RISKS THAT CONTINGENT LIABILITIES ARE POSING TO NATIONAL BUDGETS

- A South African Case Study

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CONTENT

INTRODUCTION

The South African Fiscal Position

2008/09 compared to 2018/19

Context: what this case study is all about

How government support to SOCs contributed to fiscal vulnerability, over time, through contingent liability exposures

- Guarantees were used to reduce the cost of SOC borrowing since 2008/9
- Prior to this, guarantees to SOC were not encouraged.
- Government adopted a “counter-cyclical” fiscal policy stance following the financial crisis
- Eskom and DBSA used as SOC examples for purposes of this case study
- Transnet and Eskom are major players in economic infrastructure delivery

GOVERNMENT DEBT AND CONTINGENT LIABILITY MANAGEMENT IN SOUTH AFRICA – 2008/09 to 2018/19

Net debt, provisions and contingent liabilities

Total Guarantee Exposure

SOC Guarantee Exposure

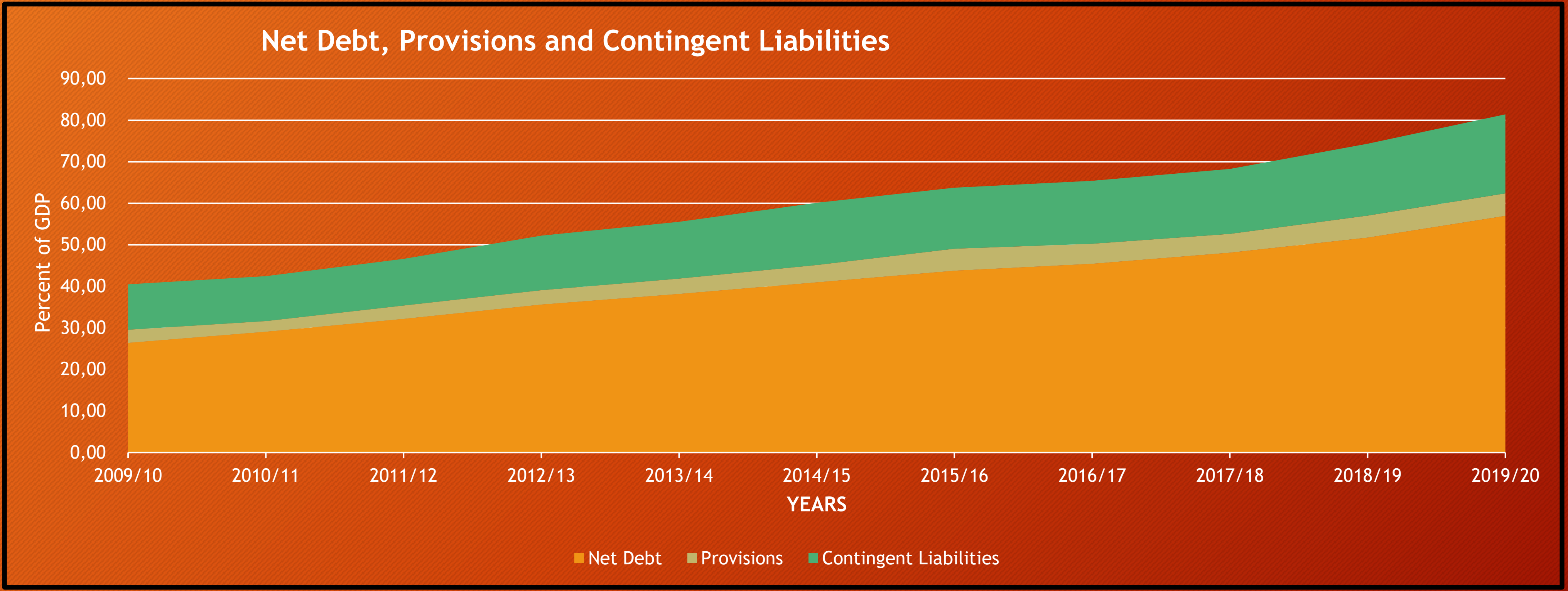
Direct Fiscal Transfers to SOCs

Eskom Guarantee Exposure in relation to total guarantees

SA fiscal position 2008/09 compared to 2018/19

Sovereign and Eskom Credit Ratings

Net loans, provisions and contingent liabilities

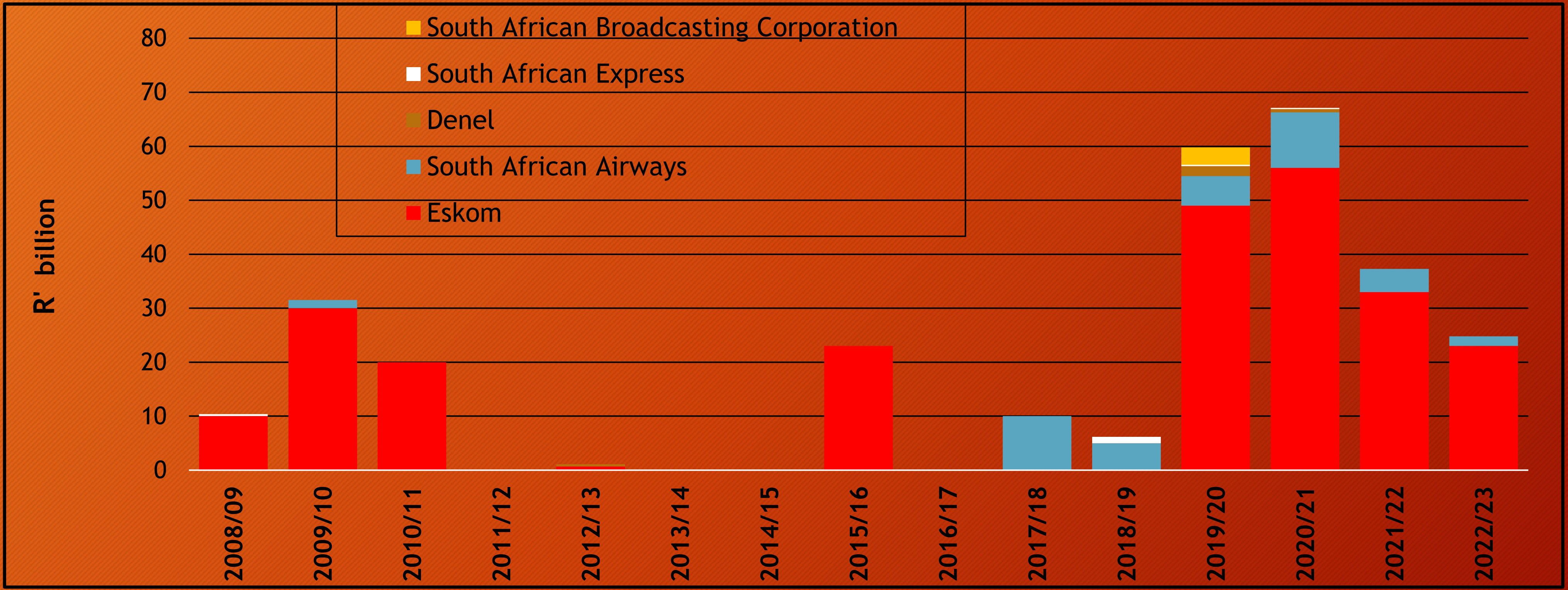


Total Guarantee Exposure 2005/06 to 2019/20

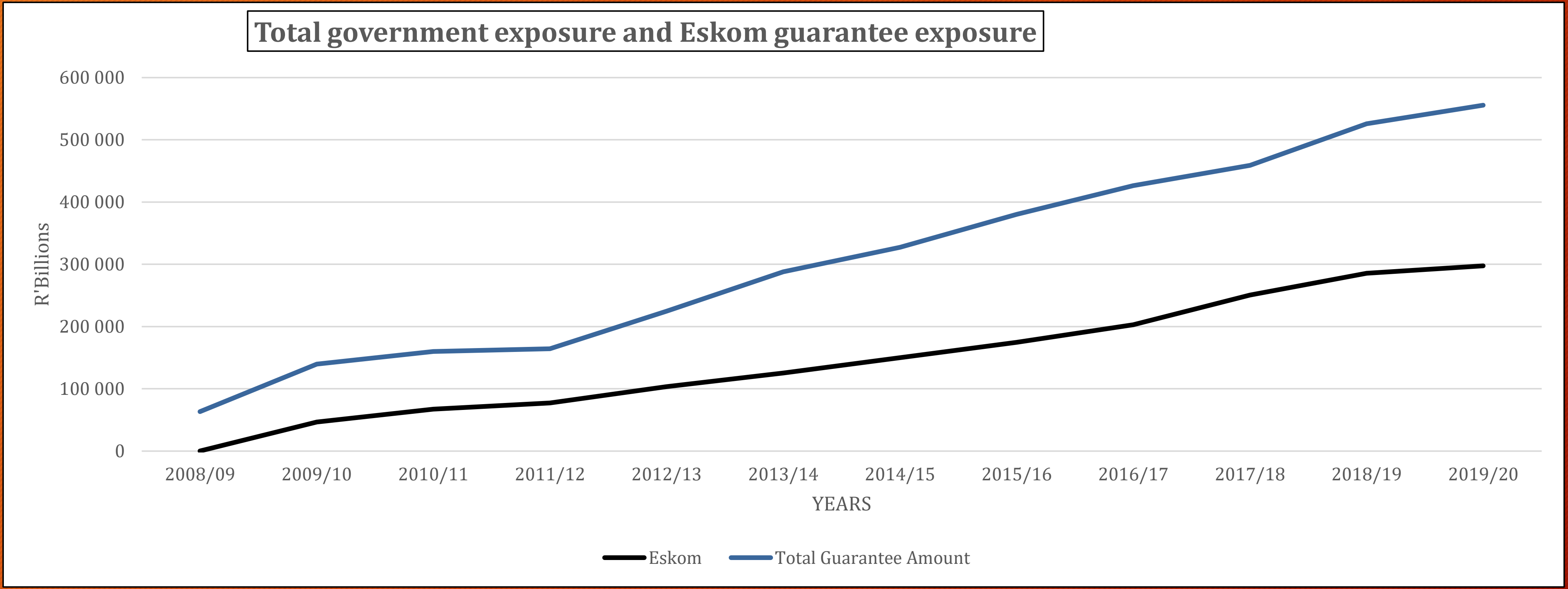
State-Owned Companies Guarantee Exposures

State-Owned Companies	As at 2008/09 R'billion	As at 2019/20 R'billion	% of total guarantees	% of total guarantees
	Exposure	Exposure	2008/09	2018/19
Total Guarantees	63,038	555,43	100,00	100,00
of which:				
Eskom	0	297,4	0,00	53,54
South African National Roads Agency Limited	6,708	39,9	10,64	7,18
Trans-Caledon Tunnel Authority	19,588	13,5	31,07	2,43
South African Airways	4,46	17,3	7,08	3,11
Land and Agricultural Bank of South Africa	1,5	0,873	2,38	0,16
Development Bank of Southern Africa	12,348	4,48	19,59	0,81
Transnet	12,895	3,8	20,46	0,68
Denel	0,88	6,93	1,40	1,25
South African Express	0,9	0,163	1,43	0,03
South African Post Office	0,4	0	0,63	0,00
Industrial Development Corporation	1,446	0,144	2,29	0,03
Other Entities (Non-Analysed)	1,7	0,8	2,74	0,15
South African Reserve Bank	0,142	0	0,23	0,00
Independent Power Producers	0	161,427	0,00	29,06
Public Private Partnerships	0	8,65	0,00	1,56

Direct Fiscal Transfers to SOCs



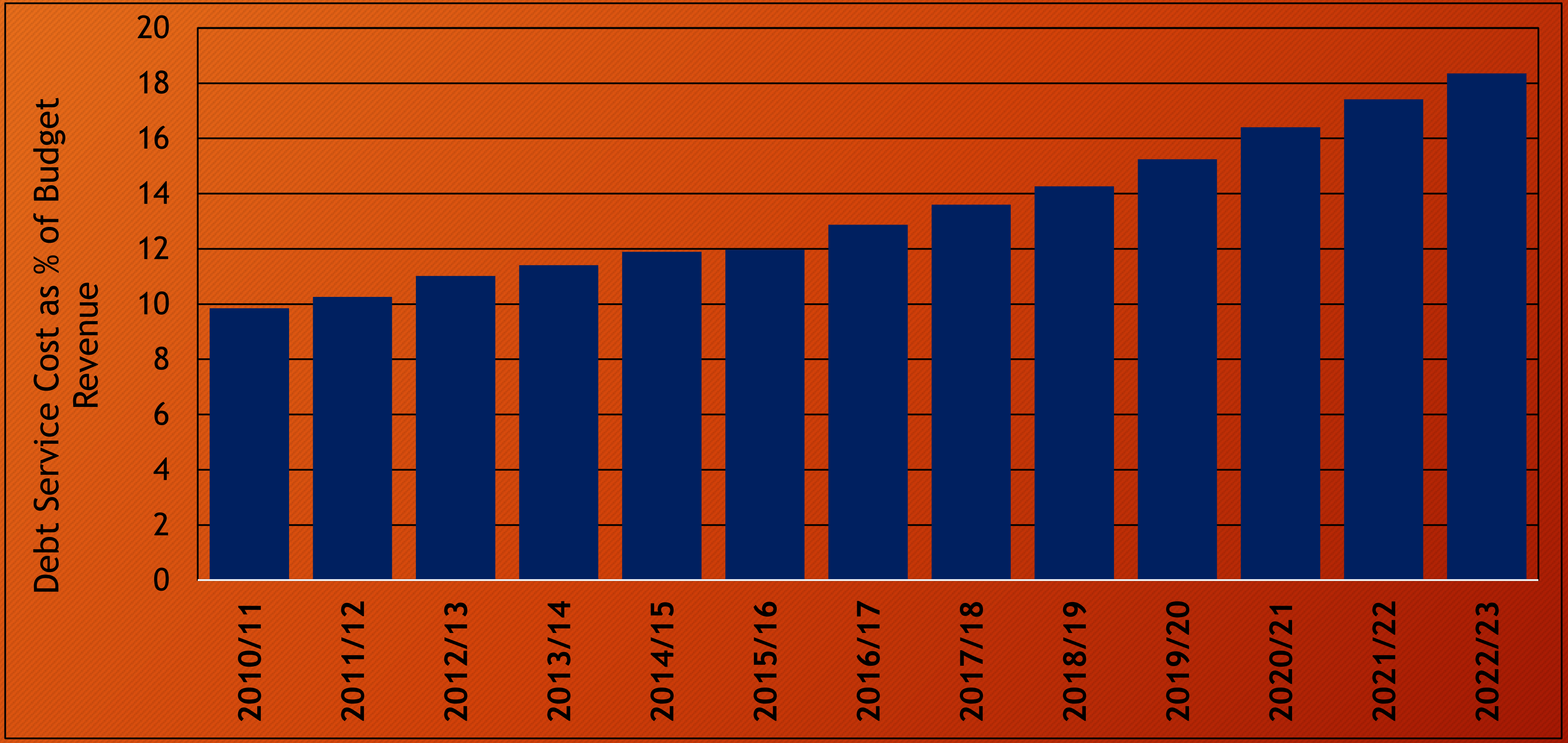
Eskom Guarantee Exposure in relation to Total Guarantees



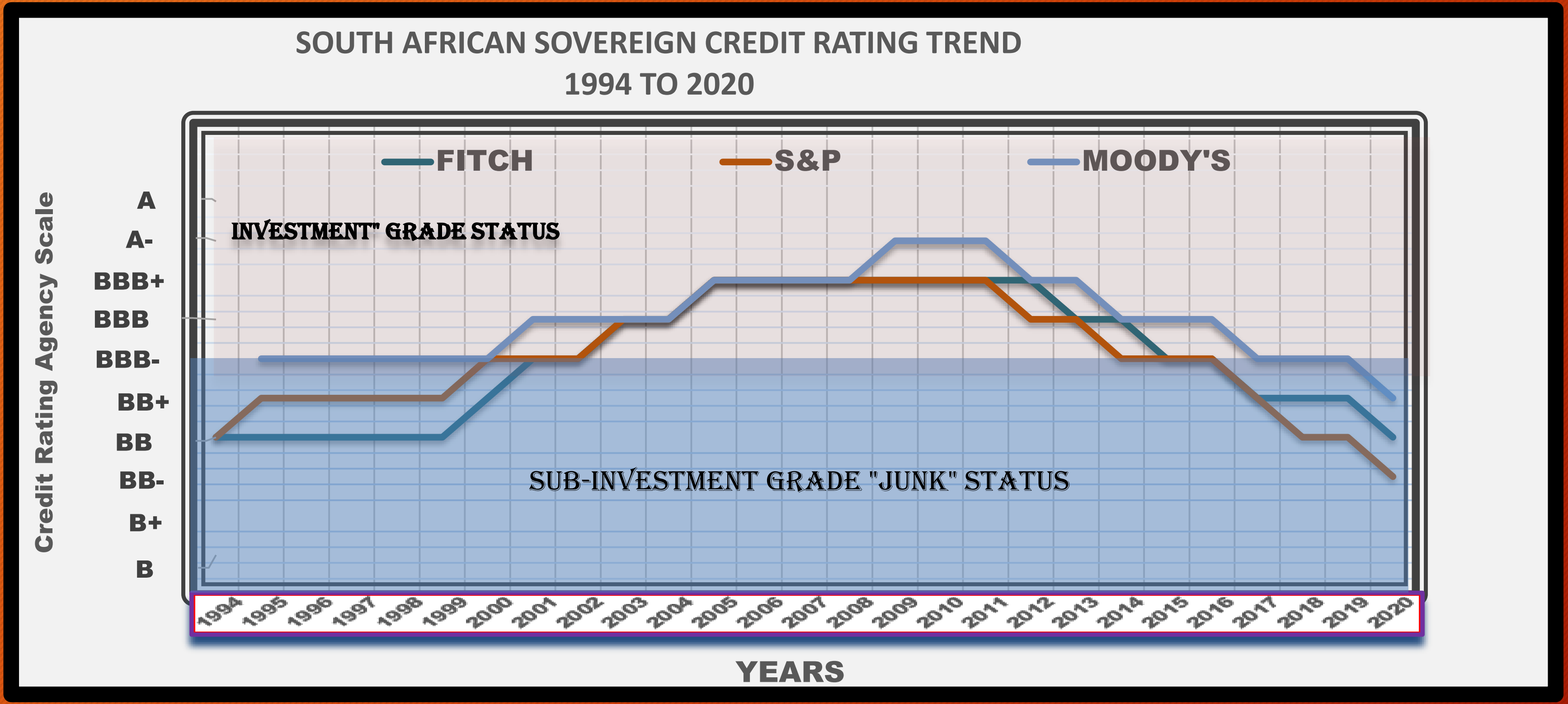
Public Finances: 2008/09 compared to 2018/19

PUBLIC FINANCES	2008/09	2018/19
National Government		
GDP at current prices (R' billion)	R2304.1	R4921.5
Consolidated Budget Balance as % of GDP	-1%	-4%
Public Sector Borrowing Requirement as % of GDP	3.9%	5.7%
(Net) Government Debt as % of GDP	22.6%	51.7%
Government Foreign Debt as % of total Government Debt (Gross)	14.4%	10.1%
State Debt Cost as % of GDP	2.4%	3.7%
Net Debt, Contingent Liabilities plus Provisions as % of GDP	34.4%	74%
Contingent Liabilities total	R160.0 billion	R879.7 billion
Government Guarantees total	R63.1 billion	R529.4 billion
Government Guarantees as % of GDP	2.95%	10.75%
Government Guarantees as a % of Contingent Liabilities	39.4%	60.2%
Eskom		
Eskom Guarantees total	zero	R294.7 billion
Eskom Guarantees as % of total guarantees	zero	55.67%
Eskom Guarantees as % of GDP	zero	5.99%
DBSA		
DBSA Guarantees total	R12.35 billion	R4.4 billion
DBSA Guarantees as % of total guarantees	18.2%	0.83%
DBSA Guarantees as % of GDP	0.54%	0.09%

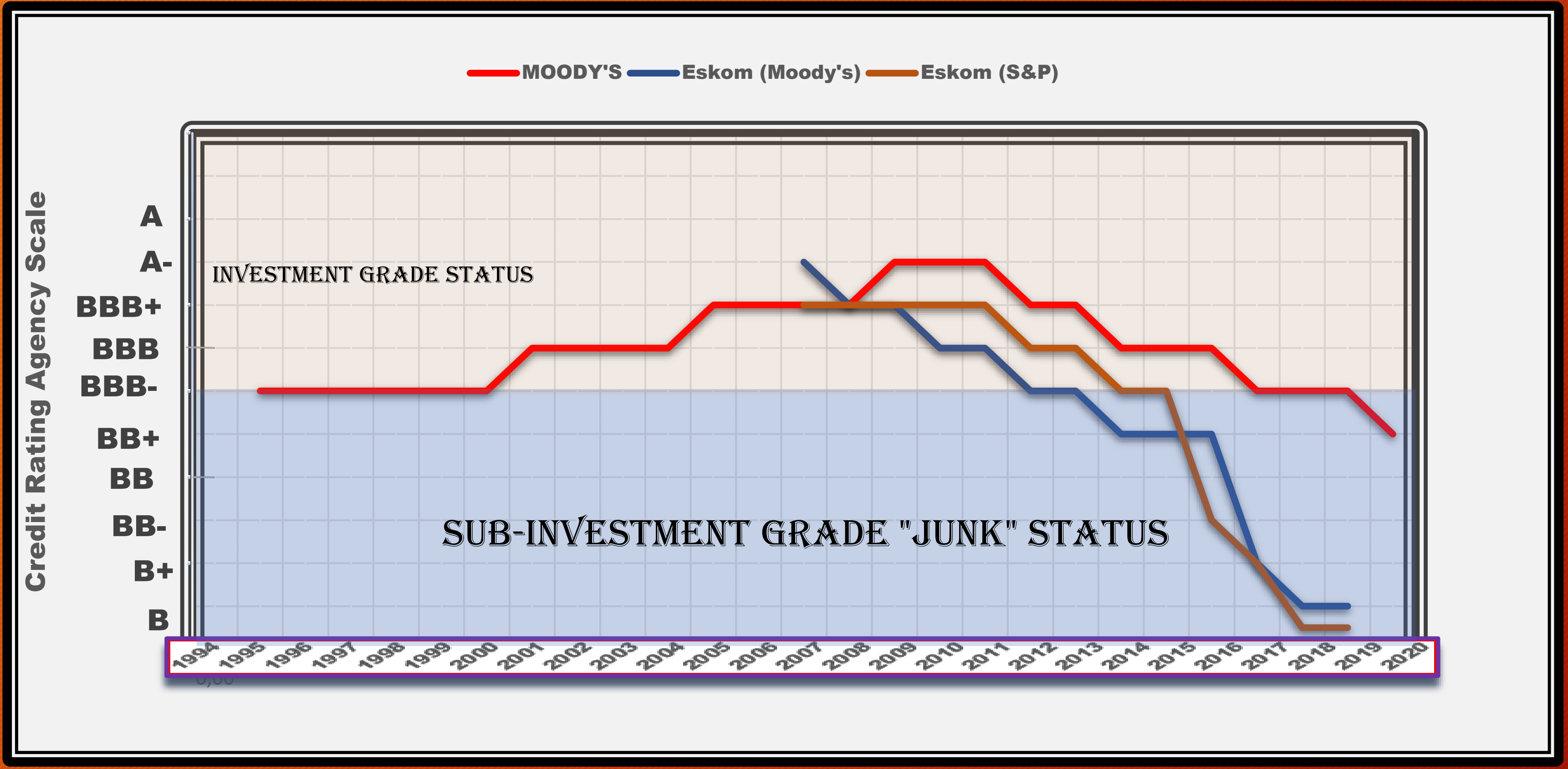
Debt Service Cost as proportion of Budget Revenue



Credit Ratings at its best in 2008/09



SA Sovereign Rating compared to Eskom Rating



SO WHERE DID IT ALL GO WRONG FOR THE ESKOM AS “PROXY” FOR SOCs?

Fiscal support to Eskom

Eskom “under the microscope”

Eskom Experience: Main points

Observations from Moody’s Rating Action (Sovereign, Eskom and DBSA)

Fiscal support to Eskom

- No explicit exposure to the state prior to 2008/09
- R60 billion initial government loan converted into a grant
- R350 billion guarantee facility (initially R176 billion)
- R23 billion fiscal transfer from sale of state asset
- R23 billion per annum over 10 years from the fiscus
- Above-inflation tariff increases over multiple years

Eskom “under the microscope”

- Unqualified audit opinion in 2008/09
- Sound treasury management function and stable management team
- Comprehensive corporate governance structure
- Huge Eskom borrowing requirement puts pressure on domestic bond market
- Increase reliance on tariff increases to meet funding needs
- New Board chairman and new CEO appointed in 2010
- Below requested tariffs approvals creates cumulative cash shortfalls
- This results in R176 billion initial guarantee being increased to R350 billion
- The DBSA, PIC and others also support Eskom’s guaranteed borrowing requirements

Eskom “under the microscope”

Other Challenges (Operational vulnerabilities)

- Non-payment for electricity by municipalities in protest” to significant tariff increases
- Unreliable energy supply and high maintenance on an ageing fleet
  - Increasing copper theft and “lost-time”injuries
- Increasing reliance on government’s sovereign rating
- Rand depreciation adds to increasing cost of imported equipment
- Uncertainties regarding future tariff increases.
- “Keep the lights on” stance adds to cost overruns
- Delays in and increasing costs of new power generation projects

Eskom “under the microscope”

Unstable Management and Board

- 2013/14: CEO, CFO and Company secretary resign
- August 2014: new CEO (former DG of shareholder department) appointed
- May 2015: CEO asked to “step aside“ and subsequently reigns (after 9 months in the job)
- Three other executives “removed” stating breach of fiduciary duties.
- This is reported to the IRBA as a “reportable irregularity”
- October 2015: new CEO, CFO and Board Chairperson appointments are made
- New executive appointments were previously CEO and CFO of Transnet, respectively.
- New Eskom Chairman previously also Board chairperson of Landbank and SABC
- 2016/17: External Auditors expresses a qualified audit opinion on Eskom finances.
- 2017/18: CEO, CFO and Board Chairperson resignations and new CEO and new Board appointments.

With new CEO and Board, some level of confidence returns to the markets

- Eskom receives a “going-concern” external audit opinion
- 2017/18 and 2018/19: significant efforts to address maladministration, strengthen internal controls and improve governance processes.

Eskom experience: Main Points

- Inappropriate funding model
- Unhealthy relationships between management and Board
- Uncertain regulatory environment
- Operational environment progressively weakening
- Progressive downgrading of credit ratings
- Sovereign credit rating downgrades /upgrades have corresponding rating impact on SOC ratings (and all other issuers in the market)

Observations from Moody’s rating action

- Sovereign credit rating action impacts other issuers in a similar manner
- Sovereign credit ratings serves as a “credit rating ceiling” for all other issuers
- Political uncertainty is undesirable
- Public sector finances is risk assessed in its totality
- The fiscal position worsens as economic performance deteriorates
- Increasing administrative prices adds to the un-competitiveness of the economy if not accompanied by improved productivity.
- Public-Private collaboration must be encouraged and supported.
- SOC Boards and management must possess the requisite competencies, both technical and ethical
- Shareholder departments must provide the necessary strategic guidance and monitoring
- Risk mitigation strategies and initiatives (and other support measures) must be identified, and appropriate action taken speedily.
- Data transparency required for effective decision-making and to determine the appropriate business model and capital structure
- Be aware of “too big to fail” SOCs – creates implicit contingent liabilities

Important Lessons and suggestions from the SA Experience

Main causes for increasing guarantees

So where to from here?

Main causes for guarantees increasing

- Poor Governance
- Inappropriate Business Models
- Policy Uncertainty
- Costly policy decisions
- Solvency and liquidity concerns
- Slow execution or agreed-to risk mitigation strategies
- Exceptions to the above scenario exist when entities are well-managed (DBSA, IDC, etc.)

So where to from here?

Conditions attached to guarantees must be well-researched and target the identified risks appropriately

“Information symmetry” of financial and “other” technical data for all relevant stakeholders

Continuous assessment of post guarantee approvals

Approved SOC policies aimed at necessary reforms to be included in SOC performance appraisals

CONCUSION

Conclusion

- Thorough planning prior to decisions on significant investments
- Effective Shareholder relationships:
  - Continuous SOC oversight, monitoring and evaluation
  - Political guidance where applicable
  - Adequate and relevant reporting
  - Identify unfunded mandates early
  - Important relationships and stakeholders include: National Treasury, shareholder departments, Members of Parliament (relevant committees), Office of the President, private sector, communities, executives, Boards, rating agencies
- Initial issuance of guarantees were justified, but compromised by weak project execution
- Appropriate skills and experience to execute on SOC mandates
- Ongoing monitoring of contingent liability exposures
- Identify “too large to fail” entities
- Prior to issuance: Guarantee conditions must be well researched, measurable and time-bound with the overall SOC financial position improving as the objective.