

EXECUTIVE REVIEW (CONTINUED)

To ensure we remain resilient for the foreseeable future, we need to address the cost competitiveness of our products and consider how best (for aspects within our control) to respond to commodity price volatility.

The table below expands on these risks, our critical controls and the year-on-year trend, based on the residual risk score.

As commodity markets remained in surplus (low demand and oversupply), prices were subdued, resulting in related risks increasing, despite controls and mitigating actions.

Risk number	Strategic objective	Risk and source	Long/medium/short-term risk	Critical controls	Residual risk score 2014		Trend	Residual risk score 2015	
					Impact	Probability		Impact	Probability
4	Achieve operational and financial excellence	Cost competitiveness of products External and Internal	Short/medium	<ul style="list-style-type: none"> Create strategic joint ventures to optimise economies of scale Focus on sustainable cost reduction Business improvement initiatives/programmes Investigate and divest non-core assets Re-optimize capital fleet – mine haul trucks, light vehicles, shovels etc Review and monitor the performance of suppliers and service providers 	Possible	Catastrophic	↑	Likely	Very high
3	Achieve operational and financial excellence	Commodity price volatility External	Short	<ul style="list-style-type: none"> Develop a communication plan that quickly communicates changes to operations Consider how changes to the above affect risk appetite Improve the speed of mine planning to match price volatility Match commodity prices to customer base Negotiate long-term fixed-price contracts 	Likely	Major	↑	Likely	Very high

Dependency on Eskom

Material issue	Key performance indicator	Sustainability capital	Current performance	Legend (indicator)
Dependency on Eskom	Core operating margin (%)	Financial	18	
	Commodity diversification	Manufactured	CCR, ferrous, mineral sands, energy	

The group relies on two major customers (AMSA and Eskom) for its revenue, at 13% and 53% (2014: 15% and 49%) respectively. Exxaro's sales volumes to Eskom were 92% of total sales, supporting close to a third of Eskom's power-generation capacity.

In 2015, several deliberations between the board and the executive committee were held on the group's dependency on Eskom as a major customer. The outcome focused on positioning our coal business to deliver coal cost-efficiently to customers. As noted by the board, we continue to work with Eskom to ensure electricity supply to South Africa, while maximising export revenue to benefit from the weaker exchange rate.

The board review noted that the materiality of this issue had increased in 2015, largely due to three factors:

- The SRC committee's decision to cease production at Matla mine 1 (after Eskom's delays in spending the requisite capital)
- As part of our continued engagement with Eskom on later dates to commission Medupi power station's next five units, we had initial discussions on a possible addendum 10 to the GMEP CSA, to review options available to both parties to reduce future take-or-pay obligations. Deliveries to Eskom were, however, in line with addendum 9
- Eskom's notice to terminate the Arnot CSA.

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Eskom issued Exxaro with a notice that the offtake of coal from Arnot mine would stop after 31 December 2015 (refer SRC committee report). Since then, all production has ceased and an official retrenchment procedure (section 189 process under the Labour Relations Act) was declared. Discussions continue with Eskom on the closure and rehabilitation of this mine (Exxaro owns the mining right while Eskom owns the assets and is responsible for the ultimate mine rehabilitation and post-closure obligations).

Exxaro acknowledges and recognises the long-term relationship we have developed with Eskom over the 40-year tenure of the CSA. We continue to value this relationship, which we anticipate will continue in terms of our remaining coal supplies from other operations.

Our response is firstly to protect the relationship with Eskom through continuous engagement at both operational and corporate levels. Further ensuring a consistent and reliable supply through existing CSA's is critical to fostering a mutually beneficial relationship. Secondly the acquisition of extra export entitlement will provide access to more offshore customers in regions that are growing through coal-based electricity generation.

Completion of ECC transaction

On 20 August 2015, the group acquired 100% of the share capital of TCSA (now ECC) for cash of US\$262 million (R3 381 million) from Total Société Anonyme plus a maximum additional amount of US\$120 million structured in a series of deferred payments linked to the performance of the API4 price between 2015 and 2019 (contingent consideration).

As noted in the board review, our strategic rationale for this acquisition was to increase the scale of the group's export allocation and coal portfolio and further entrench Exxaro as a premier coal producer in South Africa. ECC also complements our strategic imperative to focus on our coal business in the short to medium-term and provides access to primary RBCT export entitlement - an opportunity that seldom arises.

The board review and audit committee report dealt with our ability to negotiate a reduced purchase price (following market volatility), as well as the unfortunate need to impair the goodwill.

Since acquisition, we have focused on improving the profitability and cash flow of these assets, producing mainly for lower-grade export markets. Opportunities include different quality grades and volumes, as well as cutting overheads (following due process, retrenchments were limited to 33 people and concluded early in 2016).

To optimise ECC, we are implementing our operating philosophy and the Exxaro operational excellence methodology by:

- Adding a fifth 4-seam section at Forzando South which is expected to contribute 200kt to 2016 production
- Optimising the resource-to-market value chain through plant and product-mix adjustments, taking the acquired export entitlement into account (evaluating 4 800kcal and 5 300kcal option combinations for 2016)
- Rolling out cost-saving initiatives across all operations (R80 million)
- Exploring available adjacent reserves to extend the current life of mine
- Exploring the Eskom market as a potential customer
- The capital expenditure plan is continuously being reviewed and only critical capital expenditure is approved until the actions above have been finalised.

As part of the DMR's conditions for approving the transfer of ECC mineral rights to Exxaro, we are required to include additional BEE participation in the shareholding of ECC assets. This has been combined with the broader empowerment ownership project currently under way at group level.

We remain confident about the long-term strategic value of acquiring the ECC assets, especially the export entitlement.

Exxaro's integrated risk management approach, linked to our strategic focus areas, has helped us to address our reliance on Eskom as a key customer. In our last integrated report, we highlighted that one of our control measures to mitigate this risk was to increase our export allocation. This was fully implemented on completing the ECC transaction.

The table below expands on these risks, critical controls and the year-on-year trend, based on the residual risk score.

Risk number	Strategic objective	Risk and source	Long/medium/short-term risk	Critical controls	Residual risk score 2014		Trend	Residual risk score 2015	
					Impact	probability		Impact	probability
1	Achieve operational and financial excellence	Dependency on Eskom as key customer External	Short/medium	<ul style="list-style-type: none"> • Broadening local and international customer base (incl acquisition of ECC) • Establishment of bespoke rehabilitation trust fund • Cessation of operational activities at Arnot (develop a detailed closure plan for Arnot) • Conduct studies for environmental programme report • Conduct social impact studies for Arnot • Renegotiate Medupi CSA (addendum 10) • Oppose the payment of penalties • Terminate discussions on commercialisation of Matla 	Likely	Catastrophic	↑	Almost certain	Catastrophic
6	Achieve operational and financial excellence	Competition and product substitution External	Medium	<ul style="list-style-type: none"> • Early alerts on regulatory changes • Implement diversification strategy • Proactive engagement with stakeholders • Monitor interdependent sectors 	Possible	Major	↑	Likely	Major