POLICY BRIEF

FINANCIAL AND FISCAL COMMISSION (2023)

State-Owned Enterprises and the Threat to Fiscal Sustainability

EXECUTIVE SUMMARY

State-owned enterprises (SOEs) impose control over the economy by providing goods and services in a distinctly different manner from governments. SOEs offer people and businesses essential water, electricity, and transportation services. They shape industrial policy, thus transforming the economy by stimulating new industries.

In South Africa, SOEs are crucial constituents of economic growth because of their critical role in strategic network industries. They dominate the utilities, transportation, and communications sectors and provide development finance. However, SOEs continue to constitute a fiscal risk for the government as they require fiscal transfers to cover their losses and recapitalise their balance sheets. SOEs are beneficiaries of significant support from the fiscus through transfers and guarantees, thus constituting huge direct costs and, consequently, a critical source of fiscal risks in contingent liabilities. Support to entities whose operational and financial performance continues to deteriorate has thus exposed fiscal vulnerabilities.

The research aims to review the state of South Africa's major SOEs, evaluate their role in economic development, assess the risks they pose to fiscal sustainability, and examine possible SOE reforms.

The paper's findings reveal that the operational and financial health of most SOEs is deteriorating; the maturity of SOE's debt presents a substantial risk to the fiscus; most SOEs, have received direct financial support from the fiscus; Eskom's financial and technical performance metrics are deteriorating; Transnet's technical performance metrics are deteriorating; government guarantees increasingly drive contingent liabilities to SOEs; and government exposure to state-owned enterprises is very high.

Hence, the Commission recommends reducing risks from quasi-fiscal activities, avoiding excessive and discretionary resource extraction from SOEs, reducing fiscal risks from SOEs' borrowing, monitoring, reporting, accounting, and control, improving the Transparency of SOEs' operations, and establishing a centralised holding company.

THE FINANCIAL AND FISCAL COMMISSION

The Financial and Fiscal Commission is a body that makes recommendations and gives advice to organs of state on financial and fiscal matters. As an institution created in the Constitution of the Republic of South Africa, it is an independent juristic person subject only to the Constitution itself, the Financial and Fiscal Commission Act, 1997 (Act No. 99 of 1997) (as amended) and relevant legislative prescripts. It may perform its functions on its own initiative or at the request of an organ of state.

The vision of the Commission is to provide influential advice for equitable, efficient and sustainable intergovernmental fiscal relations between national, provincial and local spheres of government. This relates to the equitable division of government revenue among three spheres of government and to the related service delivery of public services to South Africans.

Through focused research, the Commission aims to provide proactive, expert and independent advice on promoting the intergovernmental fiscal relations system using evidence-based policy analysis to ensure the realisation of constitutional values. The Commission reports directly to both Parliament and the provincial legislatures, who hold government institutions to account. Government must respond to the Commission's recommendations and the extent to which they will be implemented at the tabling of the annual national budget in February each year.

The Commission consists of Commissioners appointed by the President: the Chairperson and Deputy Chairperson, three representatives of provinces, two representatives of organised local government and two other persons. The Commission pledges its commitment to the betterment of South Africa and South Africans in the execution of its duties.

BACKGROUND

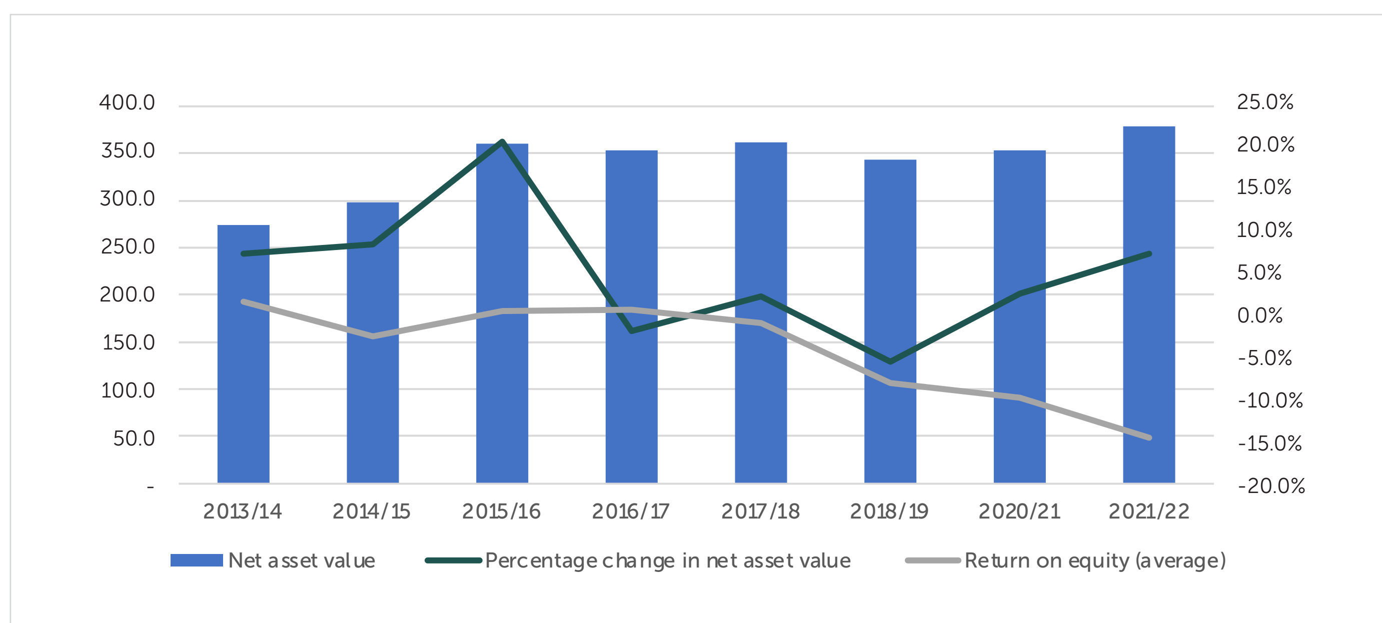
The establishment and operations of SOEs are supported by a broad legislative and policy framework, paramount of which is the National Development Plan (NDP). The role of the NDP in anchoring the mandates of SOEs is further supplemented by other key national planning documents encompassing the New Growth Path (NGP), the Medium-Term Strategic Framework (MTSF), and the Industrial Policy Action Plans (IPAPs). The SOEs governance is also subject to various corporate governance documents, including the King IV Report on Corporate Governance, the Public Finance Management Act guidelines, and the specific Shareholder Compacts for each SOE agreed upon between the SOE boards and the State's representatives.

Despite this extensive legislative and policy framework, SOEs face considerable hurdles in fulfilling their developmental mandates. The challenges they encounter entail, among other things, a lack of clarity in objectives, a multiplicity of mandates within their business models, improper costing of mandates, lack of an ownership policy, inconsistent legislative framework, complex and decentralised oversight model, deficiencies in the regulatory framework, governance interference manifested in political appointments of boards and senior management, non-adherence to international best practices in corporate governance dictates, severe breaches of procurement policies, and weaknesses in oversight by line ministries, legislature, and SOE boards.

The above mentioned challenges translate into SOEs' weak and deteriorating financial performance and a sharp decline in their performance since 2015. Consequent to this poor financial performance, substantial fiscal transfers were made to SOEs since the late 2010s to stabilise their balance sheets. There are budgetary risks stemming from government contingent liabilities resulting from these direct fiscal transfers and equity injections to SOEs. These risks are exacerbated by continued financial support to SOEs to avoid defaulting on guaranteed SOEs' debt because of liquidity and solvency challenges.

Public finances have deteriorated significantly between 2008/09 and the 2018/19 fiscal positions, with the levels of government debt, contingent liabilities, and cost of borrowing rising to unprecedented levels, partly because of the increase in financial assistance to SOEs. Net government debt, contingent liabilities, and provisions to GDP increased over this period. Government guarantees as a percentage of contingent liabilities have also risen over this period. The picture painted by the fiscal metrics above reflects a distressing deterioration in the fiscal landscape of South Africa resulting partly from the weak financial perfomance of SOEs.

Combined balance sheets of state-owned companies



RESEARCH FINDINGS

The financial health of SOEs

The operational and financial health of most SOEs is deteriorating. Their net asset value has fallen sharply between 2015/16 and 2018/19. Their return to equity metric has significantly declined. High-cost structures resulting primarily from high debt service costs and employee compensation are SOEs' main hurdles to profit-making. The SOE's net cash from operations significantly declined between 2014/15 and 2020/21. Net cash available after servicing obligations has been negative since 2014/15, and interest payments accelerated between 2014/15 and 2019/20. The poor financial health of SOEs is a significant impediment to their access to capital markets, thus increasing the dependence of these institutions on the fiscus for sustaining their operations. The combined negative cash flow of SOEs means that these institutions rely on debt to finance operations, thus minimising the scope for capital investment and rendering the financial position unsustainable.

Debt maturity and government guarantees

The maturity of SOEs debt presents a substantial risk to the fiscus. SOEs debt repayments will peak at R24 billion in 2025/26, of which the government guarantees R4 billion. In 2026/27, debt repayment by SOEs will amount to R16 billion, of which the government will guarantee more than half. Over the medium term, R67.4 billion in debt falls due of which government guarantees R14.9 billion. The poor financial health of SOEs means that this debt may require refinancing; if the refinancing of this debt is not possible, the government is obligated to make available the guarantees, thus impacting the already precarious public finances.

Government financial support to SOEs

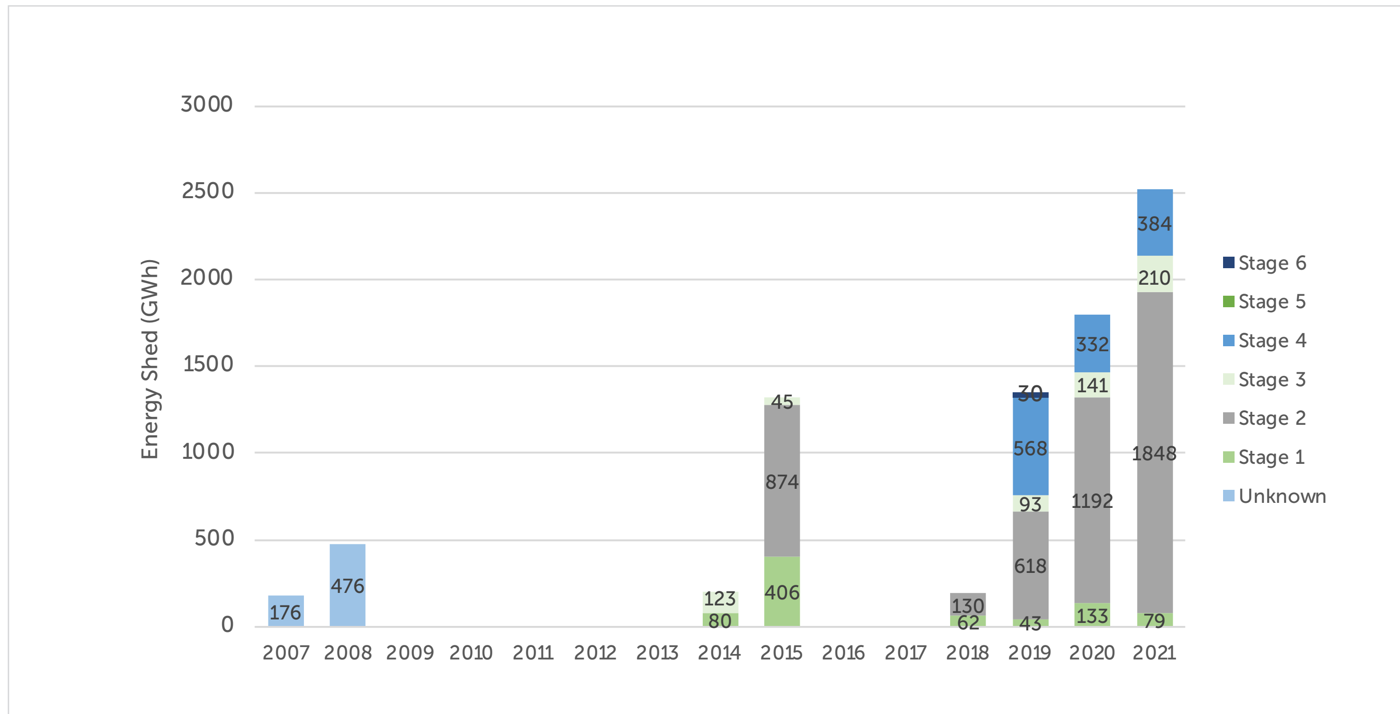
Most SOEs, including Eskom, SAPO, SABC, Denel, and SAA, have received direct financial support from the fiscus. Direct fiscal transfers to SOEs accelerated between 2015/16 and 2020/21. In the past 12 years, the government has paid over R162 billion to financially distressed SOEs. Eskom accounts for 82 per cent of the total fiscal transfers. According to National Treasury, the total cumulative number of bailouts to SOEs between 2012/13 and 2021/22 is a staggering R266.6 billion.

ESKOM

As measured by vital financial ratios, the financial health of Eskom reflects weak economic performance as both the profitability and solvency ratios are deteriorating. Eskom's technical performance metrics are deteriorating. Delayed and inadequate unplanned capability loss factor maintenance translates into declining and unreliable performance, leading to higher maintenance costs.

South Africa's escalating load-shedding challenge is significantly worsening. Load shedding in 2021 amounted to 2455 Gigawatt hours (GWh), reflecting a 37 per cent increase from the 1798 GWh load shedding experienced in 2020. The intensity of the load-shedding has also increased. Stage 3 load-shedding increased from 141 GWh in 2020 to 210 GWh in 2021. Similarly, stage 4 load-shedding reached 384 GWh in 2021, up from 332 GWh in 2020. Eskom load-shedding intensified in 2022 and overtook 2021 as the most intensive loadshedding year, more than four times more. December 2022, on its own, experienced more loadshedding than in any year before. It is the first year that most loadshedding was in stage 4 (3824 GWh), not stage 2 as was previously the case. The highest level of loadshedding implemented by Eskom thus far, Stage 6, reached 996 GWh in 2022. Notwithstanding the underperformance outlined above, Eskom continues to receive significant support from the fiscus.

Eskom Loadshedding in Gigawatt hours, 2007-2021



Transnet

Transnet is beset by historical and structural challenges, paramount of which is the disproportionate transport demand requirements of inland mining deposits far from the ports. South Africa's economic activity is primarily concentrated inland. Its non-containerised export activity also occurs inland. The rail system in South Africa is currently marred by a capital investment backlog and insufficient funding, outdated and old infrastructure, declining rolling stock, and obsolete technologies. These challenges are exacerbated by a deficient regulatory framework, particularly for freight rail and port terminal operations. The inadequacies in the system encompass the absence of a settlement process; the lack of rules on pricing, investment, and access; and the need for an autonomous regulator with statutory investigative, enforcement, and decision-making powers.

The financial health of Transnet, as measured by vital financial ratios, also reflects weak economic performance as the profitability and solvency ratios are deteriorating. Transnet's technical performance metrics are deteriorating. Transnet's volumes of coal exports decelerated by 7.76 per cent to 66.9 mt in 2021 from 72,53 mt in 2020. Transnet's volume of iron ore exports declined by 9.77 per cent from 58.85 mt in 2020 to 53 mt in 2021. The general freight volumes decelerated by 21,72 per cent from 63,4 mt conveyed by rail in 2021 to 80,99 mt in 2020. Freight Rail transported 517 889 Twenty-foot Equivalent Units (TEUs) through major corridors in 2021, reflecting a 22 per cent decline from the 660 894 TEUs in 2020.

Government debt and contingent liability management

The total contingent liabilities amounted to R195 billion in 2008/09, of which government guarantees to SOEs constituted R63 billion. Contingent liabilities are projected to reach R1.1 trillion in 2020/21, of which R569 billion will be government guarantees to SOEs, accounting for more than half of the total contingent liabilities. In 2024/25, contingent liabilities are projected to increase to R1.2 trillion, and more than 40 per cent will be government guarantees to SOEs. Contingent liabilities are increasingly driven by government guarantees to SOEs, constituting a significant risk to the fiscus, particularly when SOEs' financial and operational performance is weak. If the guarantees to SOEs materialise, government debt will increase, and the fiscal position will worsen, thus presenting significant developmental challenges.

Government exposure to state-owned enterprises is very high. In the form of guarantees, government support for Eskom increased from 6.2 per cent of GDP in 2019/20 to 6.3 per cent in 2020/21. The total guarantee to all the SOEs increased from 12.2 per cent of GDP in 2019/20 to 12.4 per cent in 2021/22. There is no correlation between the conditions attached to government issuance of guarantees and the reasons why guarantees are applied for in the first instance.

The swift acceleration of government guarantees between 2008/09 and 2018/19 is mainly attributed to SOEs' poor governance, inappropriate business models, policy uncertainty and costly policy decisions. Government guarantees have been increasing while the SOEs' financial performance has been deteriorating, as demonstrated by net profit losses, unsustainable debt levels, and worsening liquidity ratios. This unhealthy virtuous cycle has been reoccurring as weak SOEs' financial performance has led to more government guarantees to SOEs ensuing in higher fiscal vulnerability, higher financing costs, and deteriorating credit rating outcomes.

CONCLUSION

This study has analysed SOEs' challenges and the reforms required to address these problems. The SOEs are beset with weak fiscal governance, that creates cycles of dependence on the fiscus, necessitating continuous bailouts for the SOEs and guaranteeing debt issuance to cover expenses. This weak fiscal governance translates into fiscal risk or cash flow risk and risk emanating from the size of the stock of SOE liabilities. The governance problem of SOEs is not confined to corporate governance but translates to a severe fiscal governance problem. This means more than corporate governance reform is needed to mitigate SOE challenges. It is essential to implement hybrid solutions that combine administrative controls that target incentives for SOEs, their managers, and the organisations that monitor them. Adequate qualitative and empirical evidence supports the creation of centralized agencies to monitor SOEs.

Whereas substantial changes have been made at Eskom and Transnet, particularly concerning executive and board leadership, more reforms are still required before these two critical SOEs can operate optimally. There is still significantly more to be done to quell these institutions' corruption, mismanagement, and governance failures. This is particularly important given an underperforming economy, policy uncertainty, and fluid national politics.

RECOMMENDATIONS

The Commission makes the following recommendations:

Reducing risks from quasi-fiscal activities

1. *In collaboration with the relevant SOE's parent departments, National Treasury should eliminate fiscal risks emanating from the imposition of quasi-fiscal burdens by avoiding policies that result in such obligations or abolishing them if they are already in place. The reduction of discretionary fiscal governance in SOEs requires the following:*
    - *Liberalising the prices of goods and services provided by SOEs in competitive markets and regulating prices in monopolistic or oligopolistic markets at levels that would enable them to generate sufficient profit.*
    - *Subjecting SOEs to the same labour and employment regulations; eradicating any local content obligations for the SOEs and rationalising procurement procedures; and appraising SOEs' investment decisions.*
    - *Improving corporate and fiscal governance through reforms that enable SOEs' management boards the operational autonomy they require to make profit-maximizing decisions and eliminating political interference to enhance operational transparency.*

Avoiding Excessive and/or Discretionary Resource Extraction from SOEs

2. *In collaboration with the relevant SOEs' parent departments, National Treasury should reduce excessive resource extraction, which reduces the SOEs' competitiveness, through the following:*
   - *Establish explicit and progressive guidance to SOEs on expected rates of return and the distribution or reinvestment of profits. Instituting a predetermined dividend policy in the form of a fixed percentage of annual profits or linking the pay-out to achieving the desired capital structure for each SOE.*

Reducing fiscal risks from SOEs' borrowing

3. *SOEs require access to financing to maintain their operations and undertake investments. Fiscal rules that necessitate SOEs to run balanced budgets render them competitive relative to other private sector companies operating in the same sector. SOEs should therefore be allowed to charge higher prices to cover financing costs. However, the National Treasury should establish safeguards to prevent SOEs from becoming too leveraged. National Treasury should not provide preferential access to finance and contractual terms to SOEs. They should instead introduce transparent and non-discretionary controls on borrowing to ensure the SOEs remain liquid and solvent. The provision of government guarantees by the National Treasury should be subject to assisting SOEs in obtaining financing for projects with significant public benefit. National Treasury should establish an aggregate debt ceiling for each sector to be approved by Parliament. Government guarantees should then only be granted to SOEs subject to an in-depth and explicit appraisal of their ability to service the debt. The SOEs should be charged fees comparable to those imposed on any guarantees granted to private sector companies, as is the case, for instance, in Australia. Borrowing controls should be premised on clear, predetermined, and impartial benchmarks that evaluate the SOEs' capacity to service their debts. This should entail the size and structure of the SOEs' liabilities, their interest burden, debt repayment schedules, operational profitability, the size of their contingent and known future liabilities, the liquidity of their assets, and the volatility of their revenues. The evaluation must also forecast how the new capital structure will impact these indicators. At a minimum, the indicators used by National Treasury for evaluating the SOEs must incorporate the ratio of gross liabilities to revenue, debt denominated in foreign currency to foreign exchange reserves, interest payable to revenue, and liquid assets to short-term liabilities. The indicators should be standardised and weighted for making approval decisions. In monitoring, reporting, accounting, and control, the Commission recommends implementing effectual systems to monitor the execution of their budgets and provide detailed reports in this regard.*

Monitoring, reporting, accounting, and control

4. *In collaboration with the relevant SOEs' parent departments, National Treasury should obligate SOEs to implement effectual systems to monitor the execution of their budgets and provide detailed reports in this regard. National Treasury should acquire human and technical resources required to monitor the SOEs, safeguard their adherence to financial and reporting obligations, scrutinise budgets and reports, and provide appropriate feedback on necessary remedial action where necessary.*

   National Treasury must make it mandatory for SOEs to submit a consolidated set of statements that will enable statistical analysis. A separate statement must be prepared on targets for the government and SOEs and evaluated using different criteria. Government spending on SOEs should be assessed on whether it achieved aims such as macroeconomic growth and fiscal stability, and the SOEs' budgetary allocations must be evaluated on their profitability, efficiency, and liquidity. National Treasury should strengthen their SOEs' asset and liability management capabilities. This should ensure that SOEs boards have the necessary skill set to prioritise this.

Improving the transparency of SOEs' operations

5. *The public disclosure and appropriate distribution of detailed information on SOEs' operational and financial performance are critical for good governance. Moreover, examination by external stakeholders significantly increases the SOEs' accountability and discourages political complicity or flagrant corruption. National Treasury should institute reforms aimed at improving transparency, focusing on the following:*
    - *More declaration of the SOEs' contingent and future liabilities and the results of sensitivity and risk analyses.*
    - *Safeguarding that the SOEs' quarterly and annual reports include sections analysing their performance during the corresponding period.*

Establishment of a centralised holding company

6. *There is theoretical and empirical evidence that a centralised holding company, that monitors or controls SOEs, improves its performance and reduces fiscal risk. Holdings with corporate structures may not automatically produce better results than a well-staffed centralised unit within National Treasury. However, a centralised holding company is critical to reducing monitoring costs. National Treasury should establish a centralised holding company that will operate with tight ex-ante controls regarding debt and capital expenditure plans to minimise the fiscal risk inherent in the operation of SOEs.*

ENQUIRIES:

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