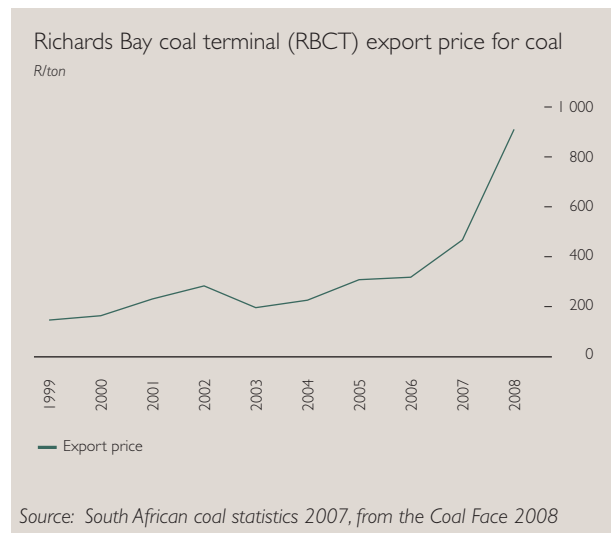


## Market and industry overview



### Financial market and economic trends

In the final quarter of 2007 and in early 2008, global financial markets were dominated by liquidity concerns as a result of the United States housing market credit crunch. As the liquidity concerns spread from the banking sector to the wider real economic sector, the American economy increasingly threatened to dampen world economic growth prospects. A crumbling housing market, increasing energy costs and rampant food inflation all contributed to a real reduction in the level of consumer demand. Weaker economic growth prospects in the United States, weighed heavily on the US dollar.

The possibility of a hard landing in the US economy, and growing concerns about the global credit crunch propelled leading central banks across the globe to inject liquidity in the financial markets. This was done in the form of direct injections, rescue packages for troubled financial institutions and softer interest rates. The US Federal Reserve was particularly aggressive by reducing its key lending rate from 5,25% in August 2007 to 2% to date. The challenges faced by the US economy and increasingly softer interest rates, drove the US dollar to an all-time low against the euro. Although a weaker US dollar raised hope of a correction of the US trade balance against the rest of the world, it also increased the risk of higher energy and food inflation.

A weaker US dollar also meant that commodity prices were pushed higher, at least in absolute US dollar terms. Oil prices continued to set new record levels with precious metals such as gold also rising to historic levels.

South Africa was also subjected to higher energy and food inflation. Faced with higher inflation and rising household debt levels the South African Reserve Bank gradually increased interest rates to maintain price stability. Although economic growth has been robust in recent times, averaging above 5,00% during the last four years, higher interest rates, slowing consumer demand and increasing infrastructure bottlenecks could result in a slower rate of economic growth in the coming quarters.

Higher inflation expectations have translated into some weakness in the domestic capital markets. Given the broader infrastructure initiatives across the economy, and thus the funding requirements, the capital markets could remain under pressure. On the positive side, the government anticipates budget surpluses in the coming fiscal years which could limit its participation in the capital markets and thus free capital for use by parastatals among others. Direct capital injections by the state into Eskom have also been an unprecedented feat, highlighting the overall challenges and opportunities from a developmental point of view.

### Supplier and industry trends

#### Impact of global expansion in the power sector

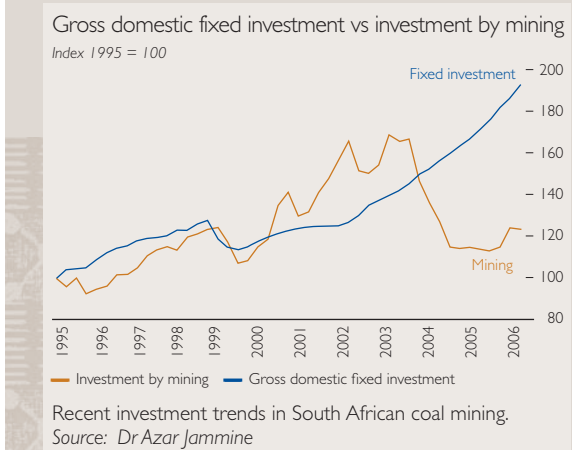
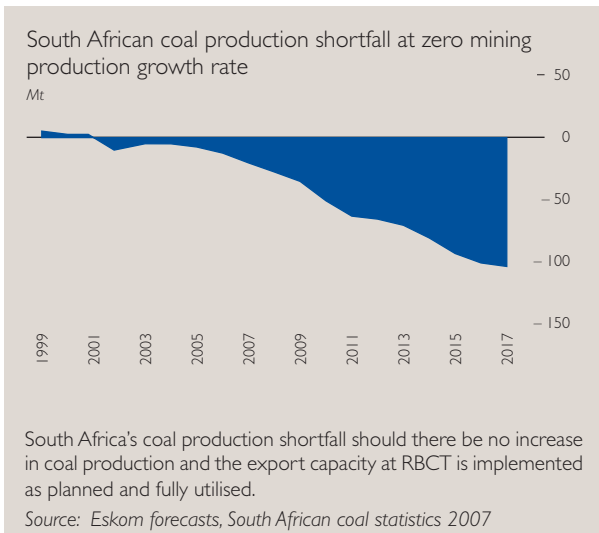
During the last year, the economy experienced extreme turbulence coupled with ever-rising primary fuel costs, commodity price increases and numerous interest rate hikes. The expansion programmes in India and China increased demand for utility-specific commodities. All these factors increased pressure on utilities to secure supply, while at the same time containing costs. Market signals indicate further turbulence in the markets during the months to come. Supply market volatility has seen suppliers struggling to meet demand. While capacity was increasing it was not keeping up with demand, leading to an increase in quality issues, prices and delivery lead times. As supply tightens, traditional suppliers are increasingly declining to bid, thereby increasing the need for global sourcing.

#### Critical skills

The global drive to increase electricity supply capacity, particularly in India and China, has resulted in a growing local and international demand for scarce technical skills both on the operating and construction side.

#### Global coal demand trends

Globally, coal is the fastest growing energy source. Demand for coal is soaring, especially in the Indian and Chinese markets. With increased demand, global coal prices are following the escalating oil price and the South African coal export price at the Richards



Bay Coal Terminal (RBCT) recently broke through USD115 per ton, up from USD53 per ton at the beginning of 2007. This puts pressure on Eskom's short-term coal price and volumes.

The quality of coal required by importers is declining, particularly in respect of the Indian coal market. This makes many current coal sources and, more importantly, potential future sources, with some beneficiation, attractive to the export market. Such coal was, historically, only suitable for the Eskom market.

**South African coal production growth**

The low growth in South Africa's coal production is of very great concern and poses a serious supply risk to Eskom and South Africa. If there is no intervention, South Africa may face an annual coal shortage of up to 100Mt by 2017.

**Water**

Eskom purchases its water at first-tier level from the Department of Water Affairs and Forestry (DWAF) directly via abstraction from state-owned water works or through intermediaries, for example, in the case of Lethabo Power Station, through Rand Water, and Matimba Power Station through Exxaro. DWAF is reviewing the institutional arrangements for the supply of water and is expected to establish the National Water Resource Infrastructure Agency (NWRIA), which will develop, operate and maintain all bulk water infrastructure of national importance at first-tier level.

**Environment and climate change**

Eskom is controlled by various independent regulators including the National Energy Regulator of South Africa (Nersa) and the National Nuclear Regulator (NNR), the Department of Water Affairs and Forestry as well as the Chief Air Pollution Control Officer (Capco) from the Department of Environmental Affairs and Tourism (DEAT). These independent regulators protect the public interest and regulate Eskom's activities to ensure effective

environmental protection. This is achieved, among others, through the issuing of authorisations for construction, permits and licences for particulate emission releases and water usage.

South Africa is a signatory to the United Nations Framework Convention on Climate Change (UNFCCC) and its implementing mechanism, the Kyoto Protocol. As a developing country, there are no binding obligations as yet for South Africa to reduce greenhouse gas emissions. However, there is increasing in-country commitment for development to be carried out in a sustainable manner that will result in benefit to the economy, society and the environment and that is compatible with actions required to combat climate change. It is important that South Africa actively contributes to global efforts to combat climate change while ensuring the sustainability of the economy and society.

Refer to [www.eskom.co.za/annreport08/001](http://www.eskom.co.za/annreport08/001) for more detail on the environment and climate change.

**Electricity distribution industry restructuring**

In October 2006 Cabinet approved the proposal to create six regional electricity distributors (REDs) to consolidate the electricity distribution businesses of the municipalities and Eskom. These REDs are to be established as public entities, accountable to the Department of Minerals and Energy. Electricity Distribution Industry Holdings (Pty) Limited is responsible for implementing government's restructuring policy. The critical next steps include the finalisation of outstanding policy issues and the drafting of enabling legislation.