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**MINISTRY**

**PUBLIC ENTERPRISES**

**REPUBLIC OF SOUTH AFRICA**

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**Minister Lynne Brown’s**

**Briefing notes on Performances and Challenges of SOCs**

**PURPOSE**

To provide Minister with briefing notes regarding the performance and challenges facing the State Owned Companies (SOCs) in preparation for the Portfolio Committee.

**DISCUSSION**

The performance of SOCs is largely influenced by the performance of the domestic economy and the State of the Global economy. Since 2007, the economy has grown on levels much lower than anticipated in Government’s economic policy framework. This context defines the operational environment of SOCs and strongly influences their financial sustainability. Assessing performance of SOCs must take this context into account.

Furthermore, post the global economic crisis, Government issued an instruction that required SOCs to be implementers of Government policy and support the implementation of the countercyclical policy framework. Since 2007, SOCs have driven the investment strategy of the State. Most of the SOCs have undertaken investments at an accelerated rate in a declining economic environment.

The SOCs are also faced with challenges ranging from financial and operational sustainability to policy decisions that have an adverse impact on the viability of the SOC operations.

There are Acting appointments/vacancies of CEOs in SOCs, in Denel the CEO position is awaiting Cabinet process; SAFCOL Board will undertake an open recruitment process; at Alexkor the CEO and CFO recruitment has begun; and Eskom CEO recruitment process has also commenced. SOC specific issues are further highlighted below.

* + 1. **ESKOM**

Eskom operates in a complex and highly regulated environment and the policy decisions determine whether the SOC will be operationally or financially sustainable or not. The challenges facing Eskom are the uncertainty regarding the role of the company in the future build programme, the adverse impact of IPP programme on the potential impact on its balance sheet, and high environmental compliance costs.

* + 1. **IPPs**: We are committed to the energy mix which includes coal, renewables, nuclear and gas. IPPs were conceived when growth was forecast above 5% and electricity demand growth has decreased. So the IPP 2010 did not materialise and price determinations made including Medupi, Kusile and IPPs (renewables, coal and gas) were made based on these assumptions.
    2. There is a risk of excess capacity; take or pay agreement commits government to long term agreements even if the power is not required, as is the case currently. Currently we have 4 000 MW any at given day. Excess capacity could lead to stranded assets which would result in rising costs of energy, which will affect long term growth. It is therefore critical that the country allows a revised plan that will better inform choices including technology and timing of implementation. As we move to implement the policy, unintended consequences have emerged and further consultations with all affected stakeholders are essential.
    3. **Environmental compliance**: Eskom estimates a total of R340 billion will be required to fully meet environmental compliance obligations placing significant upward pressure on the overall electricity price, which is unstainable and unaffordable considering the current economic environment. For Medupi alone there is additional cost of R40bn for Flue Gas Desulphurisation (FGD) installation. The coal-fired fleet is aging and many stations are undergoing mid-life refurbishments. It is therefore only possible in reality to allocate a fraction of Generation’s CAPEX budget to emissions reduction projects. Costs for Eskom’s emission reduction plan currently account for around 20% of the total MYPD3 Generation CAPEX budget (i.e. R8 billion of the total budget of R41 billion), and this is after most of the CAPEX costs of the emission reduction programme have been deferred to the MYPD4 period (from April 2018 onwards).
    4. **Regulatory uncertainty**: The regulatory uncertainty regarding NERSA Multi-year Price Determination (MYDP) decisions poses a significant challenge to Eskom’s revenues and the SOC’s ability to meet its debt payment obligations. NERSA only approved 2.2% price increase in its latest determination, and the court case regarding the legal challenge on RCA determination still remains unresolved.

Despite the above, Eskom has continued to maintain a positive financial performance with the company posting a net profit of R4.6bn in the 2015/16 financial year. Furthermore the company is projected to post a profit for the financial year ending in March 2017.

Eskom has also implemented a number of interventions to eliminate the electricity challenge experienced towards the end of 2014. The company has added over 2 000MW of new generating capacity. This has also been accompanied by an aggressive maintenance plan. This has significantly improved the energy availability factor and allowed Eskom to implement merit order within is units which is important for managing costs.

* + 1. **TRANSNET**

Transnet remains an important company to support the re-industrialisation of the South African economy through improving the performance of strategic corridors. Since 2007, Transnet has implemented an expansion programme that responds to South Africa’s industrialization requirements. The company has also started processes to explore new revenue stream to improve the long term sustainability of the company.

However, there are a number of policy decisions that threatens the company’s future sustainability and must be urgently addressed. **Corporatisation of Transnet National Ports Authority (TNPA)**: Transnet is faced with the major policy challenge as the National Ports Act requires Corporatisation of TNPA. This poses a serious risk to the strength of Transnet Group’s balance sheet; and if implemented, it could jeopardize the implementation the SOC’s investment programme as outlined in the Market Demand Strategy. The Comprehensive Maritime Transport Policy is also not specifically addressing this provision, as it remains subject to the amendment of the National Ports Act.

**The collapse of demand for commodities and the subsequent decline in export volumes** has had a major impact on the sustainability of the company. The funding model explored by the company during the commodity super cycle is no longer feasible as most of its clients cannot commit to long term off-take agreements. Diversification through expanding networks beyond the national borders and pursuing adjacent market such as manufacturing of locos is important for the sustainability of the company.

Despite these challenges, Transnet has continued to expand its networks. The company is committed to spend over R200bn in infrastructure over the next 10 years. This must be applauded as most companies are substantially cutting off their capital budgets. This commitment shows the significance of maintaining State ownership in these companies and their sustainability must be protected.

* + 1. **SA EXPRESS**

SAX is the regional aircraft of the State and has played an important role to develop routes that have seen entrance of private players. However, the company is facing some serious challenges, which are largely structural rather than operational. Responding to these challenges will require the reorganization of the State Ownership in the airline industry. However, operational improvements will also be required to set the Airline in a sustainable path.

* + 1. **Financial sustainability**: The SOC is faced with profitability and liquidity challenges. Delay in raising loans since March 2015. The SOC is unable to fulfil its debt payment obligations. SAX was expected to pay R150 million to the lenders by Friday, 24 February 2017, failing which, the guarantee provided by Government would be triggered, requiring payment within 30 business days. DPE supported the SOC to renegotiate with RMB and Nedbank to pay the banks reduced amount of R58m and the rest of installments based on a proposed repayment profile supported by financial projections until January 2018 to be submitted by SAX. Nedbank to consider SAX request and decide whether to take it to the Credit Committee for consideration of the extension of the submission of the AFS and reduction in the repayment of the loan on 24 February 2017, to avoid default. RMB would give immediate instruction to its attorneys to draft the amendment to the Facility Agreement to accommodate the revised payment for 24 February 2017. SAX and RMB would continue to engage further and final negotiations be formalized after the approval by the Ministers has been sought for the R121 million for working capital and extension of the guarantee period.
    2. **Operational challenges**: Many of SAX’s aircraft on the ground, due to maintenance issues. Some of the OEMs have retired aircrafts, negatively affecting availability of spares required and causing flight scheduling constraints for the airline. Also facing unprofitable route network; Increased charter of flights - 8 aircraft; Maintenance challenges; Poor on time performance; Increased flight delays; Loss of critical skills. Inability to demonstrate to the Auditor General (AG) ability to continue to operate on a going concern basis.
    3. **Fleet replacement**: SAX needs to replace its fleet the right way. PFMA application was received, however it was not approved. SAX is required to address DPE requirements regarding adequate fleet in its PFMA submission.
    4. **DENEL**

Denel remains Government Flagship on how to implement a turnaround strategy and hold important lesson for the State in how to optimize partnership with the Private sector. Over the past 3 years, Denel has posted profits and the trend has remained upwards. In 2015/16 financial year, the company posted a profit of R395 million. This is the largest profit that the company has ever posted since the implementation of the turnaround strategy.

However, there are some challenges facing Denel which relates to liquidity and overreliance on foreign markets.

* + 1. **Liquidity**: Ensuring sustainable funding solution for the business is critical, as the SOC has been reliant on client advance payments and short term paper to finance its working capital requirements. The strategy is not sustainable and it has exposed the business to regular cash flow shocks. A long term recapitalization plan needs to be found to ensure liquidity and sustainability.
    2. Denel is a strategic defence products provider to the Department of Defence, whose capital spending has been declining for a long time, leading to Denel increasingly relying on foreign business for its sustainability. 60% of Denel revenues are derived from exports. Foreign governments expect technology transfers when procuring from external suppliers. This results in Denel cannibalising its own long term future in order to ensure short term cash flows. State needs to guarantee Denel’s role as a prime contractor of strategic defence and security products and compelling amongst others: SANDF, SAPS, National Disaster Management Centre, and Correctional Services to protect Denel’s right of refusal on critical requirements.

Denel, for the first time ever, was ranked among the world’s top 100 global defence manufacturers. It is the second largest defence company in the Southern hemisphere; and a valued partner in the UN’s efforts to combat the scourge of land mining. The company has grown exponentially in the last few years more than doubling its revenues from R3.9 billion in 2013 to R8.2billion in 2016. Export revenue now makes up 58% of the total revenue. Denel spends approximately R500million per annum on Research and Development. The order book includes the Hoefyster production contract, the A400m Airbus work packages, the Al-Tariq stand-off weapons contract and mine resistant protected vehicle contracts. Four of these mine resistant protected vehicles (the NIMR 35) were recently deployed in Yemen. There were no casualties from the altercation an indication of the fine engineering capabilities of Denel.

* + 1. **ALEXKOR**
    2. Alexkor business sustainability from diamond deposits is a challenge going forward. The business model needs to be revisited to diversify the business by venturing into other minerals options including coal, more downstream beneficiation, Alexkor possibly branching out of the sector on condition that parliament would allow the change of mandate in the interest of diversification.
    3. The deep sea mining contract with IMDSA requires attention as the 85:15 diamond haul split in favour of IMDSA seems unfair to the community and Alexkor
    4. The Richtersveld CPA instability is affecting the implementation of the deed of settlement between the Government and the Richtersveld Community.

Alexkor and the Richtersveld Mining Company formed a Pooling and Sharing Joint Venture (PSJV) in 2012 as part of the implementation of the Deed of Settlement. Alexkor PSJV has invested over R60 million into the land mining operations which were previously abandoned. This has resulted in creation of over 150 job opportunities and indirect employment opportunities. Alexkor PSJV partnered with the local school to sponsor the salaries of teachers with emphasis on mathematics and science, over R934 thousands has been spent on the salaries of teachers in 2016.

* + 1. **SAFCOL**
    2. The business sustainability is affected by tough traditional markets and inability to access new markets due to limited product offering. The business is over reliant on sawlog product and needs to develop alternative product line based on increased value addition, which shall investment capital and the business is constrained in this regard.
    3. The resumption of operations in IFLOMA Mozambique is critical in realising the business’s Africa ambitions. The operations in Mozambique have been under care and maintenance since 2014/15 FY and over R250 million has been invested into the operations without returns. It however remains an attractive proposition, what it requires is management and board focus.
    4. Land claim settlement process remains a challenge to SAFCOL as it affects the company’s relationship with neighbouring communities and eventually impacts on the future partnerships that SAFCOL aims to undertake with communities. This process is beyond SAFCOL’s or DPE’s control as the land claims settlement process is led by the DRDLR.

Safcol’s operations are mainly in rural areas which ideally positions the SOC to foster rural economic development. Revenue has grown year-on-year for the past three years. Safcol’s plantations in South Africa are certified by the Forest Stewardship Council (FSC) according to sustainable forest management practices despite challenging operational environment. The company spends R16.8 million per annum on Research and Development activities. The implementation of the social compacts with the communities is progressing well.

**CONCLUSION**

The analysis of the performance of SOCs clearly shows that these companies are contributing positively to the South African economy and they are advancing the developmental obligations of the State. All of the SOCs within my portfolio have continued to operate and meet the mandates that they were established for. Eskom is keeping the light on, Transnet is moving freight that is important for the South African economy.

This does not support the narrative that SOCs are a drain to the State and the South African economy. Furthermore, SOCs in the portfolio have been able to maintain positive external audit outcomes - with the exception of SAX. Improving Governance is at the core of the SOC reform and will remain an important part of SOCs’ performance assessment. The Department continues to strive to minimize vacancy rate at the board as well as executive levels. It is important to highlight that there are no Schedule 3 SOCs within the portfolio. The Department has developed a logical planning, monitoring and evaluation framework that outlines the key steps in the exercise of the oversight mandate.

Our SOCs are financially viable and have not defaulted on any loans guaranteed by the Government of South Africa. They continue to raise funding in both domestic and international markets at very favourable and competitive rates. All our SOC within the portfolio of DPE have thus far recorded a profit of R5.4 billion for 2015/16 financial year. Also important to note is that the DPE SOC are creating direct employment of approximately 120 000 (hundred and twenty thousand) people.