TRANSNET

RESPONSE TO QUESTIONS EMANATING FROM THE PORTFOLIO COMMITTEE ON PUBLIC ENTERPRISES ENGAGEMENT WITH TRANSNET ON THE 2020/21 ANNUAL REPORT AND FINANCIAL STATEMENT: 8 DECEMBER 2021

DIRECT RESPONSE FOR QUESTIONS RECEIVED FROM: Hon G Cachalia (DA)

At a high level, some comments and questions…

- In the previous financial year, Revenue increased by 1,3% to R75.1 billion. Net profit was R3.9bn and cash generated from operations increased by 2,1% to R35, 9 billion
- Operating costs increased by 1,9% to R41,1 billion, R4,7 billion below planned costs. EBITDA increased by 0,7% to R34,0 billion

Now Transnet recorded its first annual loss in more than a decade as revenues plummeted. In what has been described as a "trying financial year" the company has posted a R8.4bn loss down from a R2.9bn profit in the previous year, marking the first loss the company has recorded in recent memory, and certainly the first in at least the past 10 years. Revenue was down 10.5%.

In the previous annual report, the global economy was expected to remain subdued, and the impact of the COVID-19 pandemic resulting in slowing demand was foreseen.

Challenges were identified then and a new strategic outlook, with a renewed emphasis on the wellbeing of People, Safety, Customer Service, Asset Utilisation, and Cost Control, the company was supposedly well positioned to become an agile and trustworthy freight transport and logistics partner. This has not happened.

And your plan now is to:

- Improve current asset utilisation
- Contain costs in operations
- Simplify business processes
- Meet customer service expectations
- Reposition the organisation to enable growth withing core segments
- Transform core commodity segment supply chains through partnerships, operational reform and targeted infrastructure investment
- Enhance operational focus and performance areas where it has competitive advantage
- Form partnerships that enable growth in key industry focused areas
- Support the transformation of supply chains
- Implement market segment strategy for focussed growth.

While there is some operational detail, there is not sufficient explanation of how this will be achieved against downgrades to junk of your investment paper, procurement protocols that foster inefficiencies and inflated costs, loss of advantage to road in terms of volume, efficiency and technology and the adjacencies beyond your control (e.g. economic stagnation, zero effective capacity of safety and security apparatus to stem theft and vandalism).

Also the revenue loss and impairments referred to by way of explanation for the 8.4bn loss reported taken against the previous years' profit of 3.9bnplus the loss incurred in this year would still result in a significant – if lesser – loss, in the billions.

TRANSNET RESPONSE TO QUESTIONS:

Specifically, in response to the presentation:

Transnet's **revenue** decreased by 10.5 per cent to R67.3 billion, while net operating expenses increased by 16.2 per cent. This resulted in the net loss for year amounting to R8.4 billion, up from the R2.9 billion profit achieved in the 2019/20 financial year.

***RESPONSE*:**

Total irregular expenditure amounted to R104.3 billion compared to R131.2 billion in the previous financial year while fruitless and wasteful expenditure amounted to R728 million compared to R608 million in the previous financial year.

Freight Rail contributed 51.5 per cent of the entity's revenue, contributing R39.4 billion in revenue for the year. Earnings before interest, tax, depreciation, and amortisation (EBITDA) amounted to R14.3 billion, a decrease on R18.8 billion achieved in the previous year.

Transnet Property (previously a Specialist Unit of Transnet) is now a separate operating division from 01 April 2020. Revenue decreased marginally from R1.1 billion in 2020 to R1.0 billion in 2021, with EBITDA decreasing from R309.2 million in 2020 to R234.9 million in 2021. Operational expenditure increased from R768 million in 2020 to R778 million in 2021.

Transnet Engineering provides maintenance, repair, upgrade, manufacturing, and support services to Freight Rail in South Africa and to other rail and terminal operators both regionally and internationally. Revenue decreased from R11.9 billion in the previous year to R8.2 billion in 2021. EBITDA amounted to a loss of R1.5 billion, a decrease on a profit of R805 million achieved in the previous year.

Transnet Pipelines (Pipelines) established in 1965, performs a strategic role in the petroleum products supply-chain by ensuring the security of product supply to the inland market area on behalf of its clients. Pipelines manages, operates and maintains 3 800 kilometres of high-pressure petroleum and gas pipeline infrastructure, traversing five provinces. Pipelines volumes are 26.4 per cent lower than the previous year at 13.1 billion litres, from 17.8 billion litres at 31 March 2020, mainly due to the total shutdown of airports, imposed travel restrictions, and the negative impact of fuel theft incidents. This resulted in revenue decreasing from R5.7 billion in 2020 to R4.9 billion in 2021, with EBITDA decreasing from a profit of R3.8 billion in 2020 to a loss of R2.1 billion in 2021.

QUESTION NO 1:

Is the decrease in revenues due to volume or due to price; assuming impact of COVID and reduced economic activity, it is probably volumes which went down. If volumes went down shouldn't also operating activities come down and thus also costs? How come operating expenses increased by more than 10 percent (after inflation) while revenues decreased by 10 percent.

RESPONSE:

Transnet's cost base is primarily fixed, and hence a reduction in activity will not necessarily result in a significant reduction in costs. Transnet did however make significant year on year savings in variable cost categories such as energy, operating leases and materials. These savings were however offset by:

- Third party claims increasing by R3,6 billion;
- Environmental management expense increasing by R1,2 billion;
- Unbudgeted COVID 19 costs of R232 million.

QUESTION NO 2:

We understand that the PFMA and related or similar regulations place very difficult conditions on the operating environment and that many qualifications are recorded because of formalities also in the auditing process. Often these qualifications are a result of strenuous definitions and are not related to substance of the business. Can you help us understand what the case here is? Are there any qualifications, which you as leadership of the operating business regard as a threat or concern for the business and its integrity?

RESPONSE:

The qualification on its own poses a threat to the business as it raises concerns to the investor community and impacts on the funding appetite for Transnet. As the audit qualifications have mainly been driven by the non-compliances to PFMA requirements with regards to irregular expenditure, Transnet has worked tirelessly to identify the root-causes. Given the legacy nature of the non-compliances, and the time and resources required to adequately deal with them, Transnet believes that some of the issues should be ring-fenced to allow the organisation to focus on the implementation of its strategy, without compromising transparency in dealing with these matters.

QUESTION NO 3

If Transnet is in the integrated logistics chain support business – why does it not have a trucking fleet to complement eg. rail infrastructure.

1. ***Do you view investment into infrastructure as an integrated decision across the three value chains of pipelines, ports and rail – or are these decisions made on an independent stand-alone basis.***
2. ***To what extent are or should the three value chains be managed separately and independently. What is the rationale to keep all three verticals under the same management?***
3. ***To what extent will you allow private sector to invest or co-invest.***

RESPONSE:

The original decision to create separate operating divisions for Ports, Rail and Pipelines was due to the different technical competencies required to operate these businesses. While they are still within Transnet SOC, these are managed and operated as individual businesses, with their own management/EXCO structures supporting each business for specific focus on each value chain, corridors, and regions. Transnet does for strategic planning purposes take an integrated supply chain view across different commodity segments. Considering that these are a part of freight logistics value chain from point of origin of goods/commodities in SA into ports (outbound) and from ports (inbound), having them under one SOC helps with integrated infrastructure planning, interface management and optimisation, also reducing the number of handovers in the value chain.

This also helps with transformation and managing access to all stakeholders such as emerging miners and role-players in the value chain. The focus is on ensuring that customers supply chains are as efficient and effective as possible.

As far as Private Sector Partnerships go, Transnet has developed a portfolio of partnership opportunities across many market segments including containers, autos, coal, iron ore and the like. This forms a part of the company's strategy in improving the competitiveness of the logistics value chain and drive growth in priority segments critical for Transnet's business and the economy at large. More so now as the company's balance sheet and overall financial position is constrained, thus limiting its ability to invest. Transnet has taken into account the developments in the imminent rail reform and the current PSP approach is aligned with these policy objectives.

QUESTION NO 4:

Freight Rail's key objective is to shift rail-friendly – please define rail friendly: what kind of freight do you classify as suitable for rail vs road -- freight traffic from road to rail by creating capacity ahead of demand – already about ten years ago the "demand-led" strategy was implemented; to no success, it seems; what has changed? -- and offering a reliable service.

RESPONSE:

Rail friendly cargo is typically large consignments or smaller consignments that are consolidated in freight terminals (e.g., containers), that requires to be moved at a time.

Although in recent years (since 2018) there has been a drastic reduction in annual volume throughput, this is mainly attributable to the constraints that emanate from the 1064 Locomotive Contract matter, and the escalated scourge of theft, vandalism and sabotage of railway infrastructure and equipment. Despite all Transnet's efforts to mitigate against theft, vandalism and sabotage, it is in reality only the state policing and law enforcement agents that have the mandate and capacity to address crime.

Notwithstanding this, Transnet has managed through its initiatives to move more than 23mt (more that 750k truck loads) from road to rail since 2015 when its programme commenced. For example, manganese volumes on rail have doubled during this period. However, at the same time, there has been a drastic decline in the parts of the network where the theft, vandalism and sabotage is acute – e.g. most agriculture from the Free State, North West and Mpumalanga provinces has ceased.

The theft, vandalism and sabotage of railway infrastructure has not only affected Transnet and PRASA but has also continued unabated on Provincial and Local government owned infrastructure. Large industrial complexes in Gauteng like Germiston, Isando, Pretoria West, Krugersdorp, Wadeville, Midvaal and Meyerton in Gauteng, Hamilton in the Free State, and the Pietermaritburg complex in uMsunduzi Municipality (just to name a few) can no longer be served by TFR because those infrastructure owners have not been able to maintain the railway infrastructure.

QUESTION NO 5:

How many employees within TE? How will this workforce be reduced or re-deployed if you don't have work for them?

RESPONSE:

Transnet Engineering consist of 8,599 people currently. The optimising of the business is an ongoing process of engagement and consultation with Organised Labour and final outcomes have not yet been confirmed.

TE will undergo a re-organisation, expected to be completed by end of the 2022/23 Financial Year. The re-organisation will delineate TE into clearly measurable business units that are aligned with Transnet Group's Segment Strategy. This process will define TE's affordable businesses and will help determine the excess staff complement that may need to be managed.

There are very few heavy engineering companies left in SA in terms of size or turnover, and none of the same size as TE. Only the automotive manufacturing sector in South Africa (SA) comes close to offering a similar capability, albeit with a much narrower focus.

QUESTION NO 6:

The TNPA is the "authority", yes? It provides the license, yes? Similar to ICASA providing a license to telco operators; or NERSA a license for Eskom. Yet you ascribe "volumes" moved by this authority. This sounds odd. Why would we discuss the authority as if it were an operational unit? Is this simply a mistake in the narrative or is it actual true that TNPA is viewed as an "operator". If so, where is the "borderline" to TPT. And insofar that borderline is vague or maybe ill-defined, is this maybe also a reason for sub-standard performance?

How do you think about the 7 or 8 ports in the country? Are they being managed as if they were one unit, ie optimised and led by the centre? Or are they being managed on a one-by-one basis and set-up into competition with each other. What is international best practice to achieve high performing ports.

RESPONSE:

Transnet National Ports Authority (National Ports Authority) operates as the landlord port Authority responsible for the safe, efficient and effective economic functioning of the South African ports system, which it manages, controls and administers on behalf of the State.

Transnet Port Terminals provides cargo-handling services to a wide spectrum of customers from across the economy, including the shipping industry, vehicle manufacturers, and the agricultural and mining industries. The TNPA is one of the operating divisions of Transnet. It is distinct from TPT in that TNPA is not an operator of terminals, but rather the entity that grants terminal operator licenses and oversee terminal performance.

TPT operates a complementary ports system. All the ports operate in unison to minimise the overall vessel stay in the country.

SA's 8 commercial ports are managed as a single system where ports complement one another. The Port Authority is responsible for a number of functions including providing basic port infrastructure, issuing operating licences, overseeing terminal performance and ship pilotage and berthing.

QUESTION NO 7:

How many container moves are you achieving and how does this compare to best practice? To what extent is the total available terminal space for containers and what is the average duration of a container in the port.

What % of containers that go in and out of SA is being transported on rail vs road?

RESPONSE:

Container moves per hour for international ports is not available as operating terminals usually do not publish these. However, a recent World Bank Productivity Benchmarking report (9 Dec 2019) reflects an average of 15 cranes moves per hour for South Africa ports. The comparative measure for similar ports of similar sizes is 19,2.

The market share of rail in the Cape region is low, however, information for the Natcor i.e., Gauteng to Durban Container Terminal Pier 2 is as follows:

Imports – 9,2% rail (YTD as at end of Nov 2021)
Exports – 16,7%

QUESTION NO 8:

You moved from Carlton Centre to Waterfall – citing amongst others safety reasons. Now you're moving back – what's the rationale and have the safety aspects been attended to? What is the cost of moving?

RESPONSE:

Rationale

The move was necessitated, among other things, the following:

1. High cost of occupation while in difficult financial position (Transnet was paying more than R80 million per annum to the landlord in rental and utilities).

2. New property strategy which seeks to consolidate Transnet operations in Transnet-owned buildings.

Security concerns:

The move from Carlton to Waterfall was not for security reasons but primarily to decongest the office tower in preparation for the refurbishment of the precinct.

It must be noted that the low rise of the office tower was and still is occupied and the retail section has always been operational.

Safety concerns:

Safety deficiencies noted then, are being addressed as follows:

- High and middle rise towers are currently unoccupied.
- Replacement of lifts for the occupied lower rise in progress.

Maintenance contractors have been appointed for all critical services (lifts, escalators, water, fire, etc) to attend to all arising defects

QUESTION NO 9:

How big is the head office payroll – cost and numbers?

REPONSE

The head office labour cost bill was R1,4 billion in 2020/21

QUESTION NO 10:

W***hat is the total consulting group spend per annum?***

RESPONSE

FY 2020/21= R98 million

QUESTION NO 11:

Given the context of large monopolies being split into constituent parts to save group costs and drive efficiencies. Rail, port and pipelines to not have major managerial overlaps. Why not split them. Where internationally does any company today manage all these under one entity? Canada Pacific and Canada rail replaced the management team by people with deep railway experience and track records. They reduced the operating ratio from above 80% to below 60%. Are you

employing people like this or continuing with deployment? If so, why aren't you following the Hunter Harrison example at all levels – top to bottom?

RESPONSE:

Transnet has well established and successful recruitment methodology that ensures the attraction of the best talent. The selection methodology is role specific in line with benchmarks and is competency based.

The job roles comply with legislation as required, inter alia, by the Railway Safety Regulator, SAMSA and the National Ports Act/

The Hunter Harrison Hiring Methodology is relatively unknown and limited reference material is available on this recruitment methodology. It is therefore difficult to assess the potential to render the outcomes that Transnet desires. Nevertheless, Transnet continuously benchmarks best in practice talent attraction, development and retention methodologies.

In conclusion:

Growth is a key metric in all your strategies.

But you are not a listed company…you need to fix efficiencies and not necessarily drive bottom line growth for your shareholder. You need to deliver public goods and you need to do so efficiently. Why not focus on that instead – growth requires money in any event and that you don't have.

QUESTION NO 12:(Three final riders)

What are Logistics costs as a % of transportable GDP (services don't need transport). This is what Transnet should be measured on. It will help disaggregate the relative advantages of road vs rail for e.g.

RESPONSE:

According to estimates by Professor Jan Havenga and the team at "the GAIN Group", South Africa's logistics costs are R559 billion which as a percentage of transportable GDP is 52,4%.

What Is TFR's Operating Ratio which shows the efficiency of a company's management by comparing the total operating expense (OPEX) of a company to net sales. What is the trend? how does it compare to the benchmark?

What is your net promoter score (NPS)? What is your target, what is it now? Are you still measuring? If not, why not?

RESPONSE:

The last survey was done in **2020/21** Financial Year and the result was -45. The function has been decentralized to the Operating Divisions.

(Response to TFR's Operating Ratio will be submitted as a separate document.)