Presentation of the PBO Report on State-Owned Enterprises

Joint Sitting of the Standing Committee on Finance and Portfolio Committe on Public Enterprises

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Parliamentary Budget Office

PARLIAMENT
OF THE REPUBLIC OF SOUTH AFRICA

Presentation outline

1. Introduction
2. State-owned enterprises in a developmental state
3. Non-commercial mandates
4. Financing state-owned enterprises
5. Asset sales

Note on terminology

SOE: state-owned enterprise (also used for 'state-owned entity')

- State-owned entities: all (national, provincial and local) entities listed under the Public Finance Management Act schedules
  - from Constitutional institutions to museums, water boards and large commercial entities
- State-owned enterprises: "legal entities created by government to undertake commercial activities on its behalf"
- For consistency with local and international literature we use 'SOEs'
  - Other terms used are: 'Government Business Enterprises' and 'Major Public Entities' (PFMA)
  - The report did not look at Development Finance Institutions (DFIs)

3

- State-owned enterprises can take various forms; those governed by Companies Act also called SOCs. The taxonomy used by the PRC is provided in the full report.

Typical roles for SOEs

In countries with mixed, market-based economies a common question is: "why are SOEs necessary?" Common reasons are:

Market failure

Where the private sector does not undertake investment or production in a certain area despite that yielding a net benefit to society (e.g. social housing)

Equitable access and affordability

Ensuring universal access to critical services and infrastructure (early example: postal services)

Natural monopoly

Where government owns an enterprise to limit the negative consequences of monopoly power that arises from a sector's structure (e.g. rail infrastructure)

Strategic significance

Enterprises that are relevant to national security, or securing supply of a critical resource, are often referred to as 'strategic' and placed under state ownership (e.g. defence-related activities, or critical infrastructure)

4

- These are the 'textbook' reasons for SOEs, relative to the assumption that private ownership is the default situation. The approach may be quite different in the case of a country like China, where public/state ownership has been the norm.
- An important point, which we deal with further below, is that these are not the only possible roles for SOEs. In countries with governments that intervene more actively in the economy, there may be other/additional reasons for establishing/having SOEs.

Background: MTBPS

- Terms of Reference derive from the following statements/commitments in the 2014 MTBPS

1. "[developing] a new framework for funding state-owned companies that will distinguish purely commercial activities from the costs of exercising their developmental mandates"
2. "state-owned companies should operate on the strength of their balance sheets"
3. "capitalisation will only be funded by the sale of non-strategic state assets, and will not be drawn from tax revenue or added to the debt of national government"

- Clear that SOE financing is therefore relevant to the fiscal framework and revenue proposals (SCoF)

5

- In the past, SOE oversight has mostly been conducted by Portfolio Committee on State-Owned Enterprises and Standing Committee on Public Accounts. The current environment, and the PRC Report discussed below, suggest a greater role for coordination between Parliament's committees of Finance, Appropriations, State-Owned Enterprises and relevant portfolio committees (e.g. Energy).

Background: PRC

- Three phases of SA policy on SOEs: privatisation; restructuring; rationalisation
- Presidential Review Committee on State-owned Entities ('PRC') was established in 2010 and published its final report and recommendations in 2012
  - A significant component concerned governance issues, largely outside the scope of the current report
  - Recommended that government should "periodically review and balance the social, political and economic priorities of SOEs"
- PRC recommended that a 'transitional SOE reforms committee' and an 'SOE Council of Ministers' be established to take forward its recommendations

Background: PRC

- Another important high-level recommendation is the passing of 'SOE Act' based on the Draft Government Shareholder Management Bill (2008)
  - Reportedly to be tabled before the Portfolio Committee on State-Owned Enterprises in 2015
- Some of the PRC recommendations relevant to the current report:
  - The need for a consolidated funding framework for commercial SOEs and DFIs
  - Approach to 'non-financially viable commercial SOEs'
  - Economic regulation
  - SOE self-financing through debt
  - Private financing

Current report: terms of reference

- Given the above, the terms of reference for the current report has four topics:
  1. The role of the SOEs in forging a developmental state in South Africa
  2. Separation of commercial and developmental mandates
  3. Alternative approaches to deciding the extent of state financial support to SOEs
  4. Factors relevant to determining whether state assets are 'non-core' and can be sold to raise revenue – as proposed in the 2014 MTBPS
- Detailed analysis of any SOE is out of the scope of the report – some illustrative examples have been provided in relevant sections.
  - Further work on particular enterprises is possible

Current report: information sources

- Based mostly on analysis of local and international literature, policy documents, secondary data and – for very recent developments – press statements and newspaper articles
  - Was not possible to obtain data from 2012 database created for PRC. Currently housed at HSRC and needs to be updated.
  - Obtained useful policy documents from National Treasury and some aggregate data, but detailed data on SOE balance sheets and data on state assets was not provided.

The developmental state and SOEs

- Current policy framework draws on the notion of a *developmental state*
- *Developmental state*: government plays a central and active role in the process of economic development
  - In contrast to a *regulatory state*: government focuses its resources on regulating private sector activity
- Characteristics of successful developmental states
- Additional role of SOEs in a developmental state – in addition to 'traditional' roles listed previously

10

- Successful developmental states characterised as those that plan, coordinate and implement steps to achieve a vision for economic development. Doing this requires technical capacity and competence, an ability to establish social compacts, and avoiding capture by partisan interests.
- SOEs provide a potential lever for government to influence or direct economic activity. Among the expectations of SOEs that may go beyond their more traditional roles are: investment in economic infrastructure; promotion of industrial policy; and increasing the competitiveness of South Africa's economy

Non-commercial mandates

Government is proposing a new framework for funding state-owned companies that will distinguish purely commercial activities from the costs of exercising their developmental mandates

(National Treasury, 2014 MTBPS)

Non-commercial mandates

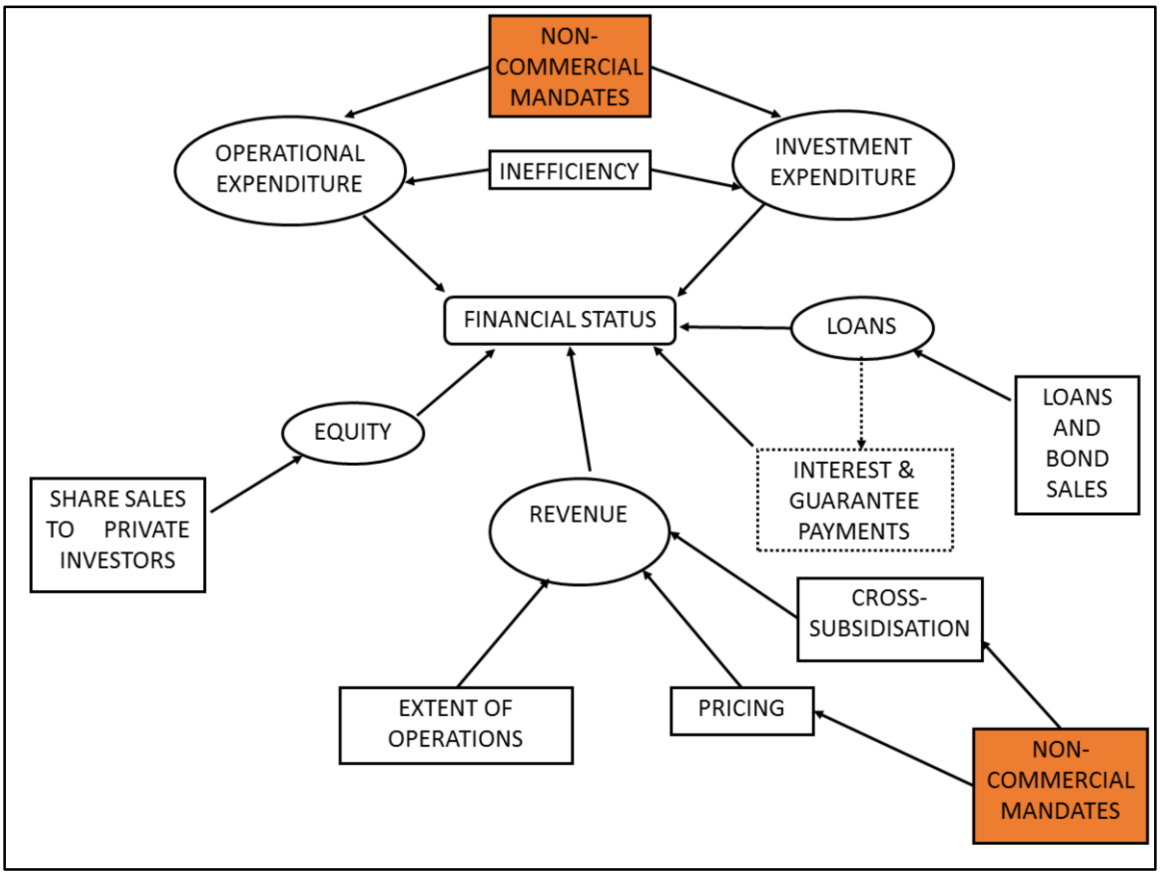
- A *non-commercial mandate*: could be anything that an entity does, or is expected to do, that would not be expected of a private company in the same industry or situation
- Examples: e*xpanding access* to services; providing *affordable services; investing in infrastructure* that has wider social and economic benefits; providing, or generating, *employment*.
- In SA context could add: skills development, preferential procurement and small business development
- (Implicit forms of such mandates can also potentially arise from vested interests and weak governance)

12

- Note that the notion of a formal mandate arises particularly in context of the corporatisation of SOEs.

Topical examples

- It has been claimed that non-commercial mandates have negatively affected various SOEs. For example:
- Eskom
  - Delayed maintenance and use of diesel turbines
  - Non-collection of municipal debt (to protect municipalities?)
  - Inadequate tariff increases (to protect consumers and firms?)
  - Empowerment requirements in the coal supply chain
  - Expansion of access (to address Apartheid legacy)
- SAA
  - Loss-making international routes
- Outside scope of the report to assess these claims, but evidently important for assessing SOE finances



- Simplified diagram illustrates the logic behind concerns relating to non-commercial mandates:

1. Standard 'commercial' factors affecting enterprise finances
2. Problems with finances could be caused by inefficiency (poor planning, wastage, overspending, corruption, etc)
3. But could also be caused, in part, by non-commercial mandates

Implicit funding of mandates

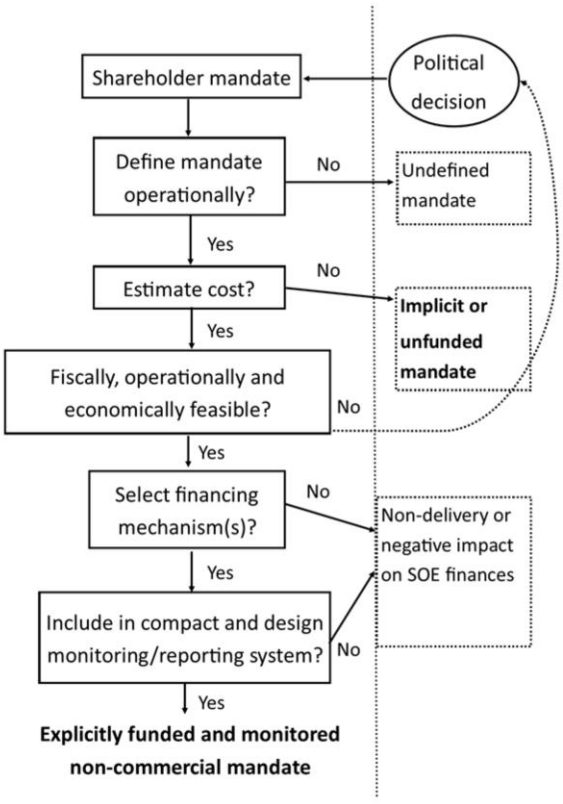
- Various ways in which non-commercial mandates are/can be funded implicitly:
  - Reduced earnings expectations from the state shareholder
  - Allowing (relatively) higher tariffs for SOE's goods/services
  - Cross-subsidisation within an SOE
  - Cash transfers/'bail-outs' in response to financial difficulties
- In some instances these may be an acceptable 'second best' solution, however:
  - Makes performance monitoring more difficult
  - Under some circumstances(e.g. bail-outs) may increase financing costs
  - Unlikely to be work well when mandate costs are large

Separation of mandates

- PRC argues that non-commercial mandates should be explicitly contracted and funded by the state – consistent with international literature and NDP
- Some reasons for explicit separation and funding:
  - Ensure SOE is adequately compensated (neither excessively nor inadequately)
  - Makes costs of mandates transparent
  - Better prioritisation of mandates
  - Strengthens performance monitoring and evaluation

Practicalities of separation

- Various possible approaches to separation. All likely to share some core requirements and challenges
  - Some countries opt to 'commercialise' non-commercial mandates
- Among the challenges:
  - Defining mandates operationally
  - Costing mandates
  - Determining appropriate financing mechanisms
- Role of shareholder compacts (in SA)
- Illustration of what basic process might look like:



- Diagram provides a rough outline of what a structured approach for selecting and financing non-commercial mandates might look like.
- The process begins with political/policy decision that determines a broad mandate. Various practical steps are required to get this to the point of an implementable, affordable and funded mandate for which performance can be monitored and accountability ensured.

Key issues

- To what extent have non-commercial mandates contributed to current SOE financing requirements?
- Do SOE financing initiatives take into account the consequences of past and present approaches to funding non-commercial mandates?
- Are there cases where implicit financing of mandates is undermining the state's broader developmental objectives?
- Do the existing guidelines for shareholder compacts make adequate provision for mandate separation and funding?

19

- The issues listed emerge from the preceding discussion and analysis. In the written reports (Overview and full report) they are listed at the end of each section.

Key issues

- What progress is being made in providing shareholder compacts to Parliament for oversight?
- What role may the draft Government Shareholder Management Bill play in addressing the separation and financing of non-commercial mandates?
- What are the alternatives to separation in cases where it is not feasible?

Funding state-owned enterprises

The State, as owner should ensure [state-owned entities] access to adequate funding... The Government should adopt appropriate funding principles and models...Government should address the issue of non-financially viable commercial SOEs

(Presidential Review Committee on State-owned Entities, 2012)

Funding state-owned enterprises

Given fiscal constraints over the next two years, capitalisation will only be funded by the sale of non-strategic state assets, and will not be drawn from tax revenue or added to the debt of national government. Government policy remains that state-owned companies should operate on the strength of their balance sheets.

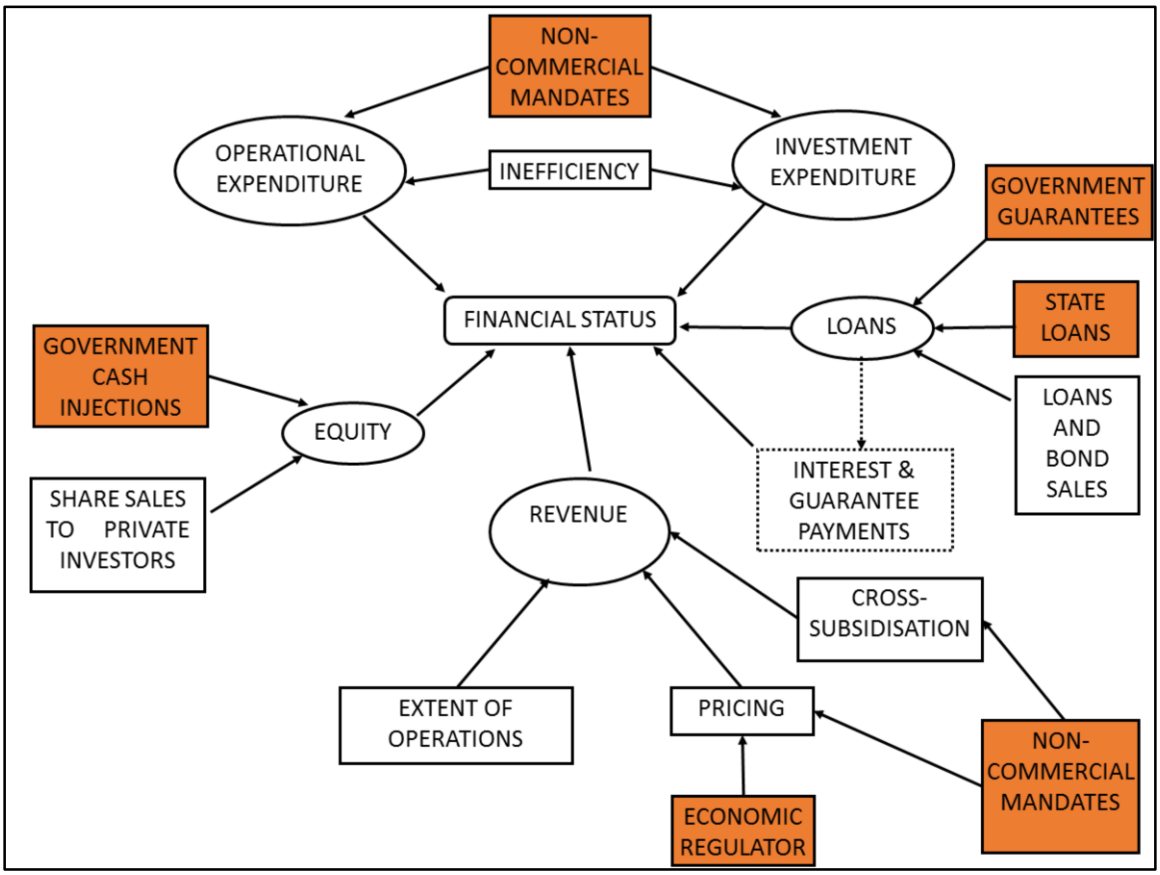
(National Treasury, 2014 MTBPS)

Why fund SOEs?

- As commercial entities, SOEs earn revenue and can borrow from financial markets: why fund them?
- Three main reasons:

1. Capitalisation
2. Non-commercial mandates
3. Reducing (public) borrowing costs

- Other reasons: economic shocks; SOE not entirely self-sufficient; recapitalisation for infrastructure projects; etc
- Furthermore, various mechanisms that can be used to provide financing/financial support



- The diagram shows the previous, simplified model of SOE finances (commercial aspects plus non-commercial mandates) extended to include state financing channels/mechanisms.

Important observations

- The *balance* in SOE financing matters: financial outcomes can be compromised by a number of sources
- The merits of financing an SOE are inherently linked to the reason for the SOE's existence and its mandates
- Government can provide *direct* or *indirect* financial support to SOEs
  - Both must be considered in assessing financial performance
- PRC outlined alternative approaches to 'non-financially viable commercial SOEs'
  - But how to assess inherent 'financial viability' given complex set of influences on financial outcomes?

25

- Balance is important. If any one source of financing is inadequate it may place a greater burden on other sources. Alternatively, if financing from one source is excessive, it will limit the efficacy of any conditions attached to other sources.
- Examples of indirect financing are government guarantees and regulated tariffs. Examples of direct financing are cash transfers and loans. Table 1 in the full report lists some advantages and disadvantages of different financing mechanisms.

PRC on 'non-financially viable' SOEs

The *PRC has recommended* that government "should address the issue of non-financially viable commercial SOEs…by considering some of the following options:

- Rationalisation of SOEs based on certain criteria; or
- Limit State involvement where technology disrupts natural monopolies; or
- Retaining and adequately funding them as non-commercial entities; or
- Injecting private sector practices and therefore gradually phasing them into commercial entities with a mix of public and private equity ownership; or
- Completely disposing of them as State entities; or
- Absorbing them into the line function department where there is a case for running them less costly as a Government line function.
- The final determination should be done in concurrence with the SOE Council of Ministers."

Competitive neutrality

- Literature on SOE financing produced by IFIs increasingly focuses on 'competitive neutrality'
  - The idea that state support to SOEs should not benefit those enterprises relative to actual or potential private sector competitors
- In SA:
  - Incremental adoption of some principles (e.g. debt guarantee fees)
  - Recent PRC recommendations relating to economic regulation
- However, unclear how/whether this principle is compatible with developmental state orientation

27

- Rationale for competitive neutrality is that allowing SOEs advantages over private firms dulls the effect of competition ('market discipline') and thereby allows inefficiencies, reduces social welfare, etc
- However, it is not clear that such considerations are necessarily the primary concern in developing countries or, specifically, developmental states

Direct versus indirect funding

- Direct funding places immediate burden on the fiscus; part of standard Budget process and oversight
- Indirect funding increases risk of future costs to fiscus or shifts burden to other parts of society/the economy
  - Relieve the burden on public finances
  - Less oversight by legislature (and general public)
  - More often neglected when looking at SOE financial outcomes
- Report focuses on three forms of indirect funding:
  1. Economic regulation (tariff determination)
  2. Debt guarantees (contingent liabilities)
  3. Public-private partnerships (PPPs) and sale of equity (involvement of private capital)

Economic regulation

- Tariff regulation by independent regulators has major effect on SOE revenue
- PRC notes serious concerns with regulation to date:
  1. Unwarranted negative effect on finances from *low* tariffs, particularly SOEs with large infrastructure programmes
  2. Possibly *excessive* tariffs compromising incentives for efficiency and industrial policy
- Tariffs are appealing as way of reducing strain on fiscus
- Limitations:
  - Distributional consequences
  - Effect on economic activity
  - Administered price contribution to inflation

29

- Poor regulatory decisions are, according to the PRC, partly due to capacity problems in regulators themselves, but also due to unclear policy frameworks and processes.

Debt guarantees/contingent liabilities

- National Treasury can issue debt guarantees to SOEs
  - Allow an SOE to borrow more and/or at a lower rate
- Advantages:
  - SOE debt stays on their balance sheets not government's
  - Can potentially reduce SOE borrowing costs to better reflect risk – *if* government has better information than markets
- Disadvantages:
  - Increased risk of future demands on public finances
  - Deferring financial difficulties could encourage inefficiencies
  - Can reduce oversight of public finances

Debt guarantees/contingent liabilities

- Contingent liabilities discussed in PBO input on the Budget
  - South Africa's net liability levels, including debt guarantees, are planned to stabilise at 58% of GDP by 2017/18
  - Debt guarantees utilised by SOEs total R224.9 billion in 2014/15: 5.8% of GDP from low of 2.6% of GDP in 2008/9
  - *Total* guarantees issued by the National Treasury are R461.1 billion (11.9% of GDP), of which majority (R350billion, 76%) is to Eskom
- Closer monitoring of the risk to the fiscal framework posed by contingent liabilities may be advisable

Private capital: equity and PPPs

- Constrained public expenditure and apparently large cash reserves being held by private sector firms makes *involvement of private capital* appealing
  - Sale of equity in SOEs could be part of 'restructuring' (PRC)
  - Would need to be reconciled with rationale for SOE & mandate
- Since financing difficulties often arise from infrastructure projects: PPPs are an appealing option
  - Can alleviate immediate funding problem
  - Utilise private sector knowledge and expertise

Private capital: equity and PPPs

- PPPs have a number of limitations and risks
  - Typically do not *reduce* total financing burden, just shift it to later periods
  - May be accompanied by significant risks (financial, performance, political, etc)
  - Treasury has PPP Unit but designing appropriate contracts is challenging
- If financing burden is reduced, this is typically through 'user pays' structures which have their own challenges
  - PRC notes the potential for distinguishing between social and economic infrastructure

Key issues

- Where does the responsibility lie for ensuring an appropriate balance between financing mechanisms?
- To what extent can existing financial challenges be alleviated by changes in SOE management or operations?
- Assessing financial viability – as per PRC – requires accounting for weaknesses in funding and policy frameworks.
- Economic regulation of tariffs has been problematic, particularly for SOEs with large infrastructure programmes.
- PRC envisages uniform framework for economic regulation being implemented between 2020 and 2025; what should happen with tariff-based financing until then?

34

- Reproduced from the overview report.

Key issues

- The relationship between developmental state economic policy and competitive neutrality must be adequately reconciled.
- What is National Treasury's plan to manage contingent liabilities over the MTEF, and how can Parliament improve its oversight of any associated risk to public finances?
- Can the use of private capital be reconciled with the reason for state ownership of enterprises?
- PPPs can spread-out the burden of infrastructure financing, but can also expose the state to significant risk. Could be subject to greater Parliamentary oversight.
- For accountability and equity the financial burden and financial risk of SOE funding should be distributed equitably over generations.

Disposal of state assets

Over the next two years, capital injections for Eskom and funding for other state-owned companies will be raised in a way that has no effect on the budget deficit. In some instances, government will dispose of non-strategic assets to raise resources for financial support. Such assets could include property, direct and indirect shareholdings in listed firms, non-strategic government shareholdings in state-owned companies and surplus cash balances in public entities.

(National Treasury, MTBPS)

General points

- ‘Non-strategic assets’ not clearly defined
  - ‘Strategic’ typically used differently in SOE literature
  - Appears to imply: a commitment that no asset required for implementing important policies will be sold
- Implies other mechanisms are not appropriate: should be considered in light of previous slides on SOE financing
- Limited Parliamentary oversight of asset sales
- Database of assets not provided to PBO, which has limited analysis possible
  - Speculation by other analysts that shareholdings in listed companies (financial assets) likely to be sold

Practical considerations

- Existing asset database is likely to have a number of limitations (as in other countries)
  - E.g. comprehensiveness and asset valuations
- Commitment to provide SOE transfers only after receipt of funds sends positive signal of sorts, but:
  - Pressure on sale process could lead to lower prices
  - Uncertainty/risk could negatively affect SOE financing costs
- Important aspects of process:
  - Pre-sale valuation
  - Selection and design of appropriate sale/disposal mechanism
  - Time required to structure sale of certain assets
- Currently unclear how surplus cash balances of public entities could be used to finance SOEs

Policy considerations

- Since the stated purpose of the disposal is to raise revenue, proposals should be assessed by this standard
- In addition:
  - Should not sell assets required for implementation of important policies: onus on Executive to address this
  - Asset ownership after sale should not excessively compromise other policies/priorities (e.g. creation of an oligopoly)
- Other basic principles:
  - Maximum transparency
  - Avoidance of 'rent-seeking' (where private interests benefit from the asset being sold at below its market value)

Thank You