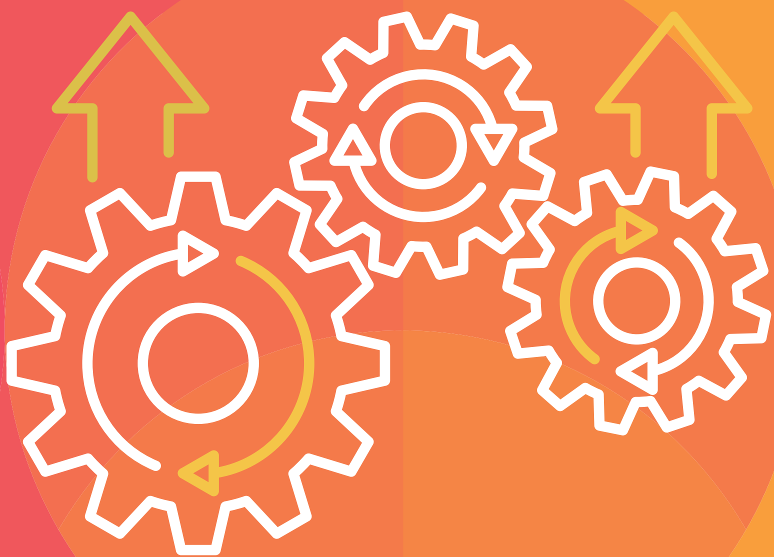
GOVERNANCE OF STATE-OWNED ENTERPRISES IN SOUTH AFRICA

enhancing performance, efficiency and service delivery



United Nations
Economic Commission for Africa

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CONTENTS

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EXECUTIVE SUMMARY

1. Historically, South Africa has used State-owned enterprises (SOEs) for economic development, in particular to expand productive capacities and foster economic growth. The first major SOE, the Electricity Supply Commission (Eskom), was established in 1923 to support industrialization while taking advantage of the vast coal resources that the country possessed. Eskom was followed by other entities such as Telkom Limited (wireline and wireless telecommunications provider) and Rand Water (a water utility) in the first decade of the twentieth century, which became the powerhouses of the economy. At various times, these entities suffered governance and operational weaknesses and the Government came under intense pressure to privatize them in the 1960s; however, the two-pronged objective for SOE establishment, which is socioeconomic development and financial sustainability, made it difficult to heed the privatization calls. Furthermore, under the apartheid era, these SOEs were in the service of a small white minority – a key constituency for the apartheid-era Government – either through reserving jobs for white South Africans or nurturing a racially exclusive entrepreneurial class.

2. In the democratic South Africa, the purpose of these SOEs has been expanded to serve the entire population irrespective of race, but their mandate has never been clearly articulated. As a consequence, SOEs have suffered from a variety of challenges, including an absence of a clearly defined development mandate. State capture[1] has added to, and intensified, these challenges. While corruption is a catch-all phrase and tends to be used by individuals or those working with a syndicate to exploit loopholes in the State, the phenomenon of State capture is more systemic, has political or ideological angles and is sanctioned by a network of powerful actors. State capture has hollowed out critical elements of the Government, eroded value in SOEs, and weakened the rule of law. The extent to which this phenomenon has seeped into the institutional makeup of the country, and especially that of SOEs, is the subject of the ongoing Commission of Inquiry into Allegations of State Capture, which is chaired by Raymond Zondo, the Deputy Chief Justice.

3. State capture has caused serious damage to South African institutions (including SOEs), but is not the only cause of institutional failure. Many of the challenges faced by SOEs relate to governance failures on the part of both the shareholder (government departments with responsibility over SOEs) and the board of directors. It is often assumed that political principals understand corporate governance principles and grasp the importance of board independence, but this is not always the case. The overreach of political principals can generate judgement failure that could undermine the effectiveness of the boards in exercising their fiduciary roles and in setting strategies. The latter can suffer if shareholder compacts are not clearly defined and boards are not clear about the political imperatives of a particular SOE. This could create a mismatch in expectations and strain the relationship between the shareholder and the board, and the board and the executive, especially if the political authority – often a government minister – overreaches and has no regard for corporate governance norms.

4. Fixing SOEs, including by conducting an enquiry into the extent of State capture, is necessary to instil confidence that could restore trust in these institutions. These efforts could go a long way to

1 "State capture" is a type of systemic political corruption in which private interests significantly influence a State's decision-making processes to their own advantage.

improving the financial position of these entities so that they do not pose a long-term risk to the nation's finances. Beyond these actions, it is important that the Government defines exactly the development imperatives of these SOEs, clarifies their mandates, develops a legislative framework that ensures greater accountability, and insists on the appointment of boards that are competent, independent and ethical. The various SOEs that are highlighted in the present report have been afflicted by various sets of problems. At the core, these problems relate to political interference and poor corporate governance.

5. Not all SOEs have been victims of State capture, even though they have all suffered governance and operational challenges of one form or another. The present report provides case studies on five enterprises: Eskom, Denel, South African Airways, Transnet (rail, port and pipeline company), and the Water Research Commission. Getting the State sector right in South Africa has an indirect positive effect on neighbouring countries in the Southern African Development Community (SADC) region, since South Africa has relatively well-developed corporate governance frameworks, sound institutions, and legislative processes that have a degree of credibility[2] Furthermore, some of the South African SOEs, especially those in infrastructure sectors (e.g., transport and energy), have been active in the region for decades, and could play a key role in promoting regional integration. This is especially so given the growing emphasis in the past decade on infrastructure as a pillar of regional integration and an enabler of development. Accordingly, the country's inability to turn around its SOEs could have a negative effect on the region.

6. The present report does not contain comments on State involvement in the economy, as such debates tend to be mostly unhelpful. There are countries in which Governments have used SOEs successfully as a force for development; in some cases, these entities have worked with the private sector, and in others they have performed well on their own. Of critical importance are the reasons why the Government has been holding ownership of certain enterprises – the development value of such enterprises, their governance models, the accountability structures in place, how they are managed, and their systems of monitoring and evaluation. These types of questions provided the focus for the present report.

7. The coronavirus disease 2019 (COVID-19) pandemic has provided the South African Government an opportunity to overcome some of the weaknesses suffered by SOEs through repurposing them to align their mandates with its plan to reshape its economic landscape, as indicated in the country's economic reconstruction and recovery plan. This could be achieved through accelerating reform measures, replenishing the capacities of these entities, appointing credible boards, and implementing the reform measures that were planned but never brought to fruition. This requires a clear sense of purpose that defines a compelling narrative for transformative change and how the various SOEs might contribute to such. In certain areas, tactical decisions might need to be taken, whether to exit partially or to expose some of these entities to competition.

KEY LESSONS FROM GOVERNANCE AND PERFORMANCE OF STATE-OWNED ENTERPRISES IN SOUTH AFRICA

8. There are very important lessons that can be drawn from both history and current efforts at restructuring SOEs in South Africa. The following lessons learned pertain to corporate governance,

2 Even though South Africa has been the joint eighth most deteriorated country on the continent in overall governance in the past decade according to the 2020 Ibrahim Index of African Governance, South Africa ranked in the top ten highest-scoring countries in 2019 (sixth), with a score of 65.8 (out of 100.0) (Mo Ibrahim Foundation, 2020).

the role of the shareholder, and financial performance, alongside the potential benefits of a well-structured SOE:

(a). SOEs have an important role to play in contributing to social and economic change in South Africa. There are SOEs that can be harnessed for infrastructure expansion, modernization, and delivery of high-quality services. In addition, SOEs in the transport and energy sector can contribute towards the realization of regional integration objectives;

(b). SOEs can promote national economic and strategic interests. The current system of managing SOEs is fragmented, and these are not pulling in the same direction to achieve clearly defined national objectives. There is scope for some SOEs to collaborate with development finance institutions, and in some cases, to work in partnership with the private sector to build shared value in the provision of infrastructure or other public goods that equally generate benefits for the private sector;

(c). Corruption and rent-seeking behaviour by powerful networks that have political influence can destroy value in SOEs. Strengthening oversight by the shareholder department, the national treasury and parliament is, therefore, key to securing the integrity of these entities. When the rule of law is weak and acts of corruption go unpunished, then physical, financial and human capital will dissipate. In addition, there are grave risks to the nation's finances given that the debt of many SOEs is guaranteed by the State;

(d). Good and effective governance is important in SOEs. Governance should be conceived broadly to include the quality of the structures of accountability or oversight, including shareholder responsibility; compliance with relevant prescripts for corporate governance and legislative frameworks; independent, competent and ethical boards; and merit-based appointments in SOEs;

(e). Periodic review of the performance of SOEs is important to monitoring their activities, stewardship over resources, and effectiveness in achieving the strategic objectives set by the shareholder. This measurement should consider both financial sustainability and qualitative outcomes in terms of achieving specific objectives.

RECOMMENDATIONS

9. As important as SOEs are for achieving development objectives, not all of them should remain in State ownership. In restructuring SOEs, it is important that Government decisions are based on financial considerations (value for money) and development value. Some of the key questions that need to be asked of SOEs are: what would the Government lose if it were not to own a particular enterprise? What would it gain if it were to sell it, be it partially or wholly? In addition, what is the long-term strategic value of a certain enterprise? If a service can be provided by a private company more efficiently and competitively, greater consideration should be given to the State exiting from such activities, or inviting a strategic partner, more so if there is no development value in offering such services.

10. Greater urgency should be given to restoring the financial vitality of SOEs, which requires several actions to be taken. The following recommendations should be considered:

(a). The government should restructure SOEs so that they are not a burden to the nation's finances and become engines of economic revival. The SOE restructuring plan should not merely be changing boards, management structures and functions, but rather go deeper and establish robust governance frameworks. There have been many good plans and turnaround strategies for SOEs, which should be implemented with urgency;

(b). There needs to be in place a clear ownership policy that defines the overall rationale for State ownership, the State role in corporate governance of SOEs, and how the Government will implement its ownership policy;

(c). There should be constant monitoring and evaluation of these entities, with focus on both the manner of their operations, how they deploy capital, and their development effectiveness;

(d). The Government should rethink the current shareholder model and create a high-level structure that is centralized to supervise the governance and performance of SOEs. Such a structure could be part of the current Department of Planning, Monitoring and Evaluation, or could be created as a specialized agency in the presidency. This would ensure harmony in the development of norms for governance of SOEs and that there is a single point of oversight for shareholder compacts. Various departments could continue to have responsibility for setting policy, but oversight could be the preserve or shared function with an agency responsible for monitoring performance and ensuring compliance with corporate governance frameworks and legislative prescripts;

(e). SOE boards of directors should be selected based on merit and enjoy independence from politicians. Building State capacity is essential if SOEs are to optimally utilize their physical, financial and human capital to deliver on development mandates. A crucial step is to ensure the sustainability of SOEs that are regarded as strategic, and then to bolster these entities to achieve their development mandates. It is not just the capabilities of SOEs that need improvement, but those of the departments and agencies that set the policy frameworks for oversight mechanisms;

(f). The evidence that comes out of the State capture processes should be acted upon urgently to restore confidence in SOEs. Those that have been implicated in criminal conduct should bear the consequences. The work of restructuring SOEs should not just be fixing problems created by State capture. The Government needs to focus on State capture and the strained economic circumstances facing the country to accelerate reforms. This will be important for restoring credibility in these entities and ensuring that they are galvanized to contribute to the Government's economic recovery and reconstruction plan.

11. South Africa has a rare opportunity in the context of the COVID-19 pandemic to do everything possible to drive major economic change, including reformatting key institutions such as SOEs.

SECTION1: OVERVIEW OF THE STUDY

1. The study is structured into four sections. The first section provides the introduction and sets out the rationale and methodology of the study. The second section provides an assessment of the various reform phases in South Africa, from the apartheid era to the post-apartheid political dispensation – shedding light on some of the challenges that have inhibited reforms, including those relating to ideology, politics and governance. The third section contains discussions on the various SOEs that have been selected as case studies – Eskom, Denel, South African Airways, Transnet, the Water Research Commission and the Land Bank. While the specific problems that these SOEs have had to contend with vary, they all suffer from governance weaknesses, poorly defined mandates and lack proper oversight. The fourth section provides an overview of the implications for the Southern African region of not having well-structured and effective SOEs, and the impact this could have on realizing regional and continental integration. Section five ends the study with conclusions and recommendations.

1.1. INTRODUCTION

2. The concept of SOEs, sometimes called parastatals or public entities, refers to commercially run companies under government ownership, whether directly or indirectly, tasked to undertake both commercial and non-commercial activities on the Government's behalf (Bolton, 2010). There are various rationales given for the need for Government to own commercial entities. The more prominent among them are that public goods should be provided by the Government and that SOEs serve as pivotal instruments in discharging social objectives, along with employing State machinery to correct market failures. According to the Organization for Economic Cooperation and Development (OECD) (2018), objectives for State ownership generally fall under one of the following categories:

   (a). Supporting national economic and strategic interests;

   (b). Ensuring continued national ownership of enterprises;

   (c). Supplying specific public goods or services (after deeming the market cannot supply the same goods or services);

   (d). Performing business operations in a "natural" monopoly situation;

   (e). Creating or maintaining a State-owned monopoly (or oligopoly) where market regulation is deemed infeasible or inefficient.

3. The extent to which SOEs have been successful in fulfilling their objectives has been mixed at best. Globally, some SOEs have performed extremely well while some have proven to be laggards. The latter group of SOEs, having failed to serve their purpose, have become burdens to the budgets of their respective Governments. The abysmal performance of these SOEs is generally attributed to the existence of soft budget constraints and the high likelihood of bailouts from Governments, which tend to foster a culture of lax management within SOEs.

4. Notwithstanding the mixed results, SOEs have historically demonstrated their business acumen or their ability to meet development objectives, which have made them a permanent feature of the commercial landscape, and thus likely to remain an influential force globally for the foreseeable

future (PricewaterhouseCoopers, 2015). This is mainly because of the critical importance that various Governments place on SOEs to achieve certain social, political and economic outcomes at the national, regionally and global levels. South Africa is no exception in using SOEs in search of these outcomes. South African SOEs, however, have monopolized headline news in recent years for reasons that are inimical to the objectives of poverty reduction, social equity and cohesion, economic growth and regional integration.

5. SOEs were initially established in developed countries for economic development. In countries such as Germany, Japan, and the United States of America, the State assumed a prominent role in the development of infrastructure and the provision of utilities in the early to mid-nineteenth century. Railway development was one of the key examples of how developed countries were actively involved in infrastructure development. The Gladstone Railway Act and the United States Interstate Commerce Act are both examples of legislative measures that gave authority to a Government to undertake economic activities (Harris, 2004).

6. In developing countries, SOEs were initially created in the colonial era to accelerate economic growth and extract resources (Chilenga, 2016). They were later inherited by newly established Governments at the time of independence, and were initially seen as instruments to develop infrastructure. At the dawn of democracy in South Africa, the African National Congress-led Government inherited SOEs that were created during the colonial and apartheid eras to facilitate the diversification of economic activities away from mining and heavy reliance on imports. These entities were built at a time when the export of diamonds and gold was the mainstay of economic activity (Ritchken, 2014).

7.. Many countries have used SOEs to expand their key infrastructure (such as rail, air and sea transport, telecommunications, water and nuclear energy); to achieve redistribution goals (that is, to provide the same services for the same price throughout the country, by subsidizing prices of products in poorer areas); and to create new industries and support infant ones. In addition, countries have used SOEs to diversify their industrial output, support the incubation of newly identified manufacturing industries and to beneficiate raw materials. In some countries, certain industries were deemed to be strategic to the national interest and national security. They have been used in some cases to augment national macroeconomic strategies (for example, to pursue countercyclical spending during economic downturns).

8. The South African Government has continued to rely on SOEs to achieve certain development outcomes, even though these have not been well articulated. Since their formation, South African SOEs have played a critical role in sectors such as transport, energy, water, land and housing. Many State-owned firms that were established during the apartheid era, were aimed at countering the impact of international sanctions against the country. South Africa has 700 SOEs at the national, provincial and local levels, and some of the major ones are Alexkor (diamonds), Denel (military equipment), Eskom (electricity generation), Transnet (transportation – railway transport and pipelines), South African Airways (SAA), South African Forestry Company (forestry) and South African Broadcasting Corporation.

9. In the past decade or so, many of the large SOEs in South Africa have been in a state of dysfunction. This dysfunction, as the present report contends, was due to multiple causes: lack of well-defined development mandates and strategic priorities; poor understanding of corporate governance on the part of the shareholder (government ministries); lack of clear definition of lines of accountability; weak monitoring and evaluation of the performance of these entities; and suboptimal boards. According to Gumede (2019), many of the country's SOEs were dependent on State guarantees

and bailouts to operate, thus posing a high fiscal burden on the nation's finances. Even with State subsidies, some of the larger SOEs have remained unproductive.

10. The challenges confronting SOEs are exacerbated if they operate without a clear legislative framework, mandate, or shareholder compact to define in precise terms their purpose or objectives. Furthermore, some major SOEs – for example, Transnet, SAA and Denel – have been separated from their policymaking ministries and placed under the Department of Public Enterprises as the SOE shareholding ministry, with the minister of the department representing government interests, while relevant policy ministries focused on policy issues (Fourie, 2014).

11. Other SOEs, however, are under the guidance of departments that are entrusted to them – for example, the Land Bank (National Treasury and the Department of Agriculture, Land Reform and Rural Development), the South African Broadcasting Corporation (Department of Telecommunications and Postal Services) and the Water Research Commission (Department of Water and Sanitation). There is no clear rationale for the division of labour in respect of oversight functions, and no central coordination exists. Furthermore, this division of roles tends to result in an opaque and uncoordinated process of setting indicators and measuring the performance of SOEs, which are never realized (PricewaterhouseCoopers, 2011). These challenges have undermined the effectiveness of SOEs.

12. Notwithstanding the serious challenges confronting South African SOEs, all is not lost, and they can turn the corner. Since 2018, there have been some serious efforts to tackle the malfeasance that has engulfed many SOEs and to set them on the right path. These efforts, however, have focused on changing boards and appointing new board members, which have yielded limited results. The narrow focus on State capture has been unhelpful as this ignores the long-standing and deep-seated challenges faced by these entities. Not all impropriety in SOEs is linked to State capture, and focusing on this phenomenon could divert energy away from some of the long-standing strategic and operational challenges, and could overlook financial underperformance caused by poor management. This point is discussed at length in the present report.

1.2. SCOPE OF THE STUDY AND METHODOLOGY

13. The main objective of the study is to discuss governance challenges facing SOEs and explore options for reform. The scope of the present report covers the history of SOEs and conceptual aspects relating to the role of these entities in national economic development; the various attempts at reforming SOEs; and challenges that are unique to specific SOEs and those that are cross-cutting.

14. The study was conducted through secondary research, with the bulk of the material generated using desktop sources, including policy documents, academic research and journalistic reporting on SOEs. A considerable amount of the policy documents was of a primary nature, in the form of reports by either SOEs or the Department of Public Enterprises to the parliamentary portfolio committee with oversight of the department and its activities.

SECTION2: OVERVIEW OF THE STATE-OWNED ENTITY LANDSCAPE AND POLICY CHALLENGES

2.1. INTRODUCTION

15. .South African SOEs have been hampered by various governance challenges and poor performance. Some concern the lack of clarity in the mandate of these institutions, while others result from ambiguities in the relationships among the government agencies that provide political oversight, the boards of these entities, and SOE managers. In recent times, State capture has worsened the governance and performance of SOEs. State capture has taken many forms, which are the subject of the ongoing commission of inquiry led by Judge Zondo that was triggered by the report "State of capture" written by the Public Protector Advocate, Thuli Madonsela.

16. The practice of State capture did not inaugurate institutional defects in SOEs; it merely exacerbated the various challenges experienced by these State entities. The various initiatives aimed at reforming SOEs that were undertaken by the Government prior to what is known as State capture, indicated that these entities were facing serious challenges long before State capture. The problems at the Land Bank, for example, have nothing to do with the State capture phenomenon.

17. Many SOEs have failed to implement their turnaround strategies, a failure that could be attributed to several factors, including insufficient capacity and weak boards. For example, the ongoing reconfiguration of business models at the power utility Eskom, without simplified and clear mandates for SOEs, means that the process is carried out based on opaque mandates.

18. The role of State capture in damaging the credibility of SOEs and in eroding their value should not be underestimated. Looking only at State capture means missing the bigger picture of what constitutes the source of failure in these entities. It is therefore important when assessing the sources of governance failures, strategic weaknesses and operational deficiencies, to look beyond State capture.

19. The present report provides an assessment of the governance of SOEs in South Africa and ways in which to enhance their performance and efficiency.

2.2. ROLE OF STATE-OWNED ENTERPRISES IN ECONOMIC DEVELOPMENT

20. SOEs are commercially run companies that are under the ownership of the Government. In some cases, the Government exercises direct ownership, and in others the ownership is indirect – some are partially State-owned and others are wholly State-owned. There is a very long history of State-backed or State-owned corporations and investment vehicles, going back as far as four centuries. The trading companies that had some indirect relationship with sovereigns from the seventeenth century to the twentieth century (such as the Dutch East Indian Company, the Danish East India Company, the East India Company, and the British South Africa Company) were some of the earlier examples of State-owned or State-backed capital. Those entities were not SOEs in the way that modern SOEs are now. The chartered companies of previous eras operated with a significant degree of autonomy from the Government but owed their charters to the State. In return, the chartered

companies would be expected to support the nation's finances.

21. Historically, Governments have had different rationales for creating SOEs. Public goods and services such as water, health care, transport and power were the domain of the State, even though these were corporatized or privatized over time. These services lay at the heart of social compact between the State and society. Beyond these, the State viewed owning critical utilities (roads, water and energy, among others), as a means of achieving its development objectives. According to OECD (2018), the objectives for State ownership generally fall under one of the following categories:

(a). Supporting national economic and strategic interests;

(b). Ensuring continued national ownership of enterprises;

(c). Supplying specific public goods or services (after deeming that the market cannot supply the same goods or services);

(d). Performing business operations in a "natural" monopoly situation;

(e). Creating or maintaining a State-owned monopoly (or oligopoly) where market regulation is deemed infeasible or inefficient.

22. The various challenges besetting SOEs and proposed policy options for reform are explored in the present report. In addition to focusing mainly on South African SOEs, it provides an assessment of the challenges and the applicability of solutions to the regional landscape. A political economy approach has been adopted in assessing the mandate, strategies and governance of SOEs.

23. The precise role of SOEs in achieving developmental objectives and creating social value is a subject worth examining, as is their role in contributing to innovation-led growth. SOEs have had a place of pride in the South African economy because it has long been a mixed economy, marked by the co-existence of a strong and dynamic private sector and an activist State. This economic profile is rooted in history (which will be reflected on) and shaped by the country's socioeconomic realities in the post-apartheid era.

2.3. EARLY REFORMS IN THE POST-APARTHEID ERA

24. During the early years of democracy, greater priority was accorded to macroeconomic stabilization. These entities languished under fiscal strains and carried heavy debt by the end of the apartheid regime in the early 1990s. The democratically-elected Government identified the restructuring of SOEs as an essential component of macroeconomic reforms. This phase of SOE restructuring focused mainly on privatizing non-core State assets – State assets were marked as either "strategic" or "non-strategic". The former would be sold off to private buyers, and the latter would remain in government hands.

25. This restructuring phase did not proceed smoothly, owing to ideological contestations within the ruling party, and between the various components of the ruling party alliance. Privatization became a heavily contested policy position. The earlier macroeconomic reforms attracted a backlash from the left-leaning sections of the ruling party, which included trade unions that were affiliated with the Congress of South African Trade Union and the South African Communist Party, which the African National Congress-led Government relied on for increasing electoral support. Restructuring or privatization was undertaken in a very partial manner, leaving vast swathes of assets under State ownership, even those entities that had no clear strategic significance for the State.

26. By mid-2000, a good measure of macroeconomic stability had been achieved. Between 2000 and 2006, the economy grew by an annual average of 4 per cent, which has remained the period of highest sustained growth in more than 25 years. Even so, SOEs continued to be plagued by underperformance and operational weaknesses. Poorly defined governance frameworks, unclear lines of accountability, and blurred lines of responsibility between boards ("governing bodies") and the Government as the sole shareholder, were some of the deep-rooted problems. Over time, corruption became a major factor in weakening SOEs and impairing their credibility.

27. After nearly three decades since the start of democratic rule, there is still no clear framework for restructuring and governing SOEs, and their mandates remain ambiguous. There have been instances where ministers have overreached and undermined the work of boards, at times extending their remit to executive decisions in these entities. The relationship between governance, strategic frameworks, and mandates are interrelated, which should be taken into account if SOEs are to be governed transparently and operate effectively.

28. Many SOEs lack clearly defined shareholder compacts that set out clear expectations between the shareholder departments and the entities; and their long-term strategic goals are often vague and their mandates not always clear. These core challenges breed more problems in the form of poor appointments, operational weaknesses, and suboptimal utilization of physical, human, and financial capital.

29. For more than a century, SOEs have been a feature of the political economy of South Africa and remain an important part of the economic landscape. Some of the examples include: the Department of Posts and Telegraphs, established in 1910, which oversaw the development of postal, telephony and broadcasting infrastructure and related services; the South African Railways and Harbours Administration, which was established in 1910 (later reconfigured to become South African Transport Services in 1981); the Electricity Supply Commission (ESCOM), established in 1922 to construct electricity generation, transmission and distribution infrastructure (ESCOM was later corporatized in the 1980s and became known as Eskom); and the Iron and Steel Corporation (Iscor), which was founded in 1928 to promote the industrial development of South Africa (Ritchken, 2014).

30. The above-mentioned entities are all infrastructure service providers, which the State saw fit to create and run because they constituted the backbone of the economy and were seen as powerful levers for achieving economic development. The first serious step towards creating SOEs in modern South Africa took place in the 1920s. The key strategic objective of that early move was to broaden the country's industrial base by reducing reliance on gold mining through the creation of a steel industry that was fuelled by cheap electricity. It was envisaged that the production of cheap steel and electricity would catalyse downstream productive processes that would, in turn, propel further movement towards full-scale industrialization. It made sense, therefore, that the first major projects in the creation of SOEs were Eskom and Iscor – both created in the same decade and with industrialization in mind.

31. The period between 1920 and 1950 witnessed the ramping up of productive capacity. This period was remarkable as it saw two World Wars: the First World War between 1914 and 1918, which sustained industrialization well into the 1920s; and the Second World War, which spurred the South African manufacturing economy and ushered the country into a golden age of prosperity that lasted well into the 1970s. In the earlier phases of State intervention in the economy, the expansion of the railways was managed by the South African Railways and Harbours Administration.

32. Since 1923, Eskom has been responsible for the provision of cheap electricity, with steel production

managed through Iscor from 1928. Chemical and synthetic fuel production has been the domain of the South African Coal, Oil and Gas Corporation since its creation in the early 1950s. The introduction of the Industrial Development Corporation in 1940 was aimed at providing critical industrial financing that would accelerate industrial development. The scientist Hendrik van der Bijl played an important pioneering role at an early stage of the national industrialization project, having founded Eskom, Iscor and the Industrial Development Corporation – entities whose formation was staggered over nearly two decades.

33. The industrial character of South Africa changed noticeably after the Second World War, especially in the late 1940s and 1950s, because of State intervention. The country underwent structural transformation from a resource-based economy to a thriving industrial economy. The success of that strategy was borne out in the emergence of Afrikaner finance capital, along with the expansion of the electricity, coal and chemical sectors, and other State-driven financing activities to support the Afrikaner commercial agricultural sector. That was a period that saw the growth of what became characterized as the minerals-energy complex to denote an economy marked by mutually-reinforcing dynamics between the mining and the energy sectors (Fine and Rustomjee, 1996). Nationalization and large-scale public investment in energy infrastructure and the creation of a State-owned chemicals-fuel industry were some of the hallmarks of the industrial strategy during that time.

34. The production of iron and steel by an SOE (Iscor), based on iron-ore mining, was linked to the generation of electricity by another SOE (Eskom), and the transportation of mining products was provided by yet another SOE (the former South African Transport Services, now Transnet). The very purpose of creating Eskom was to generate power without profit, and to build an institution that would constitute the backbone of forging an industrial economy, with connections among rail, coal production and energy to keep the smelters fired up. Prices were thus distorted to advance the industrialization project, a position that would prove difficult to maintain in the twenty-first century.

35. In 1981, a major restructuring of the national transport system took place, which saw the integration of railways, harbours, road transport, aviation and pipeline operations into South African Transport Services. The SOE Transnet came into existence in April 1990 as the apotheosis of restructuring in national transport, port management and logistics. Of the major SOEs that were created before democracy, the South African Coal, Oil and Gas Corporation and Iscor were wholly privatized in the 1990s, while Eskom, Transnet and many other SOEs remained under State ownership.

36. The remaining SOEs were left with severe governance challenges, especially Eskom and Transnet – two SOEs that were established in a different context to serve a purpose that would be difficult to fulfil under the post-apartheid conditions. The two SOEs faced conditions such as a stretched fiscal capacity and the pressures associated with the competitive imperatives of a highly connected global economy, and the new regulatory framework that had emerged during democracy to discipline anti-competitive behaviour.

37. It would be difficult today to provide cheap energy to the extent that was possible in much of the twentieth century. Eskom has been battling to keep up without steep tariff increases. Its value had significantly eroded during the State capture period, but even if there were no State capture, the company would have needed to modernize and change its business model to ensure both sustainability and competitiveness. Companies such as Iscor (which revitalized as ArcelorMittal), struggled to cope in the highly competitive international trade environment.

38. Even under the apartheid-era Government, SOEs were plagued by governance failures and with a weak base of technical capabilities. Those failures generated debates on the denationalization of SOEs in South Africa. The Marias Commission, which looked at denationalization in the late 1960s, issued a report in 1969 setting reasons for the denationalization of the railway utility, the South African Railways and Harbours Administration, on account of inefficiencies in the parastatal. Its recommendations, however, were rejected by the Ministry of Transport in 1970. The genie was already out of the bottle, and the denationalization debate intensified, which culminated in the privatization of Iscor in 1979 and the dissolution of South African Transport Services into various units and divisions in 1981.

39. Almost a decade later, the Government tabled the "White paper on privatization and deregulation in the Republic of South Africa" in 1987, which was aimed at achieving development and growth through a market-based economy (Meyers, 1997). Throughout the period between 1960 and the late 1980s, the dying years of the apartheid-era Government, SOEs continued to experience problems of underperformance. In 1990, various State-owned transport modes under the umbrella of South African Transport Services were separated into commercialized divisions of Transnet (Department of Transport, 2017). This was done in the context of deteriorating SOE performance and weakening governance. That SOEs have been plagued by governance and technical failures was not something unique to the democratic dispensation. During the apartheid era, these entities performed a critical patronage function to guarantee jobs for the white Afrikaner constituency, which became a loyal electoral base of the Nationalist Party-led Government for the duration of that political regime.

2.4. STATE-OWNED ENTERPRISES POST-1990

40. When the democratically elected Government took over in 1994, it considered SOEs a critical instrument in the toolbox for driving economic development. These entities had a capital base that could be leveraged to deliver certain key services while providing the State with much needed muscle to bring about economic development – for example, through spending on infrastructure or stimulating economic activities through development financing. Under the previous apartheid regime, SOEs were largely in the service of a white minority; repurposing them in the democratic dispensation proved treacherous. In its Reconstruction and Development Programme document published in 1994, the African National Congress-led Government reflected on the purposes of SOEs – considering the possibility of disposing some of the public assets it deemed as lacking in strategic purpose.

41. The Reconstruction and Development Programme was never implemented in its entirety. It was only when the Growth, Employment and Redistribution framework was adopted in 1996 that the destiny of SOEs was heavily debated. The framework was underpinned by a commitment to attain macroeconomic stabilization. It intensified the focus on restructuring SOEs and privatizing non-core State assets, alongside introducing the private sector in telephony companies such as Telkom. Fiscal challenges became the singular most important consideration in undertaking restructuring. The Department of Public Enterprises (2000) acknowledged that the restructuring would stimulate investment flows, which would then help to reduce public debt. This process of privatization produced mixed results.

42. The specific activities that the Department outlined as constituting the restructuring process included setting out basic expectations of how SOEs should be managed. They were to be subjected to performance appraisal and made to adopt certain governance protocols. A policy framework entitled An Accelerated Agenda Towards the Restructuring of State-Owned Enterprises

was introduced in August 2000 to define in greater detail what privatization would entail. The policy framework built on the policy thrust of the Growth, Employment and Redistribution framework. At the crux of the new restructuring policy framework was a pragmatic approach that set out various options for the future of SOEs. These included: furthering the nationalization of SOEs for strategic reasons rather than universally imposing privatization; exploring possibilities for joint ventures between SOEs and the private sector, especially for important but loss-making SOEs; reducing the level of State ownership in order to enhance efficiencies, and to empower the historically disadvantaged through such a process. The policy framework, however, was met with intense opposition, especially from constituencies that viewed any privatization as advancing a neo-liberal agenda. The implementation of the policy framework was put on hold indefinitely. The State was in a mode of paralysis, and restructuring SOEs became an incomplete project until more than a decade later.

43. The problems facing SOEs remain, and in some cases, have deepened. These problems range from lack of strategic purpose to governance challenges and operational inefficiencies, among others. In terms of lack of strategic purpose, South African SOEs have struggled to define their purpose (especially post-1994), with no overarching strategy in place to guide the direction of the country's SOEs, which are estimated to be more than 700 in total, including municipal entities. The Public Finance Management Act 1999, defines what an SOE is in the South African context at the national and provincial levels. At the local level, SOEs are classified based on the Municipal Finance Management Act. The lack of an overarching strategy persists even with the recommendation made by the Presidential Review Committee on State-Owned Enterprises in its 2013 report.[3]

44. The lack of strategic purpose has been exacerbated by the fact that major SOEs have been separated from their policymaking ministries and placed under the Department of Public Enterprises as the SOE shareholding ministry, with the minister of the department representing the interests of the Government as a shareholder, while relevant policy ministries have been focused solely on policy issues (Fourie, 2014). In many cases, there have been no clear guidelines on board appointments.

2.5. DEVELOPMENT ROLE OF STATE-OWNED ENTERPRISES IN SOUTH AFRICA POST-1994

45. Notwithstanding the many post-1994 Government-adopted policy positions that advocated for the restructuring and privatization of State assets, the policy discussions about restructuring SOEs have been caught up in endless ideological debates. According to Mostert (2002), the goal of restructuring SOEs was vehemently opposed by labour unions as they argued that it went against the objectives of the Reconstruction and Development Programme policy. Labour unions viewed the restructuring of SOEs as a neo-liberal posture and feared the restructuring of SOEs would undermine the delivery of public services and the fulfilment of basic social needs. As such, the plan to restructure some of the major SOEs stalled. The agenda to restructure SOEs reached an ideological impasse (Ndletyana, 2013).

3 The 2007 Polokwane Conference of the African National Congress (the ruling political party) called for a review of the performance of SOEs and for policy options regarding the role of SOEs in the development State. Subsequently, the Presidential Review Committee on State-Owned Enterprises was established to address the question of whether SOEs were responding appropriately to the developmental State agenda (the Presidential Review Committee on State-Owned Enterprises, 2013).

2.6. RESTRUCTURING STATE-OWNED ENTERPRISES POST-APARTHEID

46. Various attempts at formulating a framework to guide the restructuring of SOEs in post-apartheid South Africa have been tortuously slow. In addition to being a burden on the nation's finances, some SOEs – such as Eskom, Denel, the South African Broadcasting Corporation, and others – have become seriously indebted against credit guarantees provided by the national treasury. Most of the attempts to resolve problems in SOEs have focused on replacing individuals on boards and management committees rather than on effecting much-needed institutional reforms that would place the companies on a sound and sustainable footing. The damaged furniture inside the house is constantly replaced, but the structural faults are always left untouched.

47. As corruption is a much publicized and therefore sensitive political problem in South Africa, political leaders who assume office prioritize the removal of allegedly corrupt board members and managers from SOEs. This is done to send a signal to society that the new political leadership is serious about fixing problems in SOEs, but such public gestures are never followed by substantive and structural fixes that are required to focus these entities on well-defined mandates and strategic objectives. Similar to the classical "wicked problem", the challenges facing SOEs extend far deeper than the presence of "wicked" personalities within governance and management structures.

2.7. VARIOUS PHASES IN THE RESTRUCTURING OF STATE-OWNED ENTERPRISES

48. One notable government initiative aimed at restructuring SOEs was the drafting of the document "An accelerated agenda towards the restructuring of State-owned enterprises", which was finalized in August 2000 (as aforementioned in subsection 2.3.1).

49. Another government initiative was the Presidential Review Committee on State-Owned Enterprises, which published its report in 2013. The Committee focused on whether SOEs were responding appropriately to the development state agenda. The point was to ascertain "the extent to which the State should be an active, effective and decisive owner/shareholder" (Presidential Review Committee on State-Owned Enterprises, 2013, p.7). It sought to clarify the Government's multiple roles as shareholder, policymaker, regulator and operator, and how these worked in practice.

50. Among the key recommendations made by this Committee was for the Government to adopt a policy to enforce the periodic review of the overall performance of SOEs. It was further recommended that the Government should adopt appropriate funding principles and models for SOEs and that they (SOEs) should play a leading role in socioeconomic transformation. These recommendations were too broad, however, and could not generate the needed momentum to effect serious changes in the governance and workings of SOEs.

51. Furthermore, it was suggested in the recommendations that the Committee had proceeded under the wrong assumption that a capable State was in place, which was not the case. A capable State that possesses technical and institutional capacity is essential for implementing reforms. State capacity pertains to the set of skills, capabilities and resources necessary to perform policy functions, from the provision of public services, to policy design and implementation, to the creation of markets, a role that well-functioning SOEs with properly defined mandates should fulfil.

52. The Presidential Review Committee on State-Owned Enterprises, which was chaired by Riah Phiyega, existed as a parallel structure to the Department of Public Enterprises, which had an executive mandate to oversee SOEs and to define parameters of reform. A similar approach was undertaken

towards the end of 2020, when the President of South Africa, Cyril Ramaphosa, announced the establishment of the Council on State-Owned Enterprises, which would undertake a review of these entities in parallel to the Department of Public Enterprises.

53. It is not certain whether the Council's report, when it produces one, will not suffer the same fate as the 2000 report by the Department of Public Enterprises and the 2013 report by the Phiyega Commission. As at the time of finalizing the present report (by the Economic Commission for Africa) at the beginning of 2021, the Council had not started its work in earnest. Inter-agency coordination is essential for the success of the work of high-level commissions. If a commission or an advisory structure does not have the full confidence of the line department or the minister responsible for a policy under examination, its recommendations are unlikely to be implemented.

2.8. STATE-OWNED ENTERPRISES AND STATE CAPTURE

54. Some of the recent literature on South Africa, such as Chipkin and others (2018), has cast a spotlight on how embedded the practice of State capture (a form of corruption facilitated by powerful figures within the State) has been in the State formation of South Africa, and how this has exacerbated institutional decay. Jonas (2019), looked at how these practices had undermined the social contract that was achieved at the advent of democracy in South Africa in 1994. Many of the entities that were affected by State capture were SOEs. These entities have been the subject of the Commission of Inquiry into Allegations of State Capture, chaired by Judge Zondo.

55. The testimonies presented to the ongoing Zondo Commission have provided the clearest example of how physical, financial, and human capital have been undermined by acts of corruption. It is therefore impossible to consider strategies for restructuring or rebuilding SOEs without fixing the problems associated with State capture – bearing in mind that State capture does not fully explain the governance and operational deficiencies of these entities.

56. The framework of accountability needs to be reviewed. The shareholder compacts that set out the expectations for the relationships between the shareholder departments and the SOEs under them, and how the political principals engage with the boards of directors, require clarification. Even in the absence of State capture, these entities will continue to fail if the challenges that afflict them are not properly diagnosed. The practice of cadre deployment predates the era of State capture. In addition, corporate governance norms are often lacking in many SOEs, and this deficiency has nothing to do with State capture; neither does the failure to appoint credible boards that are ethical, independent, competent, and with the right mix of skills. It is crucial that the overarching strategic objectives of SOEs are fully defined, and that entities are given clear mandates and subjected to proper oversight.

2.9. POLITICS AND GOVERNANCE

57. In the main, the sound governance of SOEs in South Africa has been undermined by either the politicization of the process of appointing members of boards of directors or the lack of a clear and systematic approach for appointing such members. The absence of a clear framework that regulates and professionalizes the appointment of members to the boards of SOEs give latitude to arbitrariness.

58. Although the Department of Public Service and Administration issued the cabinet-approved "Handbook for the appointment of persons to boards of State and State-controlled institutions" in 2008, this was not anchored in any regulation or legislation to which the Government could be held to account. Although the Public Finance Management Act is generally regarded as a sound instrument for promoting good governance, it focuses mainly on the functions of accounting authorities. Part 9 of the Treasury Regulations of 2001 augments the Act, but this mainly has to do with details relating to the responsibilities of accounting authorities. All these instruments have proved insufficient in keeping politics out of the processes by which the boards of SOEs get appointed.

59. To meet the prevailing governance and other related challenges, the Department of Public Enterprises had proposed a government shareholder management bill. It was expected that the bill would cover several shortcomings, including the appointment of board members. This was never carried out. The bill was put on hold ostensibly to allow the Department of Public Enterprises to align its work with the implementation of the Presidential Review Committee recommendations, in particular the proposal to develop a single piece of overarching legislation governing all SOEs (Department of Public Enterprises, 2017). As previously pointed out, the implementation of the Review Committee recommendations never happened. The bill proposed by the Department of Public Enterprises has not progressed either.

60. Six entities were selected for this study, based on their critical importance to the South African economy. These SOEs are in infrastructure sectors such as road and freight (Transnet), air (SAA), energy (Eskom), water (Water Research Commission), arms manufacturing (Denel), and one of the oldest development finance institutions in agriculture (Land Bank). They have all suffered governance and performance challenges, with some managing to overcome their weaknesses. The next section contains a study of each SOE, highlighting their challenges in greater detail and providing some recommendations on how these could be addressed.

SECTION3: CASE STUDIES

3.1. ESKOM

61. Eskom dominates the South African energy sector, generating more than 95 per cent of the country's electricity and accounting for approximately 40 per cent of the continent's electricity supply. The utility controls the national transmission grid and distributes around half of its electricity directly to industrial and residential consumers, with the remainder going to municipalities. Eskom is among the top 20 power utilities in the world in terms of installed generation capacity (Reuters, 2019a). Based on revenue figures, the company is markedly the largest SOE in Southern Africa. Eskom revenue at the end of the 2018 financial year was R177.4 billion, up slightly from 2017, when revenue was R177.1 billion. There has been an average revenue increase of 7.4 per cent per annum since 2013 (Eskom Limited, 2018).

62. Even with this increase in revenue, Eskom has struggled to meet demand and South Africans have experienced intermittent power cuts since 2007. The roll out of the electrification programme was advanced in accordance with the Reconstruction and Development Programme, but with no contingency plan to increase generation capacity, even though the Government was aware that electricity demand was likely to exceed generation capacity by the year 2007 (Department of Minerals and Energy, 1998).

63. The acknowledgement of government inaction was captured by the remarks of the former President of South Africa, Thabo Mbeki, in 2008, when he Stated that: "[W]hen Eskom said to the Government: 'We think we must invest more in terms of electricity generation'. . . We said not now, later. We were wrong. Eskom was right. We were wrong" (Lalk, 2012).

64. The lack of policy implementation was further reflected by the failure to act on the contents of a 1998 white paper on energy policy, which set out the Government's intention to develop an energy mix strategy, but this never materialized in time to avoid the energy crisis that hit the country in 2007. It would only be in 2011 that a new regulatory regime would emerge, paving the way for independent power producers to participate in various windows of renewable energy generation and supply through power purchase agreements (off-takes) signed with Eskom. These agreements were underpinned by technical support from the semi-independent Renewable Energy Independent Power Producer Office, which was accountable to both the Department of Minerals and Energy and the National Treasury. The complete picture of the energy mix strategy was reflected in the 2010 draft of the Integrated Resource Plan, which was revised in 2018. Ambiguities over the role of nuclear energy in the energy mix compounded the country's energy policy difficulties. Eskom was caught in the crossfire of these policy tensions.

65. Eskom actively pursued the nuclear-energy route despite misgivings by the policy department (the then Department of Energy) and critical questions raised by the National Treasury on affordability and risks to the nation's finances via the channel of State guarantees. The nuclear deal would collapse with the recall of the former President of South Africa, Jacob Zuma. What was clear during that period was that energy procurement was heavily politicized. Many of those ills have come to light at the Commission of Inquiry into Allegations of State Capture, whose work has yet to be concluded.

66. Governance failures and operational weaknesses at Eskom manifested in the utility's parlous State of finance, with critical skills leaving the company. It would be a steep path to fix deep-seated governance failures and to reorganize the utility for better operational and financial performance, a struggle that the current leadership still contends with. What is not known is the predominant philosophy at Eskom today with regard to the energy mix, something that is not helped by vague references to a mix that includes gas, nuclear and renewables; lack of a clearly articulated gas master plan; and the absence of a strategy around nuclear and other energy sources.

67. The previous challenges of Eskom regarding the programmes to build the Medupi and Kusile power stations are well known. The cost overruns in these programmes have compounded its financial predicament. The entity has a massive operating budget that includes maintenance, refurbishment, staffing costs, consulting and service contracts. The largest component of its finances is set aside for primary energy purchases – specifically for coal used in the generation of the bulk of Eskom electricity. It is in the area of primary energy purchases that the awarding of over-priced coal contracts has occurred in the past, and opaque governance practices have been evident.

68. Various problems have plagued Eskom. The new build programme cost overruns, the enormous operating budget and the over-priced coal contracts are exacerbated by the prevailing culture of non-payment by some of its biggest clients, in particular municipalities. Based on figures from the Parliamentary Monitoring Group (2019), the total arrear municipal debt (including interest) had increased by rand (R)10.1 billion – from R9.8 billion in 2017 to R19.9 billion in 2019. The top 20 defaulting municipalities constituted 79 per cent of total arrear municipal debt and more than 47 per cent of the arrear debt was owed by municipalities in Free State and Soweto – with a total population of approximately 1.3 million – being the single largest non-paying offender. Table 1 indicates the gravity of municipal debt to Eskom.

69. A total of 48 valid payment agreements are in place with the defaulting municipalities, including 12 of the top 20 defaulters; however, only 11 of these are being fully honoured, with only 4 of the top 20 defaulters honouring their agreements fully. One solution that has been proposed, which is for municipalities to diversify their suppliers, is something of a half-way house: that is to say, while it addresses the deeper issues relating to Eskom, it fails to deal with key concerns about the sustainability of the Eskom business model in the context of diverse suppliers, especially at two critical points in the business model – generation and distribution.

70. The Government established an interministerial task team chaired by the Minister of Cooperative Governance and Traditional Affairs, and comprising the Ministers of Public Enterprises, Energy, Finance, Water and Sanitation, the President of the South African Local Government Association and the Eskom Chairman. The task team was charged with tackling the high level of municipal debt owed to Eskom and finding solutions to the constitutional challenges relating to the supply and distribution of electricity. The Standing Committee on Public Accounts has requested stakeholders (Eskom, South African Local Government Association, the National Treasury, the Department of Public Enterprises, the Ministry of Cooperative Governance and Traditional Affairs) and the top 10 municipal debtors to provide an update on the status of repayment of municipal arrear debt.

Table 1 Debt owed by the top 10 municipal debtors and Soweto as of June 2019

(Millions of South African rand)

Municipalities	Total*	Interest
Maluti-A-Phofung, Free State	4 016.00	1 016.00
Emalahleni, Mpumalanga	2 761.00	504.90
Matjhabeng, Free State	2 361.00	511.50
Emfuleni, Gauteng	1 445.00	373.30
Govan Mbeki, Mpumalanga	1 236.00	209.60
Ngwathe, Free State	1 117.00	150.80
Lekwa, Mpumalanga	797.00	182.30
Thaba Chweu, Mpumalanga	591.00	63.30
Ditsobotla, North West	438.00	110.50
Modimolle-Mookgopong, Limpopo	418.00	53.90
Remaining municipalities	2 441.00	403.90
Total	17 621.00	3 580.00
Soweto	18 909.00	
Total arrear debt*	36 530.00	

Source: *Business Tech (2019).*

71. In addition to the high levels of municipal debt, the long-term debt of Eskom was at R441 billion in March 2019, up from R255 billion in 2014 (Eskom, 2019a). This was compounded by the record net-loss it experienced in the 2019 financial year to the tune of R20.7 billion. Yet, Eskom had experienced revenue growth of 9.7 per cent in real terms between 2006/07 and 2015/16, but simultaneously suffered declining profitability during that same period (Parliamentary Budget Office, 2017). This was preceded by a period in which its net profit margin averaged 12.1 per cent between 1995/96 and 2005/06.

72. The growth in revenue since 2006/07 has mostly been due to large tariff increases, influenced by the new build programme, and changes to the tariff-setting methodology derived from the 2008 electricity pricing policy. In addition to the investment in new generation capacity, the following events had an impact on Eskom finances: the rise in the price of coal; the increased use of diesel to run the open-cycle gas turbine plants to limit load shedding; the reduced efficiency of the current plant; the rise in labour costs – 46,665 group employees in 2019 (Eskom, 2019b), compared with 31,972 employees in 2003 (Eskom, 2003); and the costs associated with the Renewable Energy Independent Power Producer programme.

73. Another source of anxiety was that of contingent liabilities with the National Treasury. The financial challenges posed a risk to the country’s economy, with Eskom cited as possibly the single biggest risk to the country’s economy. State guarantees to SOEs in 2019 resulted in the National Treasury being exposed to an estimated R466 billion in contingent liabilities, which represented the amount of money that the Treasury would need to pay in case of default. Eskom, whose debt was approximately 9 per cent of the country’s gross domestic product (GDP), was the biggest culprit (Fitch Ratings, 2020). Although the factors have contributed significantly to the precarious state of Eskom, governance failures and corruption, as previously shown, have exacerbated the deterioration of Eskom.

74. The era of State capture has had a major effect on the overall performance of Eskom, both strategically and operationally. Despite a more than 500 per cent increase in tariffs from 2007 to date, Eskom has not been able to generate enough revenue to pay for its debt servicing, let alone the principal debt, and borrowing has become increasingly difficult and expensive due to high interest rates. Some of the main challenges facing Eskom include the following:

(a). A record loss of R25 billion posted by the end of March 2019;

(b). Potential inability to pay creditors, run capital programmes and pay salaries, among others;

(c). Municipalities owing the parastatal to the tune of more than R30 billion;

(d). South Africa finding itself downgraded by Moody's Rating Agency to junk status in early 2020, leading to large borrowing costs;

(e). A systemic risk of the State having to bail out the parastatal to the tune of R350 billion, which would lead to an increase in the public debt-to-GDP ratio;

(f). Risk of the Government having to approach the International Monetary Fund for debt relief support, over and above what the Government has already received for COVID-19 emergency relief measures, and the resulting potential of intrusive austerity measures.

75. The governance challenges at Eskom have led to substantial losses of both human and financial capital. Compounding the leadership failures at Eskom has been the slow pace of innovation in the sector. The prioritization of Eskom by President Ramaphosa has infused a sense of hope and direction, at least at the apex of the power utility. The recent leadership changes that have seen the installation of a new Chief Executive Officer (CEO), Andre De Ruyter, and the various senior management changes that followed, have given some hope that Eskom is on the mend. But the company's climb out of the dark hole is painfully slow.

3.1.1. ESKOM UNBUNDLING

76. During his 2019 State of the Nation Address, President Ramaphosa announced the Government's decision to unbundle Eskom into three separate units: generation, distribution and transmission. His statement was followed by a document released by the Department of Public Enterprises in October 2019, entitled "Road map for Eskom in a reformed electricity supply industry". This document set out the various options for restructuring Eskom into Eskom Holdings with three new subsidiaries (generation, transmission and distribution). This would entail improving operations and curtailing inefficiencies in generation; introducing more transparency requirements at the holdings level and at various subsidiaries; and ensuring a just transition process that would involve stakeholders. The transmission entity would be wholly owned by Eskom and act as an optimizer of energy trading over the transmission line, whereas the two other entities would be opened to competition, thereby significantly transforming the Eskom business model, with possible participation in renewable energies.

77. Eskom has planned for new power lines stretching 4,689 km between 2021 and 2025; with a further capacity of 3,567 km of power lines to be expanded between 2026 and 2030 to meet infrastructure needs. Significant support and capacity will be required to manage complex projects in the uncharted territory of restructuring a massive public utility. It is important to underline that these are targets set against the backdrop of cuts in capital expenditure, and so may not be achieved. There is a clear disjuncture between ambition and reality.

78. If the envisaged unbundling happens successfully, it will make it easier for Eskom to dispose of some of its assets. A decade ago, Eskom produced 40,000 megawatts of electricity, had 32,000 employees, had debt of R40 billion, and had employee costs of approximately R9 billion. At present, the picture is gloomy: production has risen by only 20 per cent to 48,000 megawatts, but the number of employees has risen to 47,000 (an increase of around 40 per cent). The company now spends R33 billion in employee costs (an increase of more than 300 per cent) and has accumulated R440 billion in debt (which is a 1,000 per cent increase). Cost cutting in the coming three years is estimated to reach between R25 billion and R30 billion. Unions such as the National Union of Mineworkers and the National Union of Metal Workers of South Africa, however, have already raised concerns about job losses. The above points highlight that, at some point, something will have to be done to restructure Eskom.

79. According to the Government, Eskom will be broken into three units in a three-phased process. Phase 1 will ring-fence the three units – generation, transmission and distribution. This is to create long-term efficiencies in which each unit will act as a separate entity under one Eskom holding company. Phase 2 will entail the corporatization of the units, organizing them into full-fledged subsidiaries with their own executive committees and boards, with each managing its own balance sheet. Phase 3 will involve the privatization of generation (and possibly transmission) and the creation of regional energy distributors.

80. In addition, the following timetable will be attached to this restructuring programme:

(a). Functional separation of the three components of Eskom is slated to be concluded by March 2021;

(b). Legal separation of the transmission entity by December 2021;

(c). Legal separation of the generation and distribution entities by December 2021.

81. Each of these entities will have its own board and managing director, and operate as separate subsidiaries of the Eskom holding company, each accountable for its operational structure, finances and human capital, among other aspects . In addition, the holding structure will need to have clear mechanisms for transfer pricing, asset allocation, and trading among the various entities. There is still a long journey towards completing the restructuring process, especially as key stakeholders such as labour unions have yet to support the proposed road map. The structure of the transmission entity has yet to be finalized, and it may take a while to establish this.

82. It is envisaged that transmission will be under an independent system and market operator that will manage the flow in transmission – from generation to distribution. The tariff and cost recovery by the regulator will be distributed throughout the various units rather than being limited to a central entity that then decides on redistribution according to need. The National Energy Regulator of South Africa considers the asset base and return on assets when distributing tariffs.

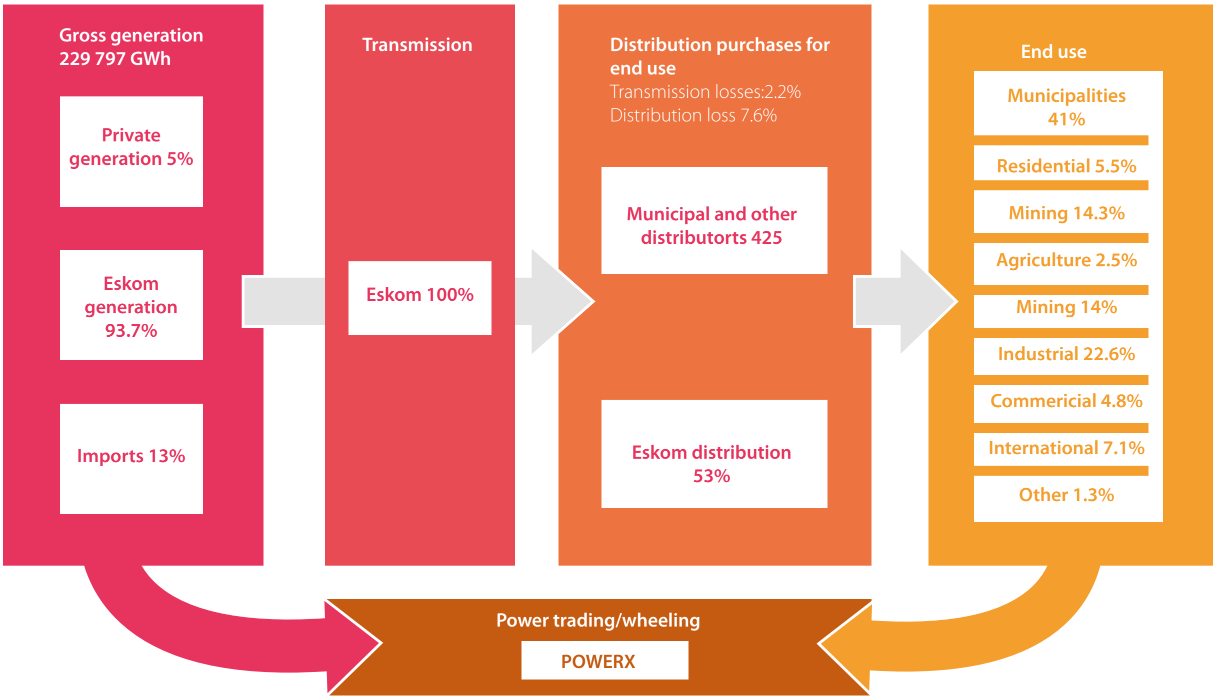
83. The decision by the Government to allow private companies to generate their own electricity and for municipalities to purchase power from private generators is an important step. The private sector is already involved in generation – for example, Khanyisa coal is an independent power producer (with GE Power as a technology partner) – but the sector remains overwhelmingly dominated by Eskom assets, both old and new. Over time, this will change. The 2018 revised (mooted) Integrated Resource Plan is not only an energy mix plan, but should also be considered a blueprint for investment. It demonstrates what the transition to a more diversified energy mix will look like from a central planning perspective.

84. Once there is knowledge of which coal-fired power stations will shut down and in what year, for example, the market components can be utilized to steer new investment to soften any negative impact that it may have on jobs. The Integrated Resource Plan provides for the allocation of new projects to independent power producers, but it makes no provision for a new build programme for Eskom, even with some of the Eskom fleet having to be retired. The allocation to independent power producers will increase at a faster rate than Eskom is able to recapitalize, because of its debt load. This will create a situation where problems could emerge in power generation, and where independent power producers are not able to make up for load shortage. This will continue to be the case especially while battery storage technology is lagging – although, through the support of the World Bank, Eskom is implementing a battery storage programme.

85. The unbundling of Eskom means having to deal with the powers of various spheres of Government. The recent past has shown that municipalities enjoy expansive powers in the reticulation of electricity. This has become problematic in that municipalities now owe Eskom more than R30 billion in arrears. What complicates the situation of municipalities regarding their electricity reticulation powers is that their provision of electricity is part of their fulfilment of a constitutional obligation. Considering that the central Government, provinces and local authorities have concurrent authority over electricity, there is bound to be conflict between the spheres of control over these functional areas. This might become more pronounced when Eskom is unbundled – questions of which sphere of governance controls generation, distribution and transmission will arise.

86. Since early 2020, South Africa has experienced lockdowns at varying levels of intensity because of the COVID-19 pandemic. During this period, Eskom has continued to operate as an essential service, as has the coal sector, which is a source of the State utility’s primary energy. The lockdown has brought about challenges in the implementation of capital and maintenance projects, owing to restrictions on the movement of people. According to Eskom interim results for 2020, critical economic indicators were down because of the economic effects of lockdown – which included a 10 per cent decline in sales volume. Average demand was down by 5,680 megawatts during lockdown level 5, with improvement in tandem with the various downward adjustments in lockdown level from 5 to 1. During the lockdown period, load-shedding was implemented for a period of three months (from July to September 2020).

Figure 1 Electricity value chain



Source: *Robb and Mondliwa (2018).*

87. Figure I illustrates the monopoly that Eskom has on generation and transmission. The power utility shares distribution with municipalities, ranging from large metropolitan areas such as Johannesburg to tiny municipalities such as Musina. Unbundling Eskom would assist in disaggregating the debt among the three units. Financiers and Government would be able to isolate the debt for each division. At present, generation is said to be the one saddled with much of the power utility's debt. Transmission is the cleanest part of Eskom. The only challenge of transmission is that South Africa has some of the longest electricity transportation lines in the world, which is something that could be dealt with in the future by having an integrated regional electricity infrastructure.

88. Besides generation, distribution is another area in which Eskom faces a lot of challenges. This is because municipalities can utilize revenue derived from selling electricity for other uses. They can divert the money because they have a constitutional duty to provide services using available means – a municipality could, for example, use the funds for health services. As this is a mandate conferred on the local authorities by the Constitution, Eskom cannot take away distribution from municipalities. Any unbundling efforts will have to take these dynamics into consideration. There is a small window for municipalities and the private sector to play a role in distribution and retail, and generation, respectively. Nevertheless, Eskom still exercises tremendous power in controlling access to the national grid, using its dominance to oppose national energy policy by, for example, refusing to sign power purchase agreements with independent power producers.

3.1.2. ESKOM AND RENEWABLE ENERGY

90. South Africa is considered world-class for renewables. A credible, low-risk renewables market among investors and clarity with respect to regulation and the energy mix would unleash investment. The recent large gas discovery by Total (the Brulpadda prospect)[4] in 2019 promises to increase the use

4 The recent discovery by Total and partners of an estimated one billion barrels of gas off the southern coast of South Africa, with production expected between 2025 and 2030, has been described by many as a "game changer" for the industry that is likely to

of gas in the energy mix. It could play a role in replacing coal-fired power generation over time and provide peaking support to variable renewables.[5] On 20 October 2020, Total announced another significant gas condensate discovery on the Luiperd prospect, located on Block 11B/12B in the Outeniqua Basin, not far from the southern coast of the country. This payable discovery may take a while, and perhaps a few regulatory hurdles to overcome to get to the stage of commercialization, but it offers South Africa a wider berth in its energy mix strategy (Total, 2020).

90. Recent analysis has shown that, in addition to the cost savings of moving to more economically viable renewables, solar photovoltaics and wind electricity generation produces 30 per cent more jobs than the energy-equivalent produced through coal-fired power generation. Discussions around the creation of a manufacturing hub for renewable energy equipment and infrastructure manufacturing in the country – creating jobs across the value chain and driving economic growth – have been gathering traction.

91. The energy transition is an opportunity for South Africa to recapture a competitive advantage by once again attracting electricity-intensive industries to revive its manufacturing sector. The country could leverage its superior wind and solar resources to produce more exportable goods. For example, the South African Coal, Oil and Gas Corporation platform could be repurposed to produce high value, decarbonized chemicals for export. Renewables experts hold the view that, if Eskom fails to transform significantly, economic pressure on electricity users may become so intense that large corporations would simply build their own solar farms to meet their energy requirements. If all paying customers were to go off the grid and Eskom were left with non-paying customers, it would force an unpleasant transition and a "potential death spiral" – a less-than-ideal scenario that can and must be prevented.

92. The growth of the renewable energy sector is held back by inertia in the coal supply chain, leading to labour and capital tensions. If major players in the coal sector are not given the option (and opportunity) to diversify or exit, they will always stand dead against renewables. Given that the transition will take many years, there may be time to shift jobs from coal to renewables through reskilling programmes.

93. It is important that reskilling is not overplayed, given that transitioning workers from low and semi-skilled coal sectors to relatively high-skilled capital-intensive sectors (such as renewable) is not something that can happen overnight. Unless there is a strong push for production of components domestically (localization), with transfer of technology, there will remain concerns about displaced workers. Some of the jobs in coal can potentially be replicated in green energy – such as mechanical, health and safety, and engineering – but these are not labour-intensive jobs. Providing preferred access to equity in large renewable projects is one option for bringing coal miners on board.

94. There is one thing that cannot be disputed – Eskom remains critical to the economy and the rest of the country. The utility must strive to deliver reliable and cost-effective electricity. It can and must play an important role in the renewable energy space, and it has to explore all potential sources of revenue. In addition, it must refocus on technology to improve its technical performance and efficiency. The need to explore and adopt an ownership and industry model that makes sense for the long term cannot be overemphasized. With that being said, all of the above will not be achieved without the buy-in of stakeholders.

3.1.3. RECOMMENDATIONS

95. Many of the recommendations given in the previous section are applicable to Eskom. These

encourage further investment and interest in resource exploration.

5 Peaking stations operate during peak periods or when the system is under stress.

include those relating to governance, independent boards, effective management structures, and a healthy human resources climate. It is important that the Government moves with speed towards implementing the Eskom road map that would bring about the unbundling of Eskom into three entities under a single holding company. It is commendable that the Minister of Public Enterprises approved the establishment of the transmission company in early 2021.

96. Much has been achieved with regard to cutting primary energy expenses and operating expenditure, but there remains a need for greater clarity on how the three subsidiary units (generation, transmission and distribution) will function, and how they will be governed. There are various problems that should be attended to that have little to do with State capture, this includes ageing infrastructure, design defects of new commissioned units, escalating municipal debt and socioeconomic tensions, and stakeholder relations in communities.

97. In addition, there are strategic questions that Eskom needs to consider with respect to it having a larger role in the region, competing in renewable energy, and structuring partnerships beyond South Africa to ensure that it is competitive and sustainable.

3.2. DENEL

98. According to the Department of Defence (2015, p. 285), Denel is regarded as a "national security asset, with the primary purpose of designing, developing, manufacturing and supporting defence material". The company is a custodian of sovereign strategic defence capabilities that designs, develops, manufactures and supports important capabilities that may not be obtainable from the market. Yet, Denel has faced severe liquidity constraints that have had implications for national security and skilled personnel in the defence sector. In the 2019/2020 financial year, it posted a loss of R1.9 billion, had equity below R4 billion with assets that were funded by debt, and was technically insolvent. This situation has built up over the years, with persistent neglect from the shareholder and lack of decisive action from the Government to ensure that the entity runs efficiently. Denel is an example of why SOEs need to be managed in accordance with basic business principles, even when their objectives are not profitability.

99. The political history of South Africa played a major role in the establishment of the Armaments Corporation of South Africa SOC Ltd (ARMSCOR) – from which Denel was later formed in 1992. During the height of apartheid, many States across the globe regarded the apartheid regime and the preceding colonial rule as unjust and immoral. In the aftermath of World War II, racial segregation policies were shunned elsewhere in the world while South Africa moved to implement the policy of apartheid. South Africa was often an agenda point in United Nations forums in the early years after World War II, especially after 1946 when India raised concerns about the treatment of people of Indian descent in South Africa. The country faced more scrutiny and many western countries attempted to persuade South Africa to reconsider its racial policies. It was only after the occurrence of the Sharpeville massacre that the South African issue was taken seriously.

100. In its resolution 134 (1960), the Security Council called upon South Africa to initiate measures to bring about racial harmony and abandon its policies of apartheid and racial discrimination. After resolution 134 (1960) was passed, South Africa continued to face isolation and economic sanctions, but many of its trading partners opposed the move. On 7 August 1963, the Security Council adopted resolution 181 (1963) – a non-voluntary arms embargo against South Africa – in which it called upon all States to cease "the sale and shipment of arms, ammunition of all types, and military vehicles to South Africa". This was in response to the worldwide perception that an arms build-up was underway in South

Africa that would be used to further the country's racial policies. Resolution 181 (1963) came after South Africa withdrew from the Commonwealth. These two occurrences provided the impetus for developing a domestic defence industry, as South Africa had relied heavily on imports of arms from abroad, especially from the United Kingdom of Great Britain and Northern Ireland (Dunne, 2006).

101. To counter this, ARMSCOR, which was initially an advisory committee to the Union Defence Force known as the Defence Resources Board from 1948 to 1964, was established as a statutory body with direct responsibility to the Minister of Defence through the Armaments Production and Development Act, Act No. 57 of 1968 (ARMSCOR, 2016). The post-1960 era was marked by a 500 per cent rise in defence spending from 1961 to 1966 (Rogerson, 1990). The acquisition of foreign production licences further helped South Africa to become self-sufficient in terms of military production. ARMSCOR was a fully-fledged State enterprise that manufactured armaments. It was responsible for the promotion and coordination of the development, manufacture, acquisition and supply of armaments. By 1977, when the Security Council passed resolution 418 (1977) (the mandatory arms embargo), South Africa had sufficient capacity to produce arms.

102. As the move towards democratization unfolded in the early 1990s, ARMSCOR was unbundled, with all the production business units separated in 1992 to form Denel Pty (Ltd) under the Companies Act as a commercial enterprise that reported to the Minister of Public Enterprises (Department of Defence, 1999). Overall, the core competency of Denel continues to be system or subsystem design, development, integration and testing, with most of the actual manufacturing and assembly being subcontracted to more specialized industries. ARMSCOR was repurposed, in accordance with the revision of the Armaments Production and Development Act, to be responsible for arms procurements only.

3.2.1. DENEL POLICY FRAMEWORK

103. The overall macropolicy on SOEs is directed by the Cabinet. The position of Denel in the public policy context could be classified as a State asset with a strategic dimension from the public policy perspective. This is defined in the 1999 "White paper on the South African defence-related industries", which states that the Government recognizes that "defence-related industries – which Denel is a component of – are an integral part of South Africa's defence capability" and that the Government recognizes "the strategic and defence value of having a local defence industrial capability" (Department of Defence, 1999, p. 2). This is exhibited by the shareholding arrangement of Denel, as only SOEs that are deemed strategic are under the Department of Public Enterprises (National Planning Commission, 2020).

104. Denel has a public policy or strategic objective and pursues commercial objectives; however, the company's profitability has been declining since the early 1990s, long before State capture had set in. Denel was one of the major State assets that were earmarked for the SOE restructuring programme. As indicated in the policy framework, "An accelerated agenda towards the restructuring of State-owned enterprises", the Cabinet had instructed the Department of Public Enterprises to prioritize the restructuring of the four largest SOEs, namely – Eskom, Transnet, Telkom and Denel.

105. The restructuring of SOEs was envisaged in the 1994 Reconstruction and Development Programme, in which is stated that the Government "inherited a range of assets that could now be sold to release resources for the implementation of the RDP" (South Africa, 1994). This resulted in several policy papers (white papers) being drafted throughout the various sectors to define the purpose of the various SOEs.

106. The "White paper on national defence for the Republic of South Africa" reconceptualized the concept of "security" such that it was no longer seen as a predominantly military and police problem. Security

was now perceived to encompass political, economic, social and environmental issues (Department of Defence, 1996). This was in light of the socioeconomic problems (such as poverty, unemployment, poor education and absence of adequate social services, among others) being seen as the greatest threat to the South African people. Even though the need to maintain a core defence capability was recognized in the white paper, redirecting resources away from military spending to implementing the Reconstruction and Development Programme policy was considered a more imperative task. The decline in the defence budget affected Denel.

3.2.2. RESTRUCTURING DENEL FOR OPERATIONAL EFFICIENCY

107. Privatization was grounded in the Growth, Employment, and Redistribution framework. According to this framework, the restructuring of State assets or SOEs would be implemented along various pathways that "may involve the total sale of the asset, a partial sale to strategic equity partners or the sale of the asset with government retaining a strategic interest" (Department of Finance, 1996, p. 17).

108. With regard to Denel, the main rationale for its restructuring was declining profitability (see table 2) that was further worsened by global developments that pointed to a declining defence expenditure and increasing competition in the defence supplies industry. This competition eroded the profitability of the industry. Internal demand, as noted by the Department of Public Enterprises (2000), shrunk because of several reasons, such as: the decrease in South African defence spending, which decreased from 4.5 per cent of the GDP in 1989/90 to 1.4 per cent of the GDP in 1997/98; and the decrease of orders from the South African National Defence Force (orders made to Denel) by 57 per cent in real terms between 1992/93 and 1998/99. The decline in orders was likely to persist, given the redefinition of security and the decision to reallocate resources towards the implementation of Reconstruction and Development Programme.

Table 2 Denel financial performance: 1992/93 – 1996/97

(Millions of South African rand)

	1992	1993	1994	1995	1996	Average 92 – 96
Turnover	3 839	3 507.0	3 376.0	3 506.0	3 013.0	
% Change		-9.0	-4.0	4.0	-14.0	-6.0
Operating profit	231.0	257.0	222.0	285.0	-72.0	
% Change		11.0	-14.0	28.0	-125.0	-25.0
Net profit	320.0	293.5	347.4	390.2	81.5	
% Change		-8.3	18.4	12.3	-79.1	-14.0
Total assets	6 166.0	5 771.0	4 562.0	4 520.0	4 253.0	
% Change		-6.4	-21.0	-0.9	-5.9	-9.0
Operating margin	6.0	7.3	6.6	8.1	-2.4	5.0
Return on assets	5.2	5.1	7.6	8.6	1.9	6.0
Value added	2 060.0	1 840.0	1 854.0	1 826.0	1 402.0	
% Change		-10.7	0.7	-1.5	-23.2	-8.7
Employment (number)	15 572.0	13 895.0	13 826.0	14 150.0	14 200.0	
% Change		-10.8	-0.5	2.3	0.4	-2.1
Capital – labour (thousands)	395.0	415.0	329.0	319.0	299.0	
% Change		4.9	-20.6	-3.2	-6.2	-6.3
Capital - output (rand)	4.1	3.8	2.8	2.6	3.0	
% Change		-5.7	-28.4	-7.4	19.8	-5.6
Output - labour (thousands)	132.0	132.0	134.0	129.0	98.0	
% Change		0.1	1.3	-3.7	-23.5	-6.5

Source: *Department of Defence (1999).*

109. Noting these developments, the Department of Defence (1996) proposed a strategic shift in favour of civilian-oriented manufacturing as opposed to narrow core defence supplies. This was expected to be achieved without the loss of key technology required for defence military production. Hence the plan to restructure Denel was aimed at separating it into different clusters or convert the different divisions into separate entities, and, once that was achieved, the State would then sell less than 100 per cent of the shares in each cluster or division. However, the high degree of linkage among its various divisions meant that it would prove difficult to sell off clusters or divisions as single corporate entities, as this might make the survival of remaining divisions difficult, and, in turn render them less attractive to prospective investors.

110. The restructuring of Denel into several business entities, including aerospace, ordnance and non-core functions, commenced in the late 1990s, and strategic equity partners in several of these business entities were immediately sought. The Cabinet approved British Aerospace as the preferred strategic equity partner for the Denel Aerospace Group and Snecma/Turbomeca as the strategic equity partner for the business unit Airmotive in October 2001 (National Treasury, 2001a). The Airmotive Division of Denel was disposed to Turbomeca Africa (Pty) Limited on 2 August 2002, and Denel held a 49 per cent stake in the company (Denel, 2004). Notwithstanding this minor progress, the plans to dispose of non-core assets began to falter as the SOE restructuring programme was met with resistance in certain sections.

111. Although the private sector had criticized the Government for the slow implementation of Growth, Employment and Redistribution framework, especially the privatization of SOEs, labour unions were opposed to the restructuring programme as they contended that the Growth, Employment and Redistribution framework (which anchored the policy for SOE restructuring) contradicted and abandoned the Reconstruction and Development Programme policy (Mostert, 2002). In addition, labour unions argued that the restructuring of SOEs would hamper the ability to meet basic social needs and was likely to lead to loss of employment.

112. Accordingly, the plans to restructure some of the major SOEs stalled. Denel continued to operate inefficiently and made losses, posting a profit only once between the 1998 and 2005 financial years. In the financial year ending March 2005, Denel posted a net loss of R1.6 billion, which made it technically insolvent as its total liabilities exceeded total assets by R770 million by the end of 2005. While the Government recapitalized Denel by R2 billion in 2006 (a total of R3.5 billion over a three-year period from 2005 to 2008), the financial position of Denel required action.

113. Denel then developed a macro turnaround strategy and began its implementation in October 2006. The strategy was aimed at improving the performance of the entity (Denel Aviation, 2008) and was anchored in the following five pillars:

(a). Secure "privileged access", which refers to the concept of local industry having a visible role in defence expenditure and participating in joint planning to adequately meet the Department of Defence requirements;

(b). Engage State agencies (align all stakeholders with the macro strategy);

(c). Evaluate the commercial viability of business entities;

(d). Create equity-based relationships/formal alliance partnerships;

(e). Raise productivity and capabilities to world-class standards.

In addition, the strategy was aimed at restructuring the business and exiting non-core and non-profitable segments. According to the National Treasury (2006), the primary aim of disposing these assets was to make the entity more focused and to inject the proceeds into the business. In 2006, Denel began the disposal of some of its non-core assets, such as its 26 per cent stake in Arivia, Irenco Electronics and Bonaero Park (Fin24, 2006). The implementation of the turnaround strategy proved to be instantly successful, as losses were reduced, cash utilization improved significantly, and its solvency improved (see figure II – the red line indicates the implementation of the turnaround strategy).

Figure 2 Denel financial performance, 2001–2008

Source: *Denel (2009).*

114. The implementation of the strategy led to Denel reducing its losses from R1.6 billion in 2015 and R533 million in 2009 to R246 million in 2010 (Creamer Media's Engineering News, 2010). While Denel was improving its financial position at the time, an equity-based relationship with Saab – in accordance with one of its macro-strategy pillars – was proving to be a challenge in terms of making a profit. Denel Saab Aerostructures (DSA), a partnership established through a 2006 agreement between Denel and Swedish-based aerospace and defence company Saab, in which Denel owned 80 per cent and Saab the remaining 20 per cent, had a negative impact on the financial performance of Denel. DSA posted a R328 million loss in 2010; and while Denel made a R111 million profit in 2011 (its first time making a profit in more than a decade), DSA continued to post losses and to drag down the overall profit of Denel.

115. The net profit of Denel in 2011, before the inclusion of DSA, amounted to R348 million. Notwithstanding the challenge posed by DSA, Denel continued to record modest profits until the financial year 2016/17. This was mainly because of the continued restructuring of the company and growth in export revenue (Denel, 2013). Denel intends to exit loss-making businesses, as part of its turnaround strategy; however, the slow progress in exiting these businesses has put further strain on its financial performance.

116. In the 2017/18 financial year, Denel recorded a R1.749 billion loss. The loss was due to, among other things, lapses in governance, mismanagement and poor contract execution that resulted in severe liquidity challenges (Denel Mechem, 2018). In that financial year, in which Denel recorded a loss for the first time in seven years, the Auditor General of South Africa found that Denel had tabled an incorrect annual report, as a clean audit opinion had initially been given with no evidence supporting that opinion. The contracted auditing firm's interpretation of irregular expenditure was believed to be incorrect. Irregular expenditure amounted to R500 million in that year.

117. While efforts to turn around the financial performance of Denel were in motion, the entity found it hard to stay afloat, as it struggled to pay its employees their full salaries and wages on several occasions – even with a R1.8 billion cash injection from the Department of Public Enterprises in April 2019. The entity has continued to post losses, as some of its projects that were deemed to be of strategic national importance have been underfunded and its debt profile has continued to worsen.

3.2.3. GOVERNANCE CHALLENGES AT DENEL

118. The unbundling of ARMSCOR to form Denel in 1992 resulted in the newly formed SOE being separated from its policymaking ministry. While Denel, (along with the other six major SOEs in the country) reports to the Minister of Public Enterprises, it is the Department of Defence that makes the policies that dictate the activities of the entity in the defence industry. The Department of Public Enterprises is responsible for appointing the board of directors that oversees the executive management that is responsible for its day-to-day operations. This means that the Department of Public Enterprises has executive authority over Denel, while the entity receives policy directives from another department – the Department of Defence. The Department of Public Enterprises, as a shareholder, is concerned with the appropriate returns on investment, while the Department of Defence is concerned with ensuring that Denel fulfils its strategic purpose, that is, to ensure that service delivery is consistent with the expected outputs (National Treasury, 2005).

119. The 2002 Protocol on Corporate Governance in the Public Sector,[6] which governs how SOEs are directed, managed and held accountable, stipulates that the executive authority (which is the Department of Public Enterprises) should set clear objectives for SOEs. This already poses challenges for SOEs as there is often a lack of coordination between the department responsible for policymaking and the shareholding department (PricewaterhouseCoopers, 2011). This is further compounded by the previously indicated lack of clear mandates for SOEs.

120. In addition to this policy-setting debacle, several governance challenges have been prevalent in SOEs. A number of legislative instruments prescribe governance structures and their duties within SOEs. These include the Constitution, the Public Finance Management Act, the Companies Act and other enabling legislation by which specific SOE has been established. Irrespective of this, there is an absence of a clear framework for appointing SOE boards. The Companies Act of 2008, which could be supplemented by any legislation governing the entity in question, is the key legislation regulating board appointments in SOEs (Hogan, 2019). The Public Finance Management Act, which is augmented by Part 9 of the Treasury Regulations of 2001[7], only stipulates the role and

6 The Protocol was first published in 1997 with a view to inculcating the principles of good governance in SOEs, and the 2002 reiteration of the Protocol constituted a substantial revision thereof considering the King Code of Corporate Governance and international developments (Department of Public Enterprises, 2002).

7 With regard to section 76 of the Public Finance Management Act, the National Treasury may make regulations or issue instructions applicable to all institutions to which the Act applies, to promote and enforce transparency and effective management in respect of revenue, expenditure, assets and liabilities (National Treasury, 2001b).

functions of the board or accounting authority. Even though the Department of Public Service and Administration issued the Cabinet-approved "Handbook for the appointment of persons to boards of State and State-controlled institutions" in 2008, this was not anchored in any formal framework, regulation or legislation.

121. The underlying causes of the governance challenges in SOEs can be pinned on the absence of clear policy frameworks that deal with board appointments and composition, which make the processes susceptible to political interference. Denel has been engulfed by these challenges. While the State capture era brought governance challenges under the microscope, especially the way that SOE boards were selected and appointed, along with the role of senior managers in the poor performance of SOEs, Denel had been marred by corruption allegations prior to that era.

122. In 2004, when Denel was experiencing management challenges, it suspended at least 22 senior managers who were alleged to have partaken in fraud and corruption after the institution of a widespread forensic investigation. Victor Moche, CEO of Denel at the time, had specified to parliament that "a report compiled by the entity's forensic unit indicated that losses due to fraud, corruption and criminal conduct had amounted to around R1 billion" [through the years] (Parliamentary Monitoring Group, 2004). The issue of mismanagement surfaced during the State capture years when allegations of fraud and misappropriation of funds at the entity were made.

123. An example of corruption at Denel in recent years was when a company – co-owned by the friends, associates and son of the then President Zuma – was awarded a contract to manufacture and supply platform hulls in 2016. The company had no experience in manufacturing platform hulls and had submitted a proposal priced over R100 million more than the usual in-house supplier that was majority owned by Denel and had the experience (BizNews, 2020). The awarding of that contract flouted the supply chain process. This was followed by a joint-venture with VR Laser Asia – a company owned by another associate who had close ties with the friends of the former President Zuma – without obtaining National Treasury approval, which is required in order to implement such a venture. These events came were the backdrop for the Denel board, which served from 2010 to 2015, being replaced in its entirety with no continuation, despite having turned around the company's poor financial position. The board members who were appointed in 2015 lacked the critical skills necessary to carry out their duties, such as having among them an individual with a financial background. The company's CEO, Chief Financial Officer and Group Secretary were all suspended and ultimately removed to make way for individuals who could be seen to be allies of the board and its interests.

124. A new board was appointed at Denel in April 2018, along with a raft of changes introduced at the management level; however, the financial challenges at Denel persisted, as the new board failed to turn the entity around. At least seven board members – including the board chairperson – tendered their resignations between January and February 2021, amid another year of poor financial performance by Denel. The resignations have now left the entity with only five board members in place – essentially rendering the board dysfunctional. This has coincided with the departure of the interim CEO. The issues surrounding the board and CEO indicate the continuance of governance challenges and unstable management at the State-owned arms manufacturer. This instability stems from the deep challenges created by previous boards and management.

125. The impact of the previous board and management on Denel indicates the dangers posed by not having a clear framework for making board appointments in SOEs. Without any clear framework, political interference can lead to the appointment of an incompetent and ethically deficient accounting authority, which can wreak havoc in SOEs and collapse their operations.

126. The Department of Public Enterprises had made a commitment to finalize the green paper for a government shareholder management bill in the 2019/20 financial year, with the bill expected to be enacted in the 2021/22 financial year (Fin24, 2020). The bill should address several issues, including the appointment of boards and other governance challenges.

3.2.4. RECOMMENDATIONS

127. At present, Denel is "structurally and operationally inefficient" and has a high probability of not meeting contractual performance obligations or its monthly operational expenses, including salaries and creditor payments (Denel, 2021). This opens the country to being technology takers and price takers, and to depend on others to protect it. Within a changing global environment, the strategic intent of Denel is not well articulated. In addition, it has suffered a Fitch ratings downgrade, which makes it harder to raise capital in debt markets. With a weak balance sheet, poor governance, and high turnover among its skilled workers, it will be a long road for the entity to return to profitability, grow a supply pipeline of critical technologies, and compete internationally. It is facing an existential crisis.

128. It is important for Denel to accelerate the process of disposing of its non-core assets, valued at R1.6 billion, and to conclude its equity partnerships. The turnaround strategy should not only focus on improving the financial position of Denel, but look at the long-term shape of the entity. Given the difficult position that it is in, deep restructuring is required, and the Government needs to rethink its value proposition in a changing global environment. At present, Denel is in a crisis mode and spends very little energy on its long-term future. The Defence and Aerospace Masterplan that is underway should provide greater clarity on the future of the sector, and especially the role of Denel in a leaner and more focused form. At the time of finalizing the present report, Denel was without a company CEO – there must be urgency in filling this position. More critically, the future shape of Denel will need to be redefined. It will need to trim its assets while sharpening its distinctiveness.

3.3. SOUTH AFRICAN AIRWAYS

129. Airlines, especially national carriers, exist for several reasons. These include the provision of public transport services, the maintenance of strategic transport services, the development of national prestige, trade and tourism. In the South African context, the initial reason for the establishment of a commercial airline was anchored in the need to provide airmail services. After a successful airmail service experiment between Durban and Cape Town in 1925, the then recently established Civil Air Body recommended that the services be operated by the South African Air Force and be taken over by a Government-subsidized commercial entity if it proved successful (Surdut, 1977). The commercial results of this service proved disappointing during the four-and-a-half-month-long experimental period that began on 25 March 1925. Notwithstanding the results, the Government entered into a three-year contract with Union Airways, a company that was registered in 1929.

130. The participation of the South African Government in the civil aviation space was informed by the Railways and Harbours Regulation, Control and Management Act, No. 21 of 1931. The Act stipulated that South African Railways and Harbours Administration would operate its own departmental aircraft for the transport of passengers and goods. After the owners of Union Airways completed their negotiations with the Government in February 1934, the Government acquired all assets of Union Airways. This step gave birth to South African Airways (SAA).

131. On 16 July 1948, the airline was designated as the country's instrument for the operation of reciprocal air transport services between the then Union of South Africa and the United States of America. At that point, SAA became the country's flag carrier. According to Motsohi (2020, p. 91), "As the flag carrier, SAA was protected from competition for over 40 years following the promulgation of the International Air Service Act, also known as the Air Services Act of 1949". Only four airlines operated in South Africa: SAA, covering main routes and main airports; Comair, servicing secondary routes since 1945; Link Airways, later SA Link, also covering secondary routes from 1978; and Bop Air or Sun Air operating from 1979 on secondary routes (Motsohi, 2020). SAA was a monopoly, with 90 per cent share of the scheduled domestic market.

132. The management of transport services came under scrutiny in the decades that followed the establishment of SAA. A proposal was made at the 1952 Durban Chamber of Commerce congress to separate the management of railway and air transport, as SAA was under the South African Railways and Harbours Administration, together with other transport-related entities owned by the State, such as rail transport services. In 1981, the South African Railways and Harbours Administration was reconfigured to become South African Transport Services and was restructured into different units and divisions. The prevailing poor performance of SOEs at the tail-end of the twentieth century precipitated a call to deregulate or privatize SOEs around the world.

133. As part of the neo-liberal wave that was in vogue at the time, the United States Government introduced the Airline Deregulation Act of 1978. Accordingly, fares, routes and entry of new airlines were determined by market forces rather than a Government's visible hand. The Civil Aeronautics Board that played a regulatory and price-setting role was folded down. During the same period, liberalization had taken grip of various regions of the world, including Asia, Europe and Latin America, with countries such as South Africa following suit just over a decade later. In 1991, the Government deregulated the airline industry in South Africa and promoted choice and competition.

134. Consequently, the South African Government tabled the "White paper on privatization and deregulation in the Republic of South Africa" in 1987, which was aimed at achieving development and growth (Meyers, 1997). The Department of Transport (2017) explained that the separation of various State-owned transport modes as commercialized divisions of Transnet Limited in 1990 was in line with the recommendations in that white paper. Transnet was the parent company of SAA up until 2006, when the South African Airways Act, No. 5 of 2007 came into effect (South Africa, 2007). Even though SAA became a separate entity after 2007, its monopoly position remained unchallenged owing to the airline's ownership by a Government intent on protecting it. The anti-competitive behaviour of SAA throttled competitors such as Flitestar, Phoenix Airways, Sun Air, Comair and Nationwide by undercutting their prices (Mhlanga, 2017). There was consolidation in the sector, with only Comair, Nationwide and SAA standing by the year 2000 (Motsohi, 2020).

135. The current vision for SAA is to "deliver commercially sustainable world-class air passenger and aviation services in South Africa, the African continent and to our tourism and trading partners" (South African Airways, 2020). Notwithstanding this vision, SAA has lost its focus, poor financial control has brought strain on the airliner, and management failures have become pervasive.

3.3.1. SOUTH AFRICAN AIRWAYS POLICY FRAMEWORK

136. While it was the deregulation of the domestic air industry in 1991 that represented a watershed moment for the airline industry, it was the 1996 "White paper on national transport policy" that set

the tone for the transport sector in South Africa. It contained the stipulation that the Government would focus on policy and strategy formulation; and that the strategic objective for civil aviation should be to "promote the national interests of South Africa in general, and facilitate and enhance the expansion of trade and tourism" (Department of Transport, 1996). There is, however, no mention of SAA in the white paper.

137. Although the Department of Transport is responsible for setting policy directives concerning the transport sector, as a major public enterprise, SAA is under the executive authority of the Department of Public Enterprises, as stipulated by schedule 2 of the Public Finance Management Act. In the 2017 "White paper on national civil aviation policy", the Government established that the Department of Transport would be responsible and accountable for all transport matters at national level, along with being responsible for aviation policy to steer civil aviation towards achieving its objectives (South Africa, 2017).

138. Government policy documents are silent on the mandate of SAA, but the carrier's mandate is indicated in its strategic documents. In articulating its vision in key documents, SAA is intended to be "commercially sustainable and, as flag carrier, to support trade and economic enablement" (South African Airways, 2014). Beyond this general statement, it is not clear how the airline contributes to the country's development or how its value creation is distinct from that of private operators.

139. The 1996 white paper on national transport policy merely signals the Government's intent to build the civil aviation sector, but it does not stipulate the role that SAA is expected to fulfil. The National Development Plan, which serves as the main plan for the country, is equally silent on the role of SAA. Similarly, no mention of the role of SAA has been made in recent policy and legislative instruments. The absence of any policy document explicitly stating the mandate of SAA is a major omission. The absence of clear mandates for SOEs is widespread in South Africa. This was flagged in the report of the Presidential Review Committee on State-owned entities, and a recommendation was subsequently made to develop an overarching long-term strategy for SOEs and to enact a single overarching law for their mandates, among other things.

3.3.2. GOVERNANCE CHALLENGES AND OPERATIONAL WEAKNESSES AT SOUTH AFRICAN AIRWAYS

140. The Legal Succession of the South African Transport Services Act of 1989 altered the path of SAA. The Act resulted in the corporatization of South African Transport Services into Transnet, of which SAA was a division. Smith (1998) pointed out that through that Act, SAA was identified as a candidate for privatization. The privatization of SAA was expected to either accompany or precede the deregulation of air services. The deregulation of air services was aimed at enhancing user choice and need satisfaction.

141. The clearest indication that SAA would be privatized was in 1997, when the Government announced its intention to sell a strategic equity stake in SAA in 1998. This essentially indicated that the plans to privatize SAA were inherited by the post-apartheid Government from the apartheid-era Government. In 1999, SAA sold a 20 per cent stake to Swiss Air and corporatized in that same year. These were promising steps towards the privatization of SAA; however, several events happened that stalled plans to completely privatize and restructure the airline.

142. First, the aggressive Swiss Air expansion plans through acquisitions led to financial troubles for the airline as it accrued losses from a failed attempt to expand across Europe between 2000 and 2001 (Olson, 2001). The aftermath of the 11 September 2001 terrorist attacks in the United States

exacerbated the decline in passenger traffic, especially across the Atlantic. As a result, Swiss Air halted all flights as of 2 October 2001 because of cash shortages – and later filed for bankruptcy. This meant that the airway's equity partner was in no position to contribute effectively to SAA, which resulted in SAA buying the 20 per cent equity stake back from Swiss Air in 2002. Even with this privatization reversal, SAA made an enormous profit from trading that equity stake: it had sold it to Swiss Air for R1.38 billion in 1999 and bought it back for R382 million three years later.

143. Second, SAA has traditionally been plagued by high management turnover and change of CEOs in the past two decades. The management challenges at SAA have persisted since the early days of the new democratic dispensation. While poor performance of SOEs is not a new phenomenon – as noted in the 1987 "White paper on privatisation and deregulation" – the continued dismal financial performance of SAA has mainly been self-inflicted. Mismanagement dates as far back as 1998 when the carrier was still a division of Transnet. A new CEO, Coleman Andrews, was brought to the airline 1998 to turn its fortunes around. During his short stint at SAA, the airline was initially said to have recorded a R350 million profit in 2000 (Independent Online, 2001a). Motsohi (2020) noted that the new CEO had focused mainly on cost cutting measures, improvement in revenue management, customer service improvement, and better fleet management, while embedding a culture of business ethics and a sound strategic vision.

144. The picture was not all together perfect. The airline's profitability during that period was primarily due to the one-off sale of 15 of its aircraft. When the proceeds of the aircraft sale were excluded from the airline's financials, it was found that SAA had made a loss during that financial year. Concerns were raised about the sustainability of the profits that were recorded that year. Mr. Andrews left SAA in 2003 – 14 months before his contract came to an end, due to what he termed as frustrations with the Government (i.e., the Department of Public Enterprises and the Department of Trade and Industry) and Transnet interference in the running of the airline (Mail & Guardian, 2001). In addition to SAA recording a staggering R700 million loss in that year (2000/01), it was discovered that Mr. Andrews had earned R232 million during his 20-month stint as SAA CEO, largely due to his package incorporating 18 million shares valued at 1 cent each, which Transnet (SAA holding company at the time) bought back from him at R2.50 each to restructure his package. The R232 million was made up of package salary and bonuses totalling R99.8 million, payment in lieu of shares totalling R58.6 million, and a termination package worth R73.8 million (Independent Online, 2001b).

145. The issues experienced at SAA during the tenure of Mr. Andrews pointed to a lapse in corporate governance. According to the 2002 Protocol on Corporate Governance in the Public Sector, the board of an entity should "monitor management closely in implementing board plans and strategies" (Department of Public Enterprises, 2002, p. 10). In addition, the OECD Guidelines on Corporate Governance of State-Owned Enterprises[8] requires that the board should take ultimate responsibility for the enterprise's performance and supervise management (OECD, 2015).

146. The earlier post-apartheid challenges at SAA, as in other SOEs, can be contextualized in the mid-1990s restructuring and rationalizing of public services. In the 1995 "White paper on the transformation of the public service", State representativeness and affirmative action were acknowledged as being among its major priorities – and the Government set a two-to-three-year time frame to achieve its transformation goals (Department of Public Service Administration, 1995). Several inexperienced individuals were appointed to senior positions in the management of SOEs and at the board level.

8 The OECD Guidelines on Corporate Governance of State-owned Enterprises provides specific advice to countries on how to manage more effectively their responsibilities as company owners, thus helping to make SOEs more competitive, efficient and transparent (OECD, 2015).

147. The operational inefficiencies at SAA were laid bare by the R13.74 billion loss it incurred between 2002 and 2008, which excluded restructuring costs of R1.345 billion and R137 million paid on loans raised with financial institutions based on Government guarantees (Politicsweb, 2008). In addition, the Government had bailed out SAA with R9.2 billion between 2004 and 2008 and provided a further R2.9 billion in guarantees during the same period.

148. Essentially, SAA has suffered from the typical soft budget constraint. The high turnover of CEOs and senior managers has had an impact on the operational effectiveness of SAA as indicated by the failure to implement the many turnaround strategies it has developed over the years. This was exhibited by the adoption of the long-term turnaround strategy developed in 2013, which was the airline's ninth strategy or plan in 15 years. The five-year turnaround plan included the following strategy pillars:

- Liquidity[9]
- Balance sheet restructuring
- Revenue stimulation
- Cost optimization
- Refining the strategy for SAA

149. Managerial challenges have been compounded by alleged corruption at the airline, especially at the height of the State capture years. Auditing firms – PricewaterhouseCoopers and Nkonki – had missed the alleged corruption at the airline for a period of five years. These were monies paid into the business account of a non-executive director at SAA, Yakhe Kwinana. In addition, some contracts were awarded to service providers who did not meet prerequisites – that is to say, SAA awarded a contract to Swissport even though it did not have an Association of Chartered Certified Accountants licence (Independent Online, 2020a).

150. These persisting challenges eventually led to the Government directing the airline to go into voluntary business rescue. The aim of this process was to institute a turnaround of the entity, but it would have ultimately led to job losses. While this process was initially met with resistance, especially from labour unions, it has now been accepted with the aim of turning the airline around and launching a new airline. The business rescue plan was approved in July 2020 at a creditors' meeting with an 86 per cent vote. To this effect, the National Treasury has allocated R10.5 billion as an in-year adjustment in the Medium-Term Budget Policy Statement.

3.3.3. RECOMMENDATIONS

151. The airline has been under an intense process of restructuring through a business rescue process. There is much that is unclear about the future of SAA and whether it will continue to rely on State guarantees and direct capitalization from the Government to continue to operate. Questions will linger as to whether the best approach for the State is to exit or to keep hoping that the airline will return to profitability. There are strong voices that believe that the airline has both a commercial and social role to play. Commercially, it can boost tourism on the African continent and from key markets in the global North, and from Asia and Latin America.

9 Liquidity – SAA has not been generating free cash flow for many years, mainly due to lack of profitability. It is important to implement key initiatives that will reduce cash burn and drive business performance.

152. On a social level, SAA has facilitated connectivity between remote areas (especially rural locations) and metropolitan areas, and should be considered key in the development of underserved zones. The problem is that the trading environment of the airline industry is extremely tough, not just for South Africa but as a global phenomenon. The COVID-19 pandemic has further heightened these risks. It is possible that SAA will continue to depend on State guarantees, and may very well make a strong case for support considering its emergence out of a business rescue process.

153. The business rescue process has cost R10.5 billion, with more resources likely to be required to get the airline back in business. Options for its re-entry have yet to be determined. The condition for operation should be the ability of the airline to attract a strategic partner and having a new strategy and corporate plan to guide the operation. At present, and in the light of the COVID-19 lockdown conditions, the airline is far from viable and it may make sense for the State to exit, especially given the intense pressures on the nation's finances.

3.4. TRANSNET

154. Transnet is one of the largest players in the business of freight logistics and the transportation of goods in South Africa and to other parts of the African continent. The company's roots stretch back to the late 1850s, when the need for railway transport for the harbours in the Cape and Natal was first recognized. A railway was commissioned to be built between Cape Town and Wellington, a distance of approximately 70 kilometres. The delays in building the railway however, meant that the Natal Railway Company (formed in 1859) was the first to realize and operationalize railway tracks in South Africa. This was a three-kilometre track from the Market Square in Port Elizabeth to the Point in the harbour area in Durban.

155. The need to develop railway tracks in South Africa was spurred by the growth in agricultural exports, with the agricultural industry largely concentrated in the Western Cape. The development of the country's interior led to other agricultural products – such as wool, skins, hides and ostrich feathers – becoming important. These became commodities destined for export. The ox and horse wagons could not keep up with these developments and a more efficient mode of transport was required, hence the need to develop railway tracks.

156. It was the discovery of minerals in the interior of the country, especially the discovery of diamonds in 1867 and gold in 1886, that served as a catalyst for State intervention. In 1872 and 1877, respectively, the Cape lines were taken over by the Cape Colony to become government property and the Cape Government Railways was born, while the Natal railways were now under the control of Natal Government Railways. These were rudimentary days in the development of a railway network in South Africa. The formation of a Union Government in 1910 saw the creation of the South African Railways and Harbours Administration, which resulted from the amalgamation of the pre-existing provincial railway management entities. In addition, the South African Railways and Harbours Administration had an air transport component. The core purpose of the country's railway network was to serve its export-oriented economy.

157. In the decades that followed, debates about the governance of the railways, harbours and ports continued. It was the proposal to separate the management of air from railway transport, made in 1952 congress of the Durban Chamber of Commerce, that set a long-term tone for the South African Railways and Harbours Administration. In 1969, the Marias Commission issued a report that set out the reasons for the denationalization of the South African Railways and Harbours Administration, but this was rejected by the Ministry of Transport the following year. In 1981, the South African Railways and Harbours Administration was reconfigured to South African Transport Services and restructured into different units and divisions.

158. As previously mentioned, the Government tabled the "White paper on privatisation and deregulation in the Republic of South Africa" in 1987. Among the aims set out in the white paper was achieving development and growth (Meyers, 1997). This was in the context of deteriorating performances by SOEs in sub-Saharan Africa. In 1990, various State-owned transport modes were separated into commercialized divisions of what was called Transnet Limited (Department of Transport, 2017). South African Transport Services became Transnet SOC and Transnet Freight Rail became the largest division in Transnet, taking responsibility for the national long-distance rail network. Transnet Freight Rail manages the bulk of freight rail infrastructure in South Africa, comprising the heavy haul lines for exporting coal through the Richards Bay Coal Terminal and for iron ore through the Saldanha port terminal. The rest of the network is operated under its general freight business.

3.4.1. TRANSNET CHALLENGES

159. Transnet SOC Ltd has been plagued by historical challenges. The major challenge could be categorized as structural, as it stems from the disproportionate transport demand owing to the country's inland mining deposits, with concomitant industrial development far from the country's ports (Havenga, and others, 2013). The country's economic activity is largely concentrated inland – its non-containerized export activity (mineral commodities and base metals) occurs inland as well.

160. These structural challenges have been exacerbated by the historical absence of a long-term strategic view for infrastructure planning in South Africa. At present, rail transport has a low market share as it only accounts for less than 20 per cent of general freight and less than 10 per cent of passengers (Department of Transport, 2017). Similarly, this trend is present in the bulk minerals freight – an area in which rail should be unbeatable.

161. The market share has been captured by the road-going side-tipper interlinks because of the deregulation of freight transportation that began in the 1970s and strengthened in 1988, when goods transported more than 400 kilometres were no longer required to be done by railways as the sole carrier. The deregulation was achieved through the Transport Deregulation Act of 1988. In addition, the capacity of roads to convey goods of varying sizes, shapes and masses over vast distances was a factor contributing to the growth and preference for road transport. The growing market share of road transporters led to large investment by road transporters and logistics companies, especially in the 2000s, based on strong economic growth. The relatively low barriers to entry meant that several new companies entered the market while firms divested from in-house logistics to focus on core operations. The deregulation seemed to have caught Transnet unawares.

162. While the deregulation created challenges for Transnet, the period prior to the deregulation could be construed as a factor that contributed to the lack of strategic insight regarding infrastructure planning, especially rail infrastructure, as it had created a monopoly for Transnet that led to chronic underinvestment in the rail and ports network. Pieterse and others (2016, p. 15), contended that the lack of proper infrastructure planning was exemplified by the fact that "the average age of locomotives in 2005 was 25 years, whereas the international best practice average is 16 years [and] that the majority of the signalling systems date back to before the 1960s."

163. The chronic underinvestment was solidified by the De Villiers report in 1986, in which he recommended that there should be a reduction in new rail investment, from R2 billion to R699 million annually, and that the existing infrastructure should be optimized to the maximum (De Villiers, 1986). This led to the decline of rail infrastructure. The rail system in South Africa is now characterized by capital investment backlog and inadequate funding, obsolete and ageing infrastructure, deteriorating rolling stock and outdated technologies.

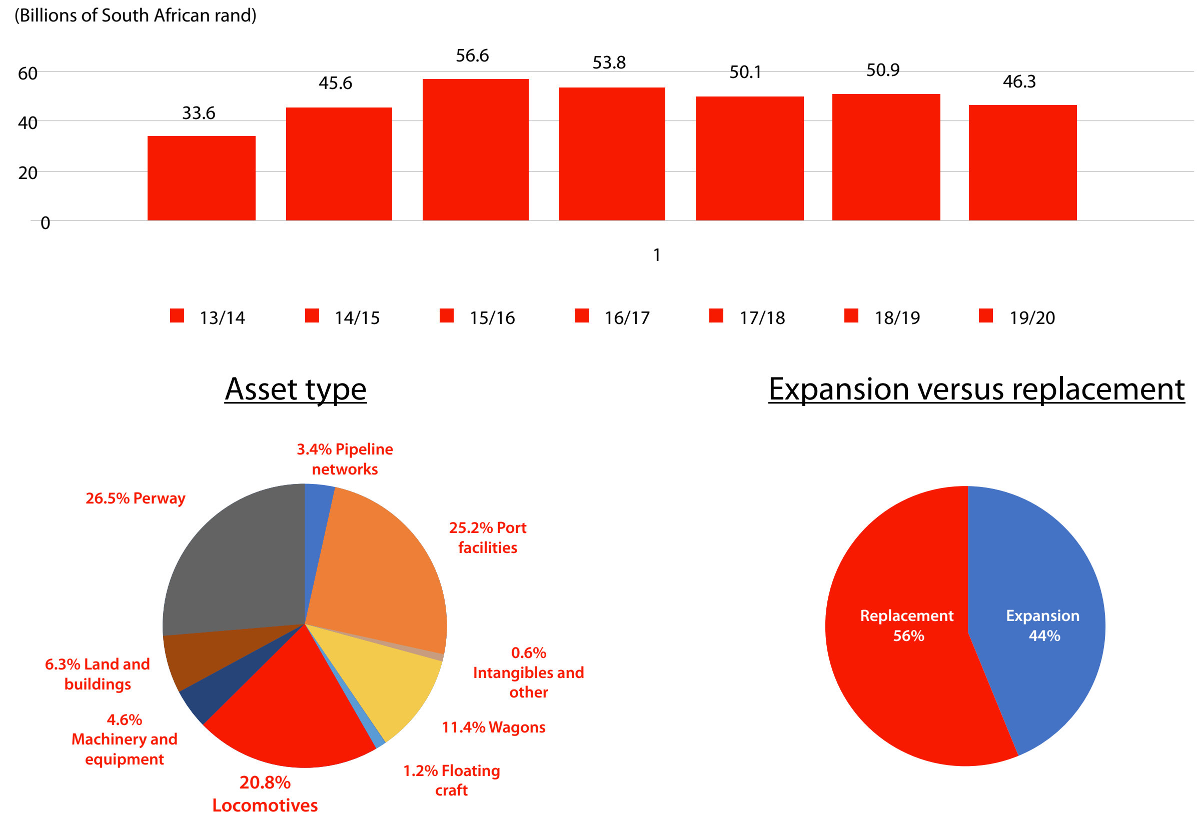
164. These challenges are accentuated by what could be regarded as an inadequate regulatory framework, especially for freight rail and port terminal operations. The inadequacies in the system include the lack of a settlement process; lack of rules on pricing, investment and access; and lack of an independent regulator with legislated investigative, enforcement and decision-making powers. A single transport economic regulator could eliminate discriminatory pricing, which in turn could eliminate occurrences such as the dispute between Transnet and coal exporters regarding the lack of rail infrastructure expansion and a tariff agreement. In addition, the pricing challenges are applicable in terminal operations throughout the ports, of which 16 are managed by Transnet Port Terminals. South African ports have some of the highest port charges by international comparison, which is mostly due to an outdated tariff regime and the lack of interport and intraport competition.

165. The unclear pricing policy, which high costs can be partially attributed to, serves as a constraint on the freight transport network. Transnet has been working with the private sector to improve efficiency in its operations. This is in line with one of its strategic objectives of leveraging the private sector in the provision of both infrastructure and operations when required. As an example, Transnet (Reuters, 2019b) has indicated that it would run a large liquified natural gas hub in Richards Bay with a private partner.

166. Working with the private sector, Transnet has been rectifying operational inefficiencies at the Durban container terminal, such as implementing international best practices with the introduction of a mandatory appointment system. While these actions are being taken by Transnet, the National Treasury (2020) has hinted at corporatizing the authority that regulates port operators and undertakes infrastructure investment, which is currently under Transnet. The idea is to facilitate better independent regulation of South African ports and increase competition in terminal operations.

167. Transnet has adopted a market demand strategy to meet the challenges associated with ageing infrastructure (Transnet Freight Rail, 2018a). The objective of the strategy was to expand and modernize the country's ports, rail and pipelines infrastructure, with a view to achieving a significant increase in freight volumes, especially in commodities such as iron ore, coal and manganese, for a seven-year period beginning in the 2013/14 financial year (see figure III). The strategy entailed investing in new infrastructure, with a R300 billion infrastructure investment programme proposed.

Figure 3 Transnet seven-year capital investment plan, by year



Source: *Transnet (2015).*

168. During the State capture years, corruption seeped into Transnet, which caused delays in implementing some of their proposed plans. The acquisition of 1,064 locomotives, as part of the Transnet market demand strategy, was marred by grossly inflated prices and allegations of kickbacks.

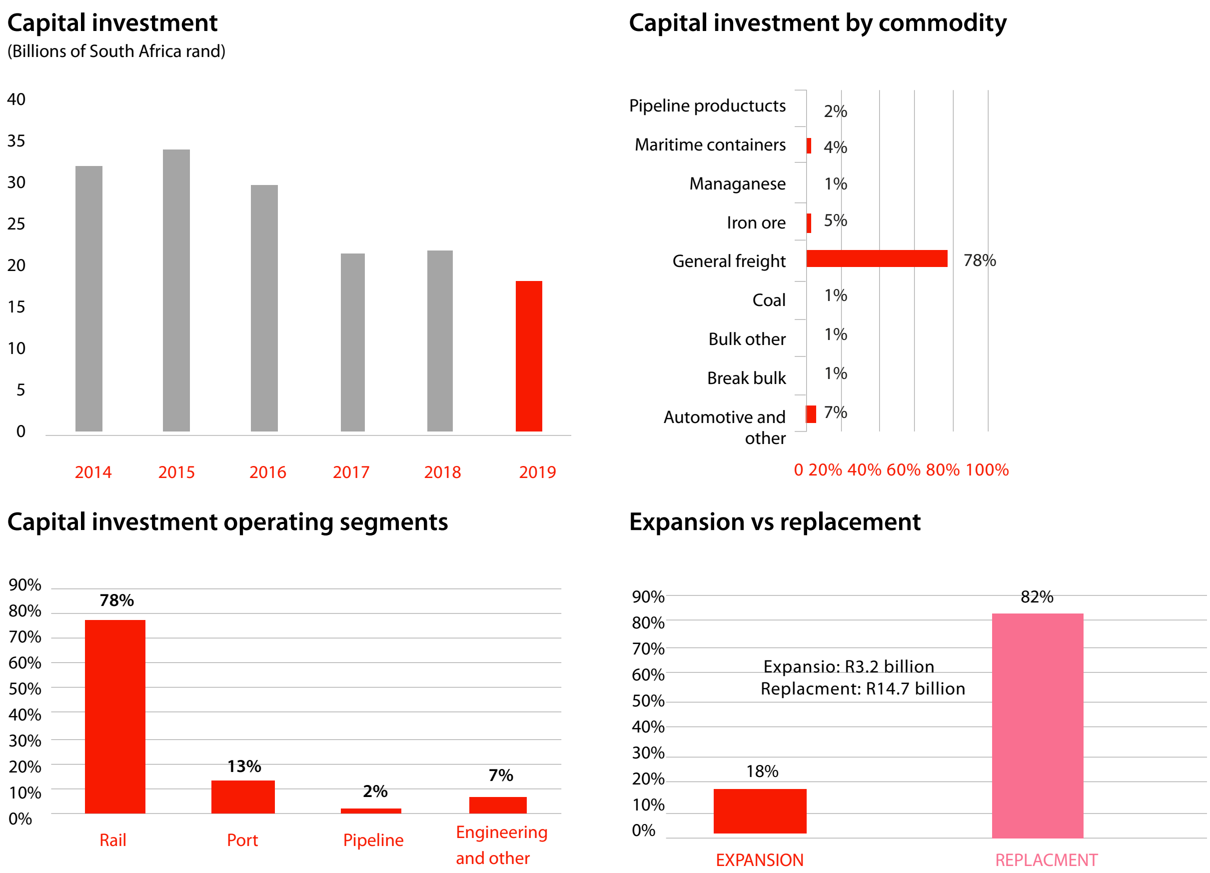
169. Results from a 2018 National Treasury forensic report indicated that Transnet had paid R509 million more for 100 locomotives after switching a supply contract from Mitsui of Japan to a Chinese rail company, China South Rail, alleging wrongdoing. The Chinese rail company enjoyed so much clout in its dealings with Transnet during the State-owned company's procurement of locomotives between 2011 and 2015 that the company defied the strict conditions set to it, with no consequences. Its second contract with Transnet, for another 100 locomotives, saw China South Rail calling the shots after being approved on an allegedly flawed confinement basis (National Treasury, 2018).

170. According to a testimony given by Mncedisi, Ndlovu and Sedumedi Attorneys at the Commission of Inquiry into Allegations of State Capture in May 2019, China South Rail was irregularly appointed and remunerated, in what reflected the flouting of the entity's procurement regulations. The Chinese company first secured a R2.6 billion contract for 95 locomotives in 2012, after procurement evaluation criteria were altered to accommodate a shortcoming in their broad-based Black economic empowerment status. Their next contract with Transnet, however, was for an even bigger consignment, 100 units, at a cost of R3.8 billion. Again, the process initially followed an open tender approach until, in October 2013, Transnet sought to get its board's approval to go the confinement route in favour of the competitor of China South Rail, Mitsui.

171. The board gave its approval, but in an about-turn three months later, a second confinement was sought, this time to cancel the Mitsui one and appoint China South Rail instead. During testimony in May 2019 at the State capture inquiry, Siyabonga Gama (CEO), Anoj Singh (Chief Financial Officer) and Brian Molefe (former group CEO) were implicated for submitting a business case to the Transnet board that had material factual errors and inaccuracies. Some of the money involved in those transactions at Transnet has been paid back. South China Rail paid back R618 million, while the Transnet pension funds recovered almost R1.2 billion from the Gupta-linked entities.

172. To rectify their failure in the implementation of the market demand strategy, which saw a decline in capital investment, Transnet adopted the Transnet 4.0 strategy, with its main growth thrust comprising geographic expansion, product and service innovation, and diversification and the expansion of the scope of the entity's manufacturing business. Central to the 4.0 strategy is growing capital investment, especially aimed at modernizing and expanding the port, rail and pipeline network (see figure IV). A proper implementation of the strategy should result in substantial growth in capital investment.

Figure 4 Transnet capital investment analysis: 2014 – 2019



Source: *Adapted from Transnet (2019).*

173. As such, the Government has said that investment in port capacity will be ramped up to support the growing number of container anwd bulk trucks, and to decongest the area around the port. The 10-year backlog of underinvestment will be cleared with the support of internationally sourced engineers. In addition, there was a plan to spend R2 billion in 2020 to replace old and ageing equipment, including a two-year delivery programme of 45 new straddle carriers for the port of Durban.

174. In as much as the corruption and external factors contributed to the challenges facing Transnet, there were other factors at play. For example, lack of management training and skills have surfaced among some of its managers. Transnet itself noted that there was a shortage of skills across most areas of the freight system. In its 2016 sustainability report, Transnet ranked "ineffective people management – talent attraction and skills development to operate the newly acquired assets" as its ninth highest strategic risk (Transnet, 2016). This was in the context of a struggling economy with a declining industrial base, exhibited through dwindling bulk cargo volumes. Transnet noted that 2019 had been a turbulent year for Transnet Freight Rail, as volumes handled by Transnet Freight Rail had dropped 4.9 per cent.

175 The operational challenges were exacerbated by governance weaknesses, as shown in the State capture inquiry. The challenges at Transnet were largely concealed by its financial performance in previous years. In 2018, it recorded its best financial results ever, posting a R4.9 billion profit. This feat was bettered in 2019 when it recorded an after-tax profit of R6.047 billion. The 2019 results were mostly due to stringent cost-cutting measures and a reduction of the entity's tax bill.

176. While Transnet has recorded a profit in successive years, it has a debt burden of approximately R128 billion. The entity's credit rating was downgraded in 2019 because of its increased liquidity risk resulting from loan covenants triggered by an audit qualification in its 2018/19 annual financial statements. Furthermore, Transnet is one of the contributory elements to the country's sluggish economic performance because of its high logistics costs and the inefficiencies and bottlenecks at the ports, with ships having to spend days at sea before cargo can be processed.

177. A leadership sweep has been carried out at Transnet as part of an effort to fix the governance failures of the past decade. A new interim board and senior management team have been put in place, and both have committed to restoring governance and to sustaining good performance in the entity. The interim board was appointed in May 2018 and a new CEO, Portia Derby, appointed in January 2020, after the axing in October 2018 of the erstwhile CEO, Mr. Gama, who had been implicated in reports by Mncedisi, Ndlovu and Sedumedi Attorneys and Fundudzi Forensic Investigators as having been involved in the awarding of a contract for 1,064 locomotives to China South Rail that grew from R38.6 billion to R54.5 billion.

178. The new CEO restructured the top management at Transnet, which was followed by an exodus of some key managers with institutional memory and a raft of new appointments to the senior management team – five of which took effect on 1 May 2020. The restructuring and the new appointments are part of a process to remove redundancies and cleanse the entity of managers implicated in State capture. In addition, the rail freight operator has set for itself the goal to recover the billions of rand that it had lost because of contracts that had been irregularly awarded. Of the R8 billion that the company lost, R7.2 billion had left the country, with recoveries of only R618 million from China South Rail. Civil action has already been instituted against Gupta-linked companies, including Regiments and Trillian.

179. Apart from the promising operational changes that have been achieved, there have been good signs of progress, albeit hazy now, in terms of capital investment. The restructuring that is underway at Transnet has led to the dissolution of the entity's group capital division, whose function was to consolidate all capital projects for Transnet. Based on this, it remains to be seen how the envisaged expansion of capital investment will take place under the new structure.

180. The proposed regulatory reforms, coupled with the restrictions on Transnet effected under the stewardship of the new CEO, may usher in a new era for Transnet and lead to a substantially different entity in the not-too-distant future. Nevertheless, several potential constraints remain for Transnet: the country's economic context will have an impact on the entity's envisaged trajectory; and persistently sluggish economic growth is likely to put pressure on its operational costs and profitability.

181. Continued cross-subsidization could also play a part in delaying the entity's response to the competitive pressure from road haulage: profits generated in the export commodity lines and other businesses to some extent permit continued underperformance by certain elements of the general freight business. Furthermore, the ratings downgrade may mean that the relatively affordable cost of capital will increase making capital investment more expensive.

182. Notwithstanding the fierce competition from road transport and the prevailing challenges faced by Transnet, rail transport still has inherent advantages that Transnet can leverage. For instance, rail transport accrues economies of scale based on its capacity to convey bulky goods, resulting in lower costs per unit of goods conveyed; and it has a low accident rate, which is significant given that accidents can be costly to suppliers, operators and consumers. The former may be utilized by Transnet to move to a lower pricing system for each service rendered. This should be supplemented by enhanced governance and operational efficiencies.

3.4.2. RECOMMENDATIONS

183. Transnet restructuring has been proceeding well, with a new board and a new management team that were put in place between 2019 and 2020. As previously discussed, Transnet was badly affected by State capture, with more testimonies of its depth surfacing at the Zondo Commission. Both the Department of Public Enterprises and Transnet leadership are now shedding that legacy and Transnet is slowly returning to sound operations.

184. One of the areas in which Transnet has been doing well is in leveraging private-sector experience, especially to clear bottlenecks at the Durban port terminal. Various innovations have been put in motion, including the introduction of an automated truck booking system to reduce high levels of congestion at the port.

185. Transnet is now in a better position to improve its long-standing infrastructure bottlenecks, including improving rail transport capacity and the security of its assets that have fallen prey to theft. In moving forward, Transnet needs to think about strategic issues such as working closely with development finance institutions, other SOEs and the private sector to co-invest in infrastructure expansion; and it needs to bolster its strategy for Africa and its international competitiveness.

3.5. WATER RESEARCH COMMISSION

186. Water resources have played a crucial role in expanding the country's development plans, in particular during the early twentieth century, when the rapid rate of industrial development

exceeded expectations. Industrial development needed to be supported, but the country's water resources were increasingly under pressure, and there was a possibility that those resources could be depleted, especially in the 1930s. This situation was due to the traditional water storage facilities – the dams built between 1915 and the late 1930s – that were no longer able to secure enough water to satisfy the country's agricultural and industrial needs (Tempelhoff, 2017).

187. According to Donnenfeld, Crookes and Hedden (2018), this development was exacerbated by the reoccurrence of drought in the twentieth century. South Africa is considered a typical water-scarce country. It experienced a number of severe droughts in the twentieth century, with extreme droughts being recorded in 1933, 1949 and 1970 that affected approximately 48, 46.5, and 28 per cent of the country, respectively (Malherbe and others, 2015).

188. Agricultural activity and the industrial development plans for South Africa were affected by those droughts. In response, the country's water resources management focused on agricultural activity in the first half of the twentieth century, with the Department of Irrigation paying attention to irrigation infrastructure and bulk water governance responsibilities – with particular focus on water storage facilities and irrigation schemes. These actions showed that water resources were vital to the country's social and economic development.

189. The growth of the mining sector and the expansion of industry in general meant that there was a need to distribute water to a range of consumers, with some not being in urban areas. Following the passage of the Water Act (No. 54 of 1956), the Department of Irrigation was renamed the Department of Water Affairs. The primary long-term objective of the Water Act was to ensure sufficient water supplies to support the country's rapidly expanding social, economic and industrial development. The mining industry was earmarked as a vital beneficiary.

190. The South African Government was predominantly advised by the Irrigation Commission on water matters during that period, while water research activities were largely confined to the Council for Scientific and Industrial Research. The Irrigation Commission was a think-tank, based on the Irrigation Commission Act (No. 22 of 1926) and reported to Parliament. However, the periodic droughts and lack of enhanced water resources demonstrated that water management had been rather lacklustre.

191. In 1966, the Government established the Commission of Enquiry into Water Matters to investigate the gravity of the situation and make recommendations on the management of water resources (Water Research Commission, 2011). A report from the Commission was published in 1970. The Government saw the need to establish a statutory body with the powers and funds necessary to promote and expedite the country's water research purposefully to respond to the prevailing challenges at the time. Subsequently, the Water Research Act (No. 34 of 1971) was passed and the Water Research Commission was established.

3.5.1. LEGISLATIVE AND POLICY FRAMEWORK OF THE WATER RESEARCH COMMISSION

192. In accordance with the Water Act, the primary objectives of the Water Research Commission were to coordinate, promote, encourage and undertake research regarding water in terms of "the occurrence, preservation, conservation, utilization, control, supply, distribution, purification, pollution or reclamation of water supplies and water; [and] the use of water for agricultural purposes, industrial purposes or urban purposes" (South Africa, 1971, p. 2). Based on this mandate, the first task of the Commission was to deal with the pressing constraints in the present and future water economy of South Africa. These constraints included insufficient and intermittent rainfall, management and practices in catchment areas, high evaporation losses from dams, rivers and canals, and the uneconomic and inefficient water use by various sectors.

193. In the post-1994 era, South Africa has seen the introduction of several legislative instruments that have direct bearing on the mandate of the Water Research Commission. The two most prominent pieces of legislation are the 1998 National Water Act (amended twice since promulgation through Act 45 of 1999 and Act 27 of 2014) and the 1997 Water Services Act. The 1998 National Water Act is concerned with establishing how South Africa should cope with unexpected changes in its climate and the challenges posed by its growing population. In contrast, according to Muller (2018), the 1997 Water Services Act is mainly focused on providing water at the local government level, as it regulates municipal water supply and sanitation services. The 1997 "White paper on national water policy for South Africa" (which preceded the two Acts) set the trajectory of water management in the country, asserting the importance of the Water Research Commission and the need to retain its founding legislation; and it set the tone for how the country's water resources are to be managed, utilized and distributed.

194. The new water policy post-1994 was created because of the radical changes in the social, political and water policy environment. It contained key proposals on tackling spatial, infrastructure and service-level inequality resulting from the apartheid Government's separate development policy.[10] In addition, the new water policy provided information on the work to be carried out by the Water Research Commission, with a view to aligning its work and research goals with national plans, policies and priorities. As a component of the water management institution, the Commission was supposed to reconfigure the manner in which it carried out its business to ensure the successful implementation of the new policy to expand services to all South Africans. It was estimated at the time that between 12 and 14 million people had no access to safe water and approximately 20 million people had no adequate sanitation.

195. Another key policy document that expanded on the strategic role of the Water Research Commission was the Second National Water Resource Strategy. The strategy provided details on the role of the Commission – to ensure that a knowledge-based water sector was developed and to engage in research dealing with aspects such as developing desalination technologies, among others. In addition, the Commission was expected to be at the forefront of awareness and education campaigns on water-related impact of climate change. The National Water Research, Development and Innovation Road Map is an intervention that is aimed at facilitating and refocusing on "research, reprioritization of funds, synergizing of existing initiatives and ring-fencing of new resources to facilitate a more optimal water innovation system" (Water Research Commission, 2015, p. i).

196. Ultimately, the Water Research Commission is mandated to produce knowledge and hone expertise to ensure the existence of a knowledgeable water sector to mitigate the impact of climate change, drought and intermittent rainfall. As stated in the National Water and Sanitation Masterplan, the Commission "exists to drive research, development and innovation strategy, fund research activities and organizations, and synergize with partners to shift solutions to practice" (Department of Water and Sanitation, 2019a, p. 39).

3.5.2. GOVERNANCE AT THE WATER RESEARCH COMMISSION

197. The governance of water resources is in line with the governance of most natural resources. It is such that the Government retains the right to regulate water use and determine its proper use. As aforementioned, the Government governs water through several legislative instruments.

10 Separate development was a policy to ensure that white South Africans and black South Africans stayed in separate localities and divided Africans into different ethnic groupings. This policy was legislated through the Promotion of Bantu Self-governing Act (Act No. 46 of 1959).

The National Water Act designates each sphere of Government that is to be involved in water management. However, as a public entity under schedule 3B of the Public Finance Management Act, the Water Research Commission is owned by the national Government and is its sole director.

198. The standards of corporate governance within SOEs designate the Government as the sole shareholder. In the case of water sector, the Minister of the Department of Water and Sanitation (formerly the Department of Water Affairs) holds the executive authority and is a shareholder representative. In addition, the Minister is accountable to Parliament for the performance of the corresponding institutions. With regard to the Water Research Commission, it is the board of the Commission that is the entity's accounting authority, and the CEO is the accounting officer of the entity who sits on the board of directors as an ex-officio member (Water Research Commission, 2018a). The role of the executive authority is to ensure appropriate returns on investment and the financial viability of the entity and provide oversights based on the prescripts of the Public Finance Management Act (National Treasury, 2005). The Minister of Finance and the National Treasury provide financial oversight – meaning that the shareholder oversight is spread between the two departments.

199. As the governing body of the entity, the board is fully responsible for the performance of the entity. PricewaterhouseCoopers (2102, p. 2), in referring to the various reference documents on corporate governance, noted that: "The fiduciary duties of directors and management of conflicts of interest are expressed differently… however, there is no conflict and all of these provisions should be read together in order to adhere to the highest standards".

200. The governance challenges at the Water Research Commission are not all together internal, but attributable to the decentralization of water management through the post-1994 policy framework. The decentralization of water management had devolved complex powers to local authorities, at which point it became clear that the latter lacked the competencies and capabilities necessary to manage those powers (IRC International Water and Sanitation Centre, 2009). The governance of the water sector was thus fragmented from a legislative and institutional perspective.

201. Some of the challenges have stemmed from the fact that the now 49-year old Water Research Act (Act No. 34 of 1971) was retained in accordance with the 1997 white paper and has not been amended. Thus, the legislation is not aligned with current governance best practice, contemporary institutional arrangements, and the Public Finance Management Act. One of the key issues identified in the South Africa's Water Research, Development and Innovation Road Map: 2015–2025 was improving governance, planning and management in relation to both supply, delivery, demand, and use of water resources (Water Research Commission, 2018b).

202. A water research amendment bill was developed in 2013 to align the Water Research Act with applicable legislation, such as the National Water Act, the Water Services Act and the Public Finance Management Act. It was intended to regulate the Water Research Commission (which would be renamed the Water Research Council once the bill was passed). Since its development, however, the bill has yet to be tabled in Parliament.

203 The primary governance challenges for the Water Research Commission have come from misaligned legislation and lack of coordination between various institutions and stakeholders in an environment where certain powers and functions of water resources management have been decentralized. The slow pace of the process to table the water research amendment bill has exacerbated some of the challenges. The plausible promulgation of the bill would regulate governance systems and

structures and provide a precise and uniform process for appointing members of the board of directors, which could improve governance within the entity.

3.5.3. OPERATIONAL CHALLENGES IN THE WATER RESEARCH COMMISSION

204. The Water Research Commission is driven by a public policy mission, as opposed to commercial interest. As such, the operational excellence of the Commission is assessed on the basis of its research output and contribution to water resources management, among other variables. The Commission's revenue is mainly generated from the water research levy even though it engages in the commercialization of the intellectual property arising from its research activities.

205. Partnerships, both locally and internationally, have helped to increase the body of knowledge on water matters as they enhance South African water research and development and the community's ability to conduct better research. The Water Research Commission has continued to forge international relationships, as shown by the organisation's corporate plan for the period 2018–2023 (Water Research Commission 2018c).

206. The Commission has approached its mandate by viewing the country's water problem as a capacity and capability challenge, which it intends to tackle as three dimensions – new knowledge, human capital, and technological solutions. This is within the context of the Commission serving as a research partner of the Department of Water and Sanitation (Water Research Commission, 2019). The current investment in water innovation has been meagre and has put a strain on innovation output.

207. The Commission, however, has continued to provide new knowledge and conduct further research in the water sector, including in one of the key strategic areas in its research and development branch, which is drinking water treatment and use. Notwithstanding this, there have been significant challenges in providing clean and safe water in various municipalities. The Commission carried out two studies (one in 2011 and the other in 2016) to assess the perceptions of citizens on the quality of drinking water. The results from the 2011 study indicated that "81 per cent of urban South Africans perceive their tap water to be safe to drink" and results from the 2016 showed that "88 per cent of urban South Africans (7 per cent more than 2011) perceive their tap water to be safe to drink" (Water Research Commission, 2016 p. iii).

208. However, the Department of Water and Sanitation failed to conduct blue drop and green drop assessments in the 2018/19 financial year (Department of Water and Sanitation, 2019b). This state of affairs is concerning given that several municipalities around the country – such as the residents of Emalahleni local municipality and Nelson Mandela Bay – have raised concerns about water safety (Goldswain, 2019; Herald Live, 2020). Even though the Water Research Commission is responsible for undertaking research to improve the quality of drinking water, it is ultimately the Department of Water and Sanitation that is responsible for managing water resources and regulating the provision of drinking water.

209. The Water Research Commission has an important public policy mandate. Some aspects of its mandate have been impeded, however, because of institutional structures and the devolvement of powers to local authorities with capacity challenges. Furthermore, the low levels of investment in water innovation have had an adverse impact on the levels of innovative research output in the water sector.

3.5.4. RECOMMENDATIONS

210. Water is a strategic resource for the country, and the management of this resource is key to human security. It is important for the Government to improve the fragmented nature in which water resources are being governed, especially as local authorities have limited capacity and competence to govern effectively.

211. Given that agricultural production uses 60 per cent of the available water, it is necessary to improve the coordination between the government department responsible for agriculture and that responsible for water affairs. At the time of finalizing the present report, both departments were in the process of developing their masterplans for the growth of the sectors.

212. The Government needs to pay attention to the risks of fragmentation, misaligned legislation, and lack of coordination between key departments, and between the central authority and various municipalities. The most critical risk is to the provision of safe drinking water at the municipal level. Better coordination and building capacity for water management at the municipal level could help to mitigate some of these risks.

3.6. LAND BANK

213. The Land and Agricultural Development Bank of South Africa (Land Bank) has been an integral part in the development of the agricultural sector and has played a critical role in the notable expansion of the sector since 1912, the year it was founded. The country's agricultural gross value-added has more than doubled since 1994 to R257 billion in 2018, in real terms (Department of Agriculture, Rural Development and Land Reform, 2019). The growth of the sector has occurred in all major subsectors, which are horticulture, field crops and livestock. This has contributed to job creation[11] and to the strengthening of the country's food security position, which are among some of the development objectives of the Land Bank (The Economist Intelligence Unit, 2019).

3.6.1. CREDIT DIFFICULTIES OF THE LAND BANK

214. Alongside the growth in output and value of the agricultural sector has been the expansion in the availability of credit to support the sector. As of 2019, the total farm debt for South Africa was at a record R188 billion. Approximately 60 per cent of that debt was with commercial banks, 29 per cent with the Land Bank, and the rest spread between agricultural cooperatives, private persons and other institutions.

215. The escalation of debt in South Africa, especially in recent years, was due to the expansion of investment in intensive farming (specifically in horticulture orchards), and, to some extent, the financial pressure brought on by frequent droughts, which has limited the agricultural output of various farms. The Land Bank's involvement in the agricultural sector is through various direct and indirect financial services dedicated to supporting both on- and off-farm agricultural activities and businesses, including input provision, land purchase, production, distribution, wholesale, processing and marketing.

11 There were 885,000 people employed in the country's agricultural sector in the last quarter of 2019.

3.6.2. MANDATE OF THE LAND BANK

216. The mandate of the Land Bank, which is classified into three themes – transformation, growth and integration – is to promote, facilitate and support equitable ownership of agricultural land, specifically the increase in agricultural land ownership by historically disadvantaged persons (Land and Agricultural Development Bank Act (Act 15 of 2002)). While the Bank's achievement of its development and transformation mandate remains below expectations, its significance has not diminished. That said, there has been some progress, with credit extended for development purposes – accounting for 17 per cent of the total loan book of R45 billion. This is the segment where black farmers continue to participate.

217. The Land Bank has a crucial role to play in increasing the number of commercial farmers in the country by supporting the graduation of emerging farmers into sustainable commercial farmers. The Government's development policy, especially the National Development Plan and the National Treasury's recent economic policy paper, have highlighted the need for transformation, job creation and growth in the agricultural sector (National Treasury, 2019). These objectives could be achieved through the expansion of primary agriculture, improvement of rural infrastructure, direct incentives, and increased investment in the sector, with the aim of ensuring black participation along the value chain.

3.6.3. RECOMMENDATIONS

218. The mandate of the Land Bank is shrouded in ambiguity. A restructured Land Bank should direct its efforts to funding emerging farmers who have been poorly served by both commercial financing institutions and the Land Bank. In addition, consideration should be given to the current funding model of the Bank. The current model is highly dependent on the debt financing raised on the volatile capital markets, where the money is largely borrowed at commercial rates. Operating under these conditions means that the Bank may not be able to meet its transformation objectives.

219. The Land Bank's dual mandate of supporting both commercial agriculture and agricultural development for emerging farmers is not sustainable, as the latter segment ends up not being properly financed. Agricultural development cannot be supported by funding raised from commercial lenders, which require compliance with onerous financial loan covenants.

220. Accordingly, in order to meet these challenges, the following interventions should be considered:

(a). Separate the commercial and development mandates of the Land Bank into two different entities, with different governing and management structures;

(b). Enhance the sustainability of the commercial mandate of the Land Bank, by adjusting its "lending-only banking model" to allow a newly formed commercial Land Bank entity to take deposits, offer transactional products and generate non-interest revenue. This can be achieved in partnership with a commercial bank whereby the Land Bank receives a profit share on white-labelled transactional accounts offered to Land Bank clients, or as a separate bank with a banking license;

(c). Establish a development Land Bank entity that is recapitalized by the shareholder (Government) to enable the Land Bank to achieve its development mandate. Terms and conditions should be clearly developed and articulated by the shareholder;

(d). Collapse much of the commercial balance sheet by "selling off" unprofitable commercial loan books to commercial banks or alternative funding vehicles at no loss to the Land Bank, prevent hoarding of cash by service-level agreement intermediaries, and negotiate an annuity future income stream on these disposals;

(e). Implement corrective strategies for high-interest non-performing loans (those with rates greater than 9 per cent).

221. The operation of the Land Bank will need to change in the future. Fully delivering on its mandate will require rethinking its strategy, governance, and the partnerships that it builds.

SECTION4: REGIONAL AND CONTINENTAL IMPACT OF SOUTH AFRICAN STATE-OWNED ENTERPRISES

222. The performance of South African SOEs has an impact that reaches far beyond the borders of the country. Some of the SOEs chosen for the present report have development mandates that extend beyond South Africa. For example, as stated by the National Planning Commission (2020, p. 38), the mission of Eskom is to "provide sustainable electricity solutions to grow the economy and improve the quality of life of the people in South Africa and the region", while one of the objectives of Transnet is to "grow footprint in the regional markets in order to drive integration in the freight system to stimulate inter-regional trade and lower transport costs" (Transnet Freight Rail, 2018b).

223. The Transnet reference to regional integration is important in the context of the need to facilitate and engineer regional integration – especially in driving sustainable development on the African continent. Regional integration has been viewed as the only way forward for Africa in terms of economic, political and social development in the post-cold war global context (Katz-Lavigne and Kiggundu, 2019).

224. Regional and continental integration can be facilitated by the development of hard and soft infrastructure such as energy, transport, and information and communications technology. It is imperative to develop infrastructure to facilitate connections not only within a country, but between a country and its region and beyond. In simple terms, there can be no regional integration without adequate infrastructure.

225. With regard to the goal of regional and continental integration, the regional and continental strategies of South African SOEs – if effectively implemented – can support the objectives of regional integration. As seen in the case of Eskom, the power utility has played an important role in providing neighbouring countries – especially in the SADC region – with its surplus electricity. As a member of the Southern African Power Pool,[12] Eskom has established several agreements with several other countries in the region, mainly through bilateral trading arrangements, using instruments such as power purchase and power sales agreements and participating in the daily marketing of power through the Southern African Power Pool (Eskom, 2016).

226. One aspect of the vision of the Southern African Power Pool vision is to ensure that Southern Africa becomes the region of choice for investment in energy-intensive development. In addition, the power utility has played a pivotal role in the generation, distribution and transmission of electricity in the region. This was implemented through regional flagship projects such as the Cahora Bassa hydroelectricity scheme in Mozambique, which is aimed at generating and distributing power to parts of Mozambique and South Africa.

227. For its part, Transnet has engaged in regional activities that are aimed at expanding its infrastructure reach and expertise in the region. The entity launched Transnet International Holdings in 2018 to facilitate multiple rail, port and pipeline projects on the African continent. This move was influenced by the African Union strategy for facilitating regional integration and connecting economies to grow intraregional trade. Intra-African trade is considered to have the greatest potential for building

12 The establishment of the Southern African Power Pool in 1996 saw the development of a common grid and a common market for electricity in the region (Eskom, 1999).

sustainable economic development and integration (African Development Bank and others, 2017).

228. As such, the enhanced expansion of Transnet on the continent can be viewed through a development lens as well. The rail capacity of Transnet International Holdings is provided for by Transnet Freight Rail, which has a presence in Maputo (Mozambique), Gaborone (Botswana), Bulawayo (Zimbabwe) and Ndola (Zambia) (Transnet, 2020). This is mainly through three corridors: the Maputo Corridor – linking South Africa, Eswatini and Mozambique; the East-West Corridor – linking South Africa, Namibia, Botswana and Lesotho; and the North-South Corridor that links South Africa, Zimbabwe, Zambia, the Democratic Republic of the Congo and the United Republic of Tanzania.

229. Beyond the provision of rail infrastructure, Transnet has considered leveraging its recent new-build experience to help to meet the surging demand for refining, storage and pipeline infrastructure capacity, in concert with ongoing discoveries of new oil and gas reserves in the region. Furthermore, Transnet – with substantial manufacturing facilities through Transnet Engineering – is well-positioned to meet the imminent increase in demand for new and refurbished rolling stock, together with associated maintenance services, with the anticipated modal shift in freight transportation from road to rail. The African Union (2015) acknowledged the capabilities of South Africa in the region (see Decision 563/24) State; in addition, Nortje (2020) noted that "South Africa will lead the manufacturing of rolling stock for the continent".

230. Transnet went on to give its subsidiary, Transnet International Holdings, seven years to establish a presence in 18 countries. The subsidiary had already clinched a five-year agreement with the Government of Ghana to refurbish a line and to provide rolling stock to move bauxite. This agreement was signed in December 2019. In addition, Transnet delivered rolling stock to the National Railways of Zimbabwe through the Transnet SOC Ltd-Diaspora Infrastructure Development Group Consortium in 2018. The agreement between Transnet and the National Railways of Zimbabwe – estimated to be worth around $400 million – would contribute to the realization of the north-south corridor programme in the SADC region and provide the requisite infrastructure to advance regional integration (Transnet, 2018).

231. While the perspective provided here is only through an infrastructure lens, it demonstrates how South African SOEs can play a significant role in providing the technical capabilities and infrastructure support required for regional and continental integration. The sound operation of these SOEs is not only important in the context of South Africa, but to economic growth and sustainable development on the continent. They are an integral part of the region's efforts to achieve regional integration.

232. The continued abysmal performance of South African SOEs poses the risk of stifling the envisaged regional and subsequent continental integration. The regional integration for sustainable development requires capable State with strong and productive institutions. SOEs are crucial in bolstering the capacity of States and should play a pivotal role in advancing State-led innovation.

233. Similarly, the poor performance of SOEs does not bode well for attaining sustainable development on the continent that is facilitated by the development of infrastructure, among other drivers. Regional integration plans are likely to be adversely affected by the poor performance of South African SOEs, and this should be viewed as a cautionary example by the rest of the region and the continent. As such, SOEs on the African continent should be properly capacitated and appropriately positioned to circumvent the pitfalls experienced by South African SOEs. This ultimately requires strong policy frameworks under which SOEs can operate, sound governance and management processes in SOEs, and discernible mandates aligned with the development plans and aspirations of various States, and ultimately, those of the region and continent.

SECTION5: CONCLUSIONS AND RECOMMENDATIONS

5.1. CONCLUSIONS

234. While significant changes have been made at Eskom and Transnet, especially with regard to leadership at the levels of their executive committees and boards of directors, there is still a long journey to travel before the two SOEs can operate as well-oiled machines and as vital organs of the economy. A great deal remains to be done to uncover the extent of corruption, mismanagement and governance failures in these institutions. All of this takes place against the backdrop of an underperforming economy, policy uncertainty, and fluid national politics.

235. There have been several positive developments since the Commission of Inquiry into Allegations of State Capture was established and since President Ramaphosa announced an economic recovery and reconstruction programme. These include: the creation of a clear framework for the restructuring of Eskom and its division into autonomous units; and the gaining of greater clarity on some of the key problems in SOEs from the testimonies presented to the Zondo Commission. Some SOEs have moved with speed towards restructuring and have new management teams in place – for example, Eskom and Transnet. The power utility, however, continues to be affected by long-standing weaknesses that reflect its history, especially underinvestment in grid maintenance. In addition, there is a lack of clarity on the precise terms of the restructuring of Eskom.

236. There is a need to build strong capabilities in these institutions, insist on a culture of technically competent and ethical boards, clarify the relationship between boards and the shareholder, fix the opaque regulatory structure, and redefine the mission of SOEs so that there is greater clarity regarding the long-term objectives and the mission-critical outcomes they are pursuing.

237. Large-scale industries such as refineries and smelter operations require a reliable and competitive supply of electricity. There is thus a need to refocus Eskom on providing reliable and cost-effective energy so that large-scale industries can realistically be established. As long as Eskom maintains a stranglehold on the economy, industrialization will be wishful thinking.

238. With regard to Transnet, overcoming historical governance weaknesses will be key to repositioning this entity to deliver bulk transportation services to miners and exporters. Eskom and Transnet are the backbone of the economy, as their performance has serious economy-wide implications.

5.2. RECOMMENDATIONS

5.2.1. IMMEDIATE RECOMMENDATIONS

239. It is advisable that the following actions be taken immediately:

   (a). The Government should accelerate the process of finalizing the shareholder management bill, which would provide greater legislative clarity on the mandate of SOEs, their strategic goals, and the relationship between the shareholder and entities. The sooner this bill is finalized, the more certainty the boards and senior leadership of these entities would have. In addition, it would give key stakeholders, including funders and other partners, a better sense of the

Government's long-term thinking with regard to SOEs;

(b). The Government, through the shareholder department, should audit the financial and operational performance of the various SOEs to better understand the sources of their difficulties. The outlines of turnaround strategies should present a clear decision matrix that categorizes the SOEs as belonging to one of the following types:

(i). Those for which capitalization will not produce desired results other than to keep the entity afloat without a clear exit plan;

(ii). Those that have a clear strategic intent that is well defined and measurable, and that, with support, are likely to create value for society within a given period of time. The financial support should be tied to a credible turnaround strategy and road map to sustainability and value creation;

(iii). Those that should operate independently, expand avenues of opportunity, and be able to enter into various partnerships both with the private sector and development finance institutions to aggregate capacity to capitalize on a defined set of market opportunities and achieve certain strategic outcomes.

Medium-term recommendations

240. It is advisable that the following actions be taken in the medium term:

(a). The Government should rationalize SOEs through the legislative framework that is currently being developed and through clear shareholder compacts. A major strategy shift may be required for SOEs for which business model rationalization could be an option. For example, in the case of the Land Bank, the commercial and the development segments could be separated with the latter integrated into the Industrial Development Corporation, and the former operating on commercial principles and under a business model that makes it self-sustaining and less dependent on the State for capitalization;

(b). The Government will need to let go of SOEs that historically have proven unable to turn the corner, compete in the market, and be self-sustaining. If a service can be provided by a private company more efficiently and competitively, the State should consider exiting such activities. If, in some cases, there is strategic value (for example, relating to national security or greater development impact), the State can invite a strategic partner. If the development value is vague (for example, in the airline sector), the State should consider exit options. Entities that are owned by the State should not be a burden to the economy. Instead, they should deliver development value. The sooner the Government sets a timetable for exiting some of the perennially underperforming SOEs, the better.

Long-term recommendations

241. It is advisable that the following actions be taken in the long term:

(a). Consideration should be given to the role and value of SOEs – in generating new innovations working with development finance institutions that are State-owned – as instruments for co-creating markets, expanding infrastructure provision, improving the provision of critical services in the rural and township economy, investing in areas that promote innovation and areas in which the private sector has not been ready to commit, and entering new domains of growth such as the green economy;

(b). Performance management of SOEs could be done under a centrally coordinated structure, preferably in the Presidency, vested with the capabilities and resources necessary for monitoring and evaluation, while policy and administrative guidance is retained by line ministries. It is not only SOEs that need to account for their performance; the line ministers should also give an account of their role in guiding these institutions on policy objectives;

(c). Some SOEs, especially those that are retained for strategic purposes, may need repositioning with regard to their business models to take into account shifts in the structure of industry, emerging developments in SOE regulation, geopolitics, and new opportunities on the African continent;

(d). In some cases, especially in relation to large infrastructure projects (including those in renewable energies), major SOEs such as Transnet and Eskom may need to develop market entry strategies as part of their internationalization strategies, and have a guiding framework for entering into or managing international partnerships, international consortiums, and joint ventures. Transnet, for example, is a key player in the SADC north-south corridor and it participates in rail development projects in West Africa. There are opportunities to work closely with development finance institutions and other external partners that are active in infrastructure development on the continent to augment its capabilities, while benefitting from technical know-how through major cross-border projects. For example, Eskom has been involved for many years in the Inga Project in the Democratic Republic of the Congo and in the Southern African Power Pool. The business model innovation of some of the South African SOEs could help them to diversify their business on the continent in ways that create mutual benefit;

(e). To bring about an effective internationalization strategy, large SOEs should cultivate very close relationships with development finance institutions that are looking to invest in infrastructure projects on the continent. In this regard, the African Continental Free Trade Area, and projects relating to the Programme for Infrastructure Development in Africa, could provide SOEs a platform for continental market expansion and contribute to the broader development of the region;

(f). To conclude, greater urgency is required to restoring the financial vitality of SOEs. Their success potentially holds promise for development gains for the rest of the region, including by sharing best practices in restructuring, governance, and effective policy guidance. South Africa has a rare opportunity in the context of the COVID-19 pandemic to push forward a major economic reform programme, to accelerate economic development, and to reform key institutions such as SOEs as pivots for delivering on development objectives, expanding infrastructure provision and unleashing innovation.

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