

AFRICA RISK CONSULTING

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Copper mining companies agree to a 30% decrease in power supply in return for state-owned power utility Zambia Electricity Supply Company (Zesco) reserving the option to purchase potentially more expensive power from neighbouring countries to make up the shortfall. The electricity shortage threatens jobs in the mining sector. Canada-based First Quantum Minerals cuts 1,480 jobs at its Trident project. The power situation deteriorates as the 'hot season' months of September and October approach. The government raises \$565m towards an \$828m project consisting of a 300MW coal plant and coal mine upgrade from major Chinese and African lenders. The plant is scheduled for commissioning in mid-2016. The government removes all electricity subsidies for large businesses without warning on 14 August to fund the remaining \$253m. The Bank of Zambia (BoZ) runs short of dollar reserves as the kwacha falls further to K8.6 to the dollar, a 35% devaluation across 2015. The BoZ keeps interest rate at 12.5% and forecasts that consumer inflation will rise above 7% in the third quarter of 2015.

Power crisis hits mining companies...

Zambia's mining firms have accepted an indefinite 30% reduction in power supply due to the country's continuing power shortage. This has already led to the loss of around 1,500 jobs in the sector and may lead to further job cuts as reduced output hits profits.

Mining companies and the mines and energy ministry engaged in talks during the first half of August to try to broker a deal. Chief executives of mining companies met with mines and energy minister **Christopher Yaluma** on 31 July to attempt to dissuade the government from cutting supply.¹ The **Copperbelt Energy Company (CEC)**, which purchases electricity from the **Zambia Electricity Supply Company (Zesco)** in bulk and sells it to miners in the **Copperbelt Region**, held off on the decision to reduce supply.² Mining companies agreed to reduce power supply by between 10 and 15% on 5 August. The companies argued that they could absorb this by reducing unnecessary electricity usage and switching off non-essential equipment.³ However, the deal that emerged on 12 August was that Zesco and CEC would guarantee 70% of the total supply, but that mining companies would have to pay for Zesco to import the remaining 30%.⁴ The power imports will come from thermal plants in neighbouring countries. Zambia has grid connections with **Angola, Mozambique, Tanzania and Zimbabwe**.⁵

"This is a bad deal for everyone – the government has made some large policy concessions to bail out the copper mining industry and now the power crisis could reduce output just as much. Mining companies may be able to shoulder the cost of higher electricity for a few months but any longer than that would be unsustainable."⁶

¹ Zambia Reports, 31 Jul 2015

² Lusaka Times, 13 Aug 2015

³ Zambia Watchdog, 5 Aug 2015

⁴ Zambia Reports, 12 Aug 2015

⁵ Zesco website, 2015

⁶ Source, mining executive, Johannesburg

The curbed supply has already affected mining companies. **Kalumbila Minerals Limited (KML)**, a subsidiary of **Canada-based First Quantum Minerals**, laid off 1,480 workers on 2 August.⁷ The company was forced to cease construction operations at its **Trident** project, the **Sentinel** copper mine and **Enterprise** nickel mine in **Copperbelt**.⁸ The company has also halted the process of hiring 350 new employees as part of a freeze on all discretionary spending.⁹ The lay-offs came before the deal as a result of a 24% decrease in power supply in the latter half of July (see *ARC Briefing Zambia July 2015*). Zesco restored full power to the Sentinel and Enterprise plants on 6 August but First Quantum has not reversed the lay-offs.¹⁰ The problems in Zambia have pushed First Quantum further towards a credit downgrade.¹¹ Ratings agency **Moody's**, which currently rates First Quantum at B1 with a negative outlook, said that the reduced electricity supply combined with low copper prices could lead to a downgrade in the next 12 months.¹² Canada-based **Barrick Gold** said that the ongoing reduction in power supply and the costs of paying for imported electricity are likely to lead to job losses at its **Lumwana** mine before the end of 2015.¹³ **United Kingdom (UK)-based Vedanta Resources** and **Switzerland-based Glencore Xstrata** also operate copper mines in Zambia and have yet to publicly comment on the effect of the power cuts. However sources within Zambia's mining community confirm that the outlook is poor:

*"We went to the minister and told him what was going to happen if the power supply decreased...he understands that this will mean more job cuts, reduced output, and reduced government revenues."*¹⁴

If the power cuts continue then mining companies may have to permanently downsize some operations:

*"If the power shortages don't stop in November the future of some of our operations here will be in jeopardy."*¹⁵

...as government tries to reduce demand and fund new generation

The government is trying to mitigate the deteriorating power situation by decreasing demand and building new power generation plants. It is funding this through international borrowing and removing subsidies from large businesses. Zesco is still unable to generate enough electricity to meet demand due to low water levels at the hydro-electric plants that make up over 90% of Zambia's electricity generation. Zesco is shedding approximately 560MW per day from the grid, and will continue to do so until the water level rises.¹⁶ Zambia is due to enter its hot season from September to October, the tail end of the May to November dry season, where temperatures average over 30 degrees¹⁷ and electricity demand spikes. Zesco has appealed to the public and businesses to find new sources of electricity generation including solar panels, generators and thermal energy.¹⁸ According to a source in the mines ministry:

*"If the electricity demand does not decrease Zambia will be in total blackout by October."*¹⁹

⁷ Reuters, 2 Aug 2015

⁸ Reuters, 2 Aug 2015

⁹ Reuters, 2 Aug 2015

¹⁰ Lusaka Times, 6 Aug 2015

¹¹ Moody's press release, 3 Aug 2015

¹² Moody's press release, 3 Aug 2015

¹³ Reuters, 14 Aug 2015

¹⁴ Source, mining company, Lusaka

¹⁵ Source, mining company, Kitwe

¹⁶ Lusaka Times, 12 Aug 2015

¹⁷ Lusaka Times, 14 Aug 2015

¹⁸ Lusaka Times, 14 Aug 2015

¹⁹ Source, mines ministry, Lusaka

As well as urging consumers to reduce their consumption, the government is trying to fund new power generation projects. It is raising money for the **Maamba Coal Project**, an \$828m emergency project to build new power plants, overhaul Zambia's coal production and restore full power supply to the copper mines.²⁰ A group of lenders has already raised \$365m to partially fund the project. **China**-based **Bank of China** and the **Industrial and Commercial Bank of China** will lend \$300m, and **South Africa**-based **Standard Chartered** and UK based-**Barclays** will finance \$65 million.²¹ The **Development Bank of Southern Africa (DBSA)** will lend another \$150m towards the project.²² **Singapore**-based **Nava Bahrat Ventures** owns 65% of the Maamba project.²³ The company already owns and operates the **Maamba Coal Mine** and will hold the same stake in the power plant built next to it.²⁴

Chinese state-credit agency **Sinosure** will underwrite the Chinese lending, the first time it has done so for a project in **sub-Saharan Africa**.²⁵ Chinese companies will build the plant, which will aim to be ready for commissioning in mid-2016.²⁶ However, the government still has to raise another \$253m to fund the project.

The government plans to raise the remaining funds for the Maamba coal project by pushing the cost onto businesses. The mines and energy ministry announced on 14 August that it was stopping all subsidies of power sales to large companies with immediate effect.²⁷ Government spokesperson **Vincent Mwale** said that the government would use the extra revenues to build more power plants.²⁸ The power subsidies were part of a government scheme to encourage foreign investors to take over local mines and other industrial facilities.²⁹ The government took the decision without any industry consultation, and industrial businesses are concerned that the removal of subsidies will be permanent:

*"This is an unexpected, overnight increase of expenditure...there must be other businesses out there that won't be able to absorb this cost...the government failed to invest in power generation for years, we should not be paying for this out of our pocket...I bet they won't put them back."*³⁰

Central bank runs low on dollar reserves, keeps interest rates steady

The **Bank of Zambia (BoZ)** is attempting to keep the economy and the currency stable amid the power crisis, low price of copper and strengthening **United States (US)** dollar. The bank has run low on dollar reserves as low copper prices kept the kwacha low against the dollar throughout August.³¹ The kwacha fell steadily across most of the month from K7.66 to the dollar on 1 August to K8.2 to the dollar on 23 August. However, it fell sharply on 24 August to K8.6 to the dollar at time of writing.³² The currency has devalued 35% against the dollar across 2015. This is due to falling copper prices as well as a strengthening dollar. Rumours that the **US Federal Reserve** might raise interest rates in September have prompted prospecting on the dollar on the foreign exchange (forex) markets. This lies behind the 24 August sharp decrease in value – the BoZ no longer has enough reserves of the

²⁰ Lusaka Times, 5 Aug 2015

²¹ Reuters, 5 Aug 2015

²² DBSA press release, 6 Aug 2015

²³ Nava Bahrat website, 2015

²⁴ Reuters, 5 Aug 2015

²⁵ Reuters, 5 Aug 2015

²⁶ Reuters, 5 Aug 2015

²⁷ Ministry of mines press release, 14 Aug 2015

²⁸ Zambia Daily Mail, 15 Aug 2015

²⁹ Ministry of mines press release, 14 Aug 2015

³⁰ Source, manufacturing executive, Ndola

³¹ BoZ press release, 20 Aug 2015

³² XE.com

currency to keep the value of the kwacha stable.³³ A lack of investment, particularly by copper miners, has led to a decrease in the number of dollars coming into Zambia.³⁴

The BoZ opted to keep the base interest rates the same for the third quarter of 2015. The BoZ's **Monetary Policy Committee (MPC)** met on 11 August and took the decision to retain its primary interest rate at 12.5%.³⁵ It also predicts that inflation will rise in the third quarter of 2015 to above the target rate of 7% due to the power crisis increasing the cost of living.³⁶ Erratic power supply requires businesses and individuals to pay for generators and disrupts regular supply chains. BoZ governor **Denny Kalyalya** called on the government to intervene with sound monetary and fiscal policy to ensure economic stability. He praised the government's intervention to restore power to copper mines on 5 August, and called for further curbs on government expenditure to decrease the budget deficit.³⁷

"Behind the BoZ's decision is a calculated gamble that the consumer market will be able to bear an increase in inflation in the short term so that business can continue to perform well in a relatively low interest rate environment."³⁸

Implications

The government's intervention on behalf of mining companies with Zesco and the CEC to restore power supply shows an understanding of the vital importance of mining to the economy. Unfortunately the global low price of copper and the power shortages mean that neither the government nor mining companies are able to take on the extra price of imported electricity. The government appears to be gambling on diversified mining companies being able to support a short term increase in price from August until November, when the rainy season starts. However First Quantum, Barrick Gold, and Glencore have all reported poor earnings for 2014/2015 and may need to cut back Zambian operations to stay profitable. There will be a further decline in the copper sector, and this will have an effect on the Zambian economy – forcing the government to increase its deficit further. However, there are increasingly good channels of communication between mining companies and government. Both can turn these to their advantage in order to increase production when the power supply stabilises.

When this will happen is uncertain. Zambia's almost total reliance on hydro generation has left it vulnerable to drought-based electricity shortages. The new 300MW plant will not patch the 560MW shortfall in the grid. If the situation repeats next year, the government will still need to cut supply. The government cannot afford to fund multiple \$800m power plants. However, smaller solar projects, which are reportedly in the pipeline, offer a lower cost solution to increasing grid capacity. The government's snap decision to remove electricity subsidies from large businesses shows a more worrying tendency in the administration. Despite good intentions – to fund greater power generation – the short-term effect for businesses given no time to prepare for increased costs will be severe.

The long-term effect of low copper production and power shortages are reflected in the kwacha. The currency will remain low so long as government dollar revenues continue to decline. The more the currency slides, the more it will affect the price of goods and drive up inflation. The BoZ has pushed for more time by not adjusting rates up to counteract this. However if the currency does not stabilise by November, it may need to take further action.

³³ Reuters, 24 Aug 2015

³⁴ Reuters, 24 Aug 2015

³⁵ Lusaka Times, 11 Aug 2015

³⁶ BoZ press release, 20 Aug 2015

³⁷ Lusaka Times, 11 Aug 2015

³⁸ Source, development economist, Johannesburg

About Africa Risk Consulting:

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