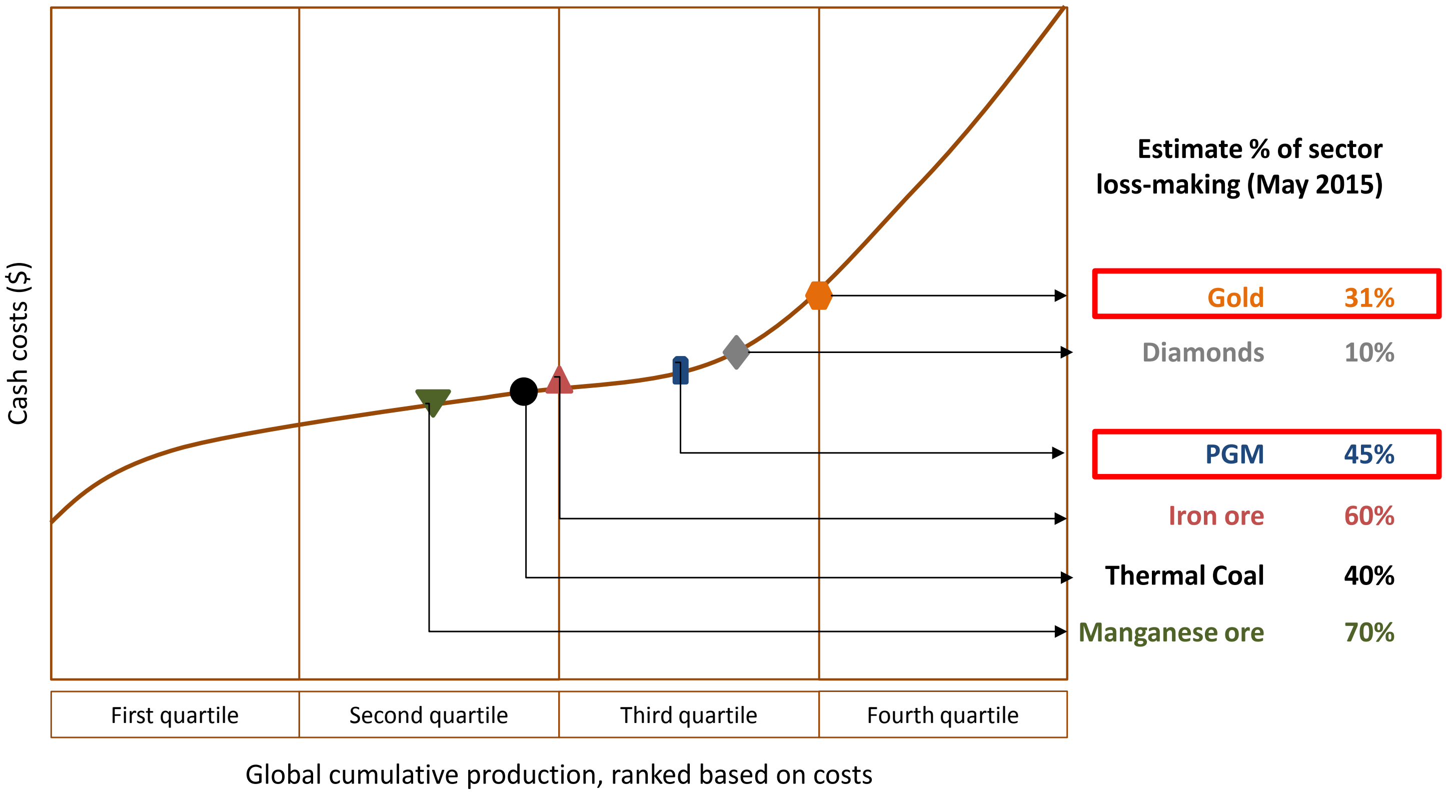
Key points

As at May 2015, on average 50% of the South African mining industry is loss making due to:

- ***Weak commodity prices***
- ***Low to negative volume growth***

Electricity intensive mining sectors = Gold and PGM on upper end of the cost curve, i.e. relatively most uncompetitive

Illustrative SA commodity mining cost curve (2015)



Source: Chamber of Mines member estimates, bank analyst estimates

Impact on Gold and PGM sectors damaging LT

The imposition of the multi-year 24% increase in electricity tariffs could result in further operation closures and job losses

- **Longer term investment and growth** would continue to be materially impacted, with no commensurate benefit:
  - Continued risk of curtailments and operational disruptions; and
  - Limited ability to commit to expansions, discouraging investment.
- For the Gold and PGM sector, we estimate that **60% and 80% respectively of the mining operations are loss-making and margina**l (less than 10% free cash flow / break even) currently
  - Given the existing retrenchments underway, this proposed tariff imposition could results in as much as 20 to 40 thousand additional retrenchments.
- **In a low margin environment, operations are particularly sensitive to cost increases**:
  - For the PGM sector, assuming a low level of commodity price increases, at the current 13% electricity tariff increase proposal, 35% of the revenue benefit would be eliminated.
  - At 24% electricity tariff increase, 70% of the revenue benefit would be eliminated. This is particularly significant when considering, it is independent of any other cost increases such as labour.

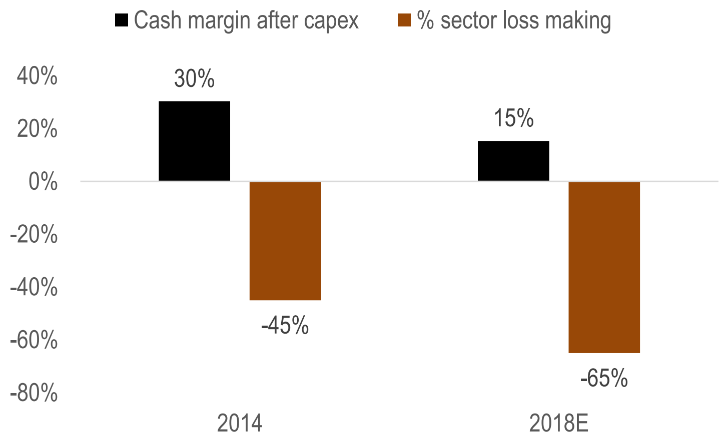
Profitability and sustainability implications

Key points

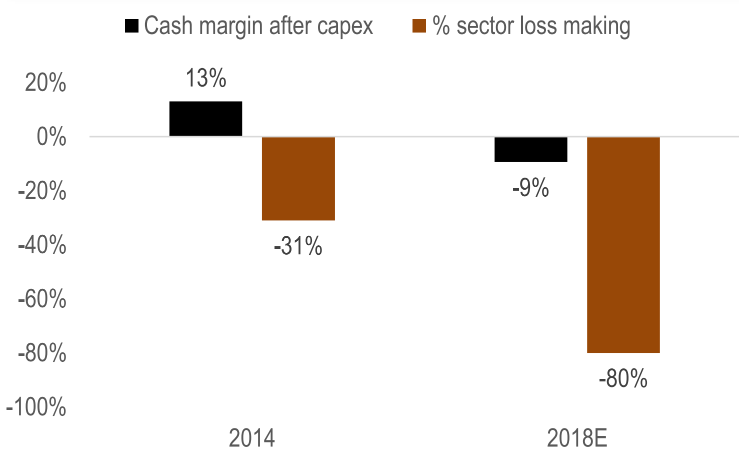
Under a scenario of low pricing environment and no volume growth, we show the impact of continued cost inflation on the sectors (including 24% tariff hike):

- ***PGM sector will fall to margin of 15%***
- ***Gold will be negative 9%***

Cash operating margin (after capex): PGM sector



Cash operating margin (after capex): Gold sector



Source: Chamber of Mines member estimates

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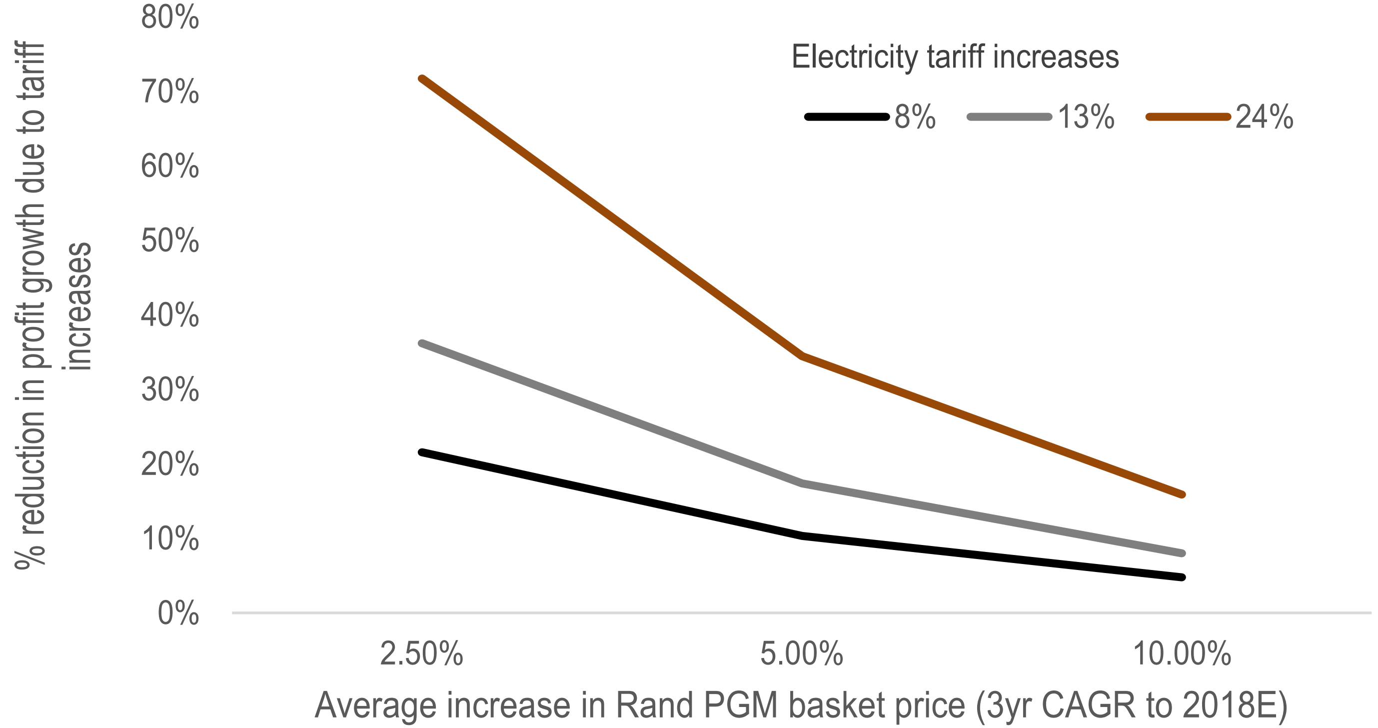
Profitability and sustainability implications

Key points

Given a weak pricing environment, this further increase to 24% would eliminate up to 70% of any potential profit benefit from commodity price increases – it has a significant impact on the industry's long term sustainability and investment potential.

Higher negative impact of tariff increase at lower commodity pricing levels

Reduction in profit growth due to electricity cost increase (Rand PGM price scenario)



Source: Chamber of Mines member estimates

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Chamber of mines position

Mining industry at tipping point – long term demand destruction occurs as negative economic impacts multiply

- **Demand destruction – electricity supply and economic growth linked:**
  - Long term damage to the underlying industry consuming electricity, due to persistent significant increases in cost changes the structural operational exposure.
  - Compromises Eskom's revenue collection base – higher tariff, lower units of consumption due to operational closures.
- **Economic impact trade-off** considerations:
  - Short term strategy of "keeping lights on" and "user pay"
  - Consumers carrying double economic cost of no certainty of supply, with higher costs
  - Long term growth undermined, resulting in mine closures or downscaling, job losses, reduced capital expenditure and negative impact on manufacturing/procurement
- **Alternative funding mechanisms** encouraged to manage the ST vs LT trade-offs:
  - Funding through traditional shareholder recapitalisation
  - Electricity levy increases – reallocation consideration
  - Addressing efficiencies and reducing operational costs in other areas

Chamber does not support the proposed funding mechanism through a tariff hike, alternate funding required to manage tipping point

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?Questions?

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