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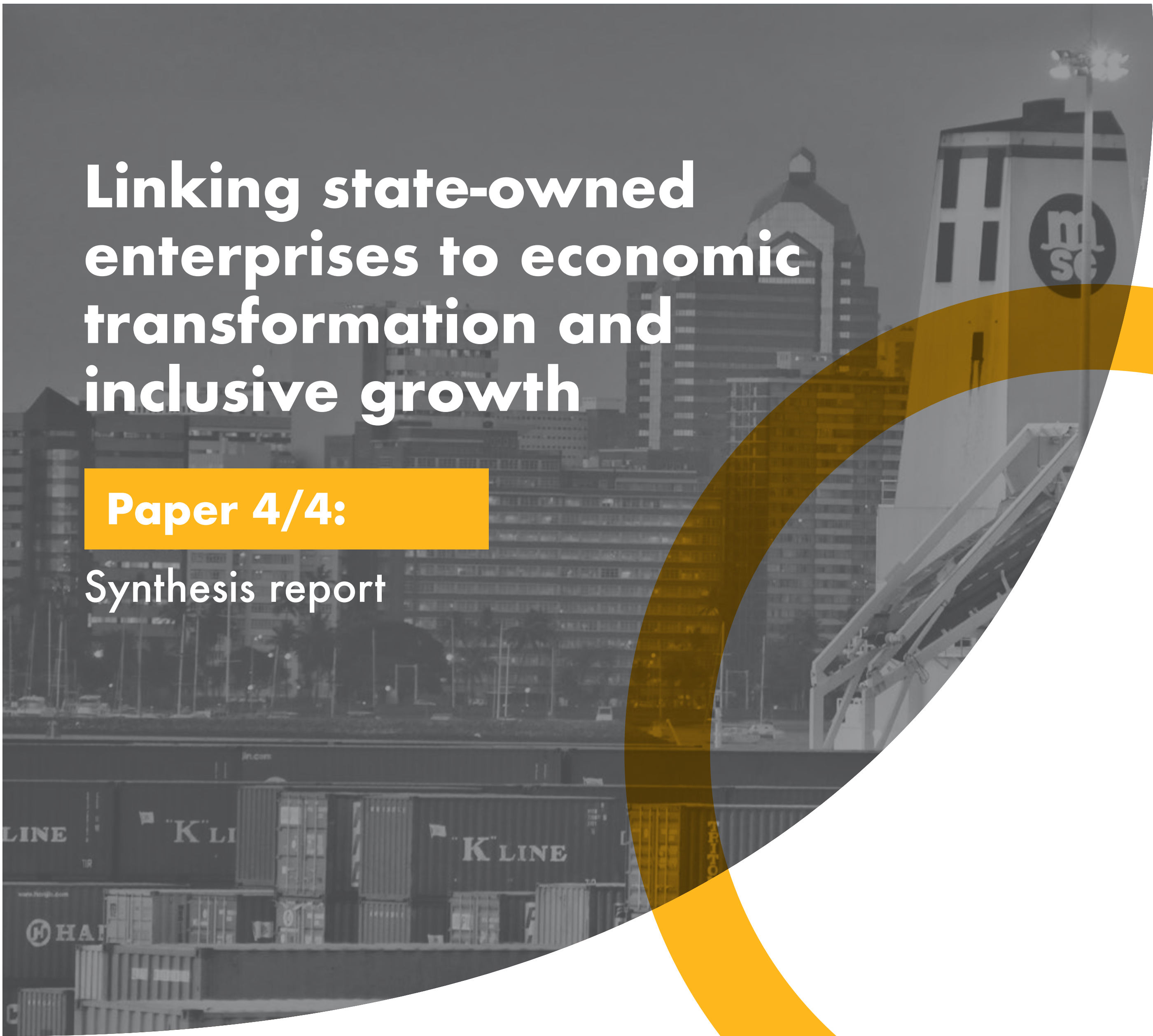

Linking state-owned enterprises to economic transformation and inclusive growth

Paper 4/4:

Synthesis report

Prepared for the African Development Bank and National Planning Commission of South Africa

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EXECUTIVE SUMMARY

The National Development Plan 2030 is South Africa's guiding economic strategy. President Ramaphosa has repeatedly reaffirmed that the National Development Plan as the country's developmental blueprint.[1] Anchored by the Constitution, the NDP envisions a just and equal society in which poverty is eliminated and inequality reduced.

Inclusive growth and economic transformation are the proposed means for achieving these goals. The plan identifies the required contribution needed by different sectors to achieve inclusive growth and economic transformation. These roles range from support for SMEs to industrial diversification to spatial transformation.

The NDP identifies state-owned entities (SOEs) as the engines of economic development. The critical economic infrastructure and services SOEs provide power the economy, support jobs in manufacturing, trade and exports, and give citizens basic goods and services like water and sanitation, energy and transport.

This four-part study assesses the contributions of SOEs in achieving the mandate set for them in the NDP.[2] Eskom, Transnet and PRASA were used research case studies from which generalised learnings and recommendations were deduced.

The NDP expects that by 2030 South Africa must have an energy sector that drives national economic growth. The sector will make investment in energy infrastructure; achieve social equity through expanded access to energy at affordable tariffs; achieve environmental sustainability through efforts to reduce pollution, mitigate climate change and increase proportional use of renewable energy."[3]

In rail transport; by 2030 the NDP envisions a sector that bridges geographic distances affordably, reliably and safely so that South Africans can access previously inaccessible economic opportunities, social spaces and services. It will allow for the easy transport of goods around the country; facilitate regional trade; and promote a low-carbon economy by offering transport alternatives that minimise environmental harm.[4]

The expected contributions of the SOEs in energy and transport sectors are not being achieved. The energy sector, dominated by Eskom, has to date not been able to provide reliable and efficient energy service. Nor has Eskom been able to obtain sufficient capacity to meet demand. As a result, the power grid has been under stress since 2007 with regular load-shedding, which has diminished from growth in the manufacturing, mining, agriculture, and small business sectors. The rail transport sector has not provided affordable nor reliable rail transport. Some poorer households still spend in excess of 40% of their income on transportation; and the state of commuter rail entrenches the exclusion of low-income households. Unreliable and unsafe service provision by Prasa has seen mini-bus taxis become the preferred mode of transport – for every train commuter there are nine commuters using mini-bus taxis – despite minibus taxis being 80% more expensive for commuters over comparable distances.

Rather than supporting trade and industrial diversification, freight rail has perpetuated the resource dependence of the economy. In 2018, port tariffs were almost 200% higher

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[1] For instance, see the State of the Nation addresses in 2019 and 2020.
[2] Please refer to Part A: Performance Review; Part B: Market Suitability Analysis; Part C: Institutional Governance Review for comprehensive analysis.
[3] NPC (2012) *National Development Plan,* p163
[4] Ibid, p183.

than the sampled international average on containers yet they were over 90% lower than the sampled international average on coal. Far greater efficiency is realised on commodity export lines than general freight lines. There are ongoing concerns about the cost, efficiency and reliability of the general freight network, evidenced by the weak market share of rail in domestic freight which presently accounts for 15% of market share, when logistics models suggest a 40% would maximise national efficiency. The branch line network has not served the rural and agricultural sectors well.

Many SOEs have been chronically underperforming which indicate systemic issues exacerbating underperformance. Years of uncertain policy, opaque funding strategies, poor institutional accountability, politicised boards and mismanagement have led to the chronic underperformance of some SOEs, and in some cases, near-collapse. Underperformance has strangled economic growth and led to alarming increases in government debt and national credit risk. Most troubling is the negative impact non-performing SOEs have on the lives of the poorest in society.

The crisis in SOEs and the system in which they operate now threatens the achievement of the NDP.

This series of papers presents analytical tools for government and advisory bodies to reform the SOEs. They include a performance framework to realign SOEs mandates with the NDP (Part A); an analytical framework to assess the purpose and positioning of an SOE in a developing market economy (Part B); and a review of the institutional governance framework to improved transparency, accountability and coordination (Part C). This paper (Part D) synthesizes learnings from the three previous papers into policy recommendations.

The decision whether a SOE should be created is primarily an economic question: it depends on the underlying nature of the market and the goods provided by that market. Government should consider a full review of the market in which SOEs operate to determine the suitability of provision through a SOE. Even where an SOE has been long established, changing market conditions and new technologies require periodic reassessment of the need for an SOE.

As a general principle established in the NDP itself, SOEs should not be used as a substitute to the provision of basic government services.

Nor should SOEs be used in markets where private enterprise can create competitive outcomes: It is hard to see on either constitutional or efficiency grounds why the state should use public resources to intervene with an SOE in private commercial activities where the market is competitive and produces outcomes that both sellers and buyers are happy with, or where light failings can be regulated. Scarce resources would be better directed to where markets do not operate efficiently, and so state intervention is necessary.

A decision to continue with an established SOE is conditional upon the continued operational performance of the SOE. Where there are repeated failures in operational performance, or where fiscal and credit risk starts to outweigh benefits, government has a duty to implement organisational reforms, first. These include corporate governance, funding, and policy and process reforms.

The performance of any SOE should be judged against the outcomes sought by the NDP. There should be a consistent performance framework applied to all SOEs which is directly aligned to the outcomes sought by the NDP. A consistent performance framework will not only ensure the NDP become more manifest in the operations of the SOEs but will diminish opportunities for political interference.

To improve performance, the report recommends that the mandate of SOEs be narrowed to three priorities – delivery of core economic mandate, improved governance, and sustainable funding. These three should carry 70% to 80% of the weighting in the shareholder compact.

The institutional governance of SOEs should be reformed to address three main challenges[5]: 1) the excessive politicization and "state capture" that have plagued SOEs; 2) coordination across government - streamlining oversight and strategic objectives and 3) more professionalism and accountability in management and overcoming the revolving door of SOE management.

To this end government should consider the options in for a new SOE holding company. Three options are given. The appointment of representatives to the Board of the state holding company should be a public process, subject to oversight by Parliament and public hearings.

If there is a persistent and chronic failure to improve performance after organisation reforms, then structural reforms should follow. Structural reforms mean government uses tools at its disposal like policy, regulation, subsidies and partnerships, to change the market structure so that other forms of provision of the good or services, other than state-provision, can arise. A range of structural reforms are set out in the papers. Discussion of structural reforms should not become trapped between the unhelpful extremes of nationalisation v. privatisation, as this overlooks other partnership arrangements that stop short of privatisation and which can improve delivery of the good or service.[6]

Without reform, it is unimaginable that the prosperous and cohesive society envisioned by the NDP will be achieved. If the nation's aspirations to abolish poverty, reduce inequality and generate mass employment through inclusive growth are to be realised – then decisive and courageous course correction on SOEs is needed from government.

[5] Please refer to Part 3/4: Institutional Governance Review
[6] Please refer to Part 2/4: Suitability Review for a mapping of the range of mechanisms to solve for different market failures (page 24 and 27).

INTRODUCTION

This is a synthesis of a year-long study on state-owned enterprises. The study was commissioned by the National Planning Commission (the NPC), and funded by the African Development Bank. The role of the NPC is to oversee the implementation of the National Development Plan (NDP). The NPC provides research support and recommendations to government on issues that impact the realisation of the NDP.

President Ramaphosa has repeatedly reaffirmed that the National Development Plan as the country's primary developmental blueprint.[7]

In reviewing progress towards the NDP, the NPC has commissioned a series of papers on the role of SOEs in the economy: This to provide the government with tools to review and align the SOEs to better support government's long-term economic strategy as laid out in the NDP. An assessment of SOEs is of critical importance given the fundamental role they play in the economy. SOEs are a significant part of the economy contributing about 8.5% of GDP and employing more than 250 000 people.[8] According to the NDP, the SOEs purpose is to provide core economic infrastructure and services efficiently; to drive economic development and trade; to drive down the costs of doing business; to lead on spatial and industrial transformation; and to provide minimum basic goods and services like water and sanitation, energy and transport. Therefore, in order to achieve national development goals it is imperative that SOEs operate effectively and efficiently. By any measure the performance of key SOEs has been disappointing. Years of uncertain policy, opaque funding strategy, poor institutional accountability, politicised boards and mismanagement have led to the chronic underperformance of some SOEs, and in some cases, near-collapse. Underperformance has strangled economic growth and led to alarming increases in government debt and national credit risk. Most troubling is the adverse impact non-performing SOEs have on the lives of the poorest members of society.

Fresh ideas, backed by evidence, are needed to improve SOEs' contribution to the NDP. The climate is conducive to sensible reforms with multiple reviews and discussions taking place at the heart of government, notably with the formation of the Presidential Council on SOEs. How the SOEs should fit into the national development strategy requires express consideration of the existence, purpose and performance of the SOEs. Reforms must be based on a sympathetic understanding of national economic and social goals, rigorous technical assessment of performance, and should draw on global best practice for SOEs in emerging markets.

The comprehensive four-part study provides government with tools and recommendations to reform SOEs. The reports used Eskom, Transnet and PRASA as case studies. Part 1 was the development of performance framework linking NDP outcomes to the performance metrics for selected SOEs. Part 2 provides an analytical framework that can be used to assess the appropriate purpose of an SOE in the economy. Part 3 re-designs the institutional governance cascade based on international best practice. Taking into account the learnings from the three reports, this fourth and final paper is to provide government with synthesized, generalised recommendations on the reform of SOEs, including operational reform, institutional governance reform, and market reform.

[7] For instance, see the State of the Nation addresses in 2019 and 2020.
[8] Sunita, K. 2018. *Corporate governance in South African state-owned enterprises: background note for the South Africa systematic country diagnostic (English)*. Washington, D.C.: World Bank Group.

THE EXPECTATIONS OF SOES

The NDP is the pre-eminent strategy document of South Africa, and is therefore the pre-eminent guide to SOE purpose. The NDP is the most appropriate benchmark against which to directly measure and guide SOE purpose and performance. The goal of the NDP is to realise a greatly improved quality of life for all South Africans by 2030. In the spirit of the Constitution, the NDP envisages an equal and just society in which poverty has been eliminated and inequality has been reduced. According to the plan, the vehicles for achieving this vision are inclusive growth and economic transformation. The NDP recognises that economic infrastructure and services provided by SOEs are the foundation of inclusive development and economic transformation.

The SOEs have a dual commercial and sub-commercial mandate to honour. The core mandate (on commercial terms) is to provide paid-for economic infrastructure and services that improve national competitiveness and support job creation through SME growth, industrial diversification and trade. In addition, SOEs are expected to fulfil a sub-commercial developmental role. For instance: while *“Eskom has a mandate to provide reliable and competitively priced electricity to mining, industry and business…it also has a mandate to extend affordable access to electricity services to poor households*.”[9]

Generally, the NDP expects that by 2030 South Africa will have an energy sector that drives national economic growth, social equity and environmental sustainability: This sector will make investment in energy infrastructure and provide reliable and efficient energy service at competitive rates. It will achieve social equity through expanded access to energy at affordable tariffs. Also, environmental sustainability will be promoted through efforts to reduce pollution, mitigate climate change and to increase proportional use of renewable energy.

Generally, the NDP expects that by 2030 the sector will bridge geographic distances affordably, reliably and safely. The sector must support economic development by allowing for the easy transport of goods around the country, it should facilitate regional trade; and it must promote a low-carbon economy by offering transport alternatives that minimise environmental harm”[10] (this would be met through the road to rail shift), and should allow citizens to access previously inaccessible economic opportunities, social spaces and services. Specifically, the NDP posits that logistics is a critical input into industrialization, allowing for increased international competitiveness and economic growth through trade, and also places an integral responsibility on Transnet for the delivery of a reliable supply of coal for Eskom. Commuter and passenger rail are important to overcoming spatial challenges by increasing the mobility of low-income households and access to public transport is seen as one of the nine elements of a decent standard of living.[11]

Specifically, the NDP sets eleven direct expectations of SOEs:

SIX OPERATIONAL THEMES

[9] NPC (2012) *National Development Plan – 2030,* p442.
[10] Ibid, p183.
[11] NPC (2012) *National Development Plan – 2030,* p28.

1. **Core mandate (commercial basis):** *The SOE must provide core economic infrastructure and services efficiently, cost-effectively and reliably so that the cost of doing business is driven down.*[12]

2. **Developmental mandate (sub-commercial basis):** *The SOE must provide the identified developmental service efficiently, cost-effectively, and reliably so that excluded or marginalised groups are included.*[13]

3. **Financial viability:** *An SOE must be financially viable as a going concern and sustain an asset base and balance sheet in order to make capital investment, and maintain and expand services. (A state agency should recover enough in user charges to cover operational and maintenance costs).*[14]

4. **Environmental sustainability:** *An SOE must support the transition to a low-carbon economy, and observe other environmental standards.*[15]

5. **Specific projects:** *The SOE must undertake any specific projects given to in the NDP.*[16]

6. **Transformation responsibility:** *The SOE must promote the equitable reordering of the economy through internal transformation re employment equity, training, and supplier development.*[17]

GOVERNANCE STANDARDS TO ENABLE THESE OPERATIONAL OUTCOMES

7. **Clear institutional governance:** *The responsibility of policy ministry, shareholder ministry, funding ministry and regulatory oversight must be clear and delineated.*[18]

8. **Clear written mandate:** *The SOE must have a well-defined written mandate (or shareholder compact) that sets out its role and is precise about what public good the SOE provides and how it serves the public interest. The mandate must be publicly available to promote accountability.*[19]

9. **Leadership:** *Senior appointments must be credible. There must be stability in senior appointments. Leadership must behave ethically and build a corruption-free culture.*[20]

10. **Expertise:** *"The SOE must formulate and implement a long-term strategy to develop the technical expertise that it needs to carry out its mandate."*[21]

11. **Partnerships:** *The SOE must have an effective framework in place to partner with the private sector and does partner with the private sector.*[22]

This long list of has sometimes distracted SOE management, or allowed poor performance in the core economic mandate to be hidden. Whilst the NDP is often referred

[12] NPC (2012) *National Development Plan – 2030,* p39 and 439.
[13] Ibid, p410 and 440.
[14] Ibid, p439-440.
[15] Ibid, p199.
[16] Ibid, p64-68 and 74-75.
[17] Ibid, p138-140. Note that transformation is not expressly listed in the NDP as an imperative for SOEs; but it is likely that state companies would implicitly be expected to be champions of these areas).
[18] Ibid, p75, 439-440.
[19] Ibid, p439-440
[20] Ibid, p439-441
[21] Ibid, p439 - 441.
[22] Ibid, p44 and 442.

to rhetorically by SOEs, alignment of performance of SOEs to the NDP is not consistently evident. Performance reporting has morphed to reflect changing policy agendas and political aspirations, and the achievement of low-hanging fruit delinked from the NDP outcomes. It sometimes forgotten that transformative role expected of the SOEs is tied to simply and firstly delivering on a core economic mandate. The notion of transformation, as important as it is, should not be confused with the concept of playing a transformative role in the economy. The distinction is subtle: the former focuses inwardly on transformation within the SOE's sphere of control – the latter focuses outwardly on the national impact of providing enabling economic infrastructure. This point is noted expressly as a concern in the NDP[23] - that much attention has been given to transformation and not enough attention on the transformative role that SOEs should play by executing on their core mandate. Put another way:

- It is utterly *transformative* for inclusive growth in the economy when ESKOM provides a supportive environment for small and medium businesses, through the provision of a reliable electricity supply;
- It is utterly *transformative* for economic transformation and inclusion when Transnet provides cheap and reliable rail transport for the movement of domestic goods, lowering the cost of doing business and ensuring market access for local producers;
- It is utterly *transformative* for economic transformation when PRASA provides low-income consumers with reliable and safe commuter rail transport, supporting access to opportunities to millions of daily commuters.

This talks to the need to 1) sharpen the mandate of the SOEs and 2) improve institutional accountability for the narrower mandate. The long list of expectations distracts from an SOE's core function. Extensive equally weighted performance expectations disguise areas of non-performance, and allow multiple and competing objectives to be foisted on SOEs, including functional expectations, governance standards and political objectives, which are impossible to meet with limited resources.

[23] NPC (2012) *National Development Plan,* p438

THE PERFORMANCE OF SELECTED SOES

Paper 1 in the series constructs a comprehensive measurement framework to link the outcomes sought in the NDP to the specific performance of Eskom, Transnet and Prasa. This establishes a rigorous evidence base of performance. The eleven areas of economic performance and governance standards were translated into indicators and metrics. Reported and modelled statistics of current performance were compared with expected levels of performance were the entities on the trajectory to achieving the NDP.

The results of this exercise showed in general that, although there are pockets of high performance in all SOEs (and notwithstanding the efforts of many dedicated staff) it is unavoidably clear that all three of the SOEs in question are not performing the role expected of them in the NDP.

In other words, on current performance trajectory the NDP will not be achieved. If the NDP is not achieved the practical result will be continued poverty, inequality and unemployment, fallings standard of living, socio-economic exclusion, discontentment and social unrest.

The measurement framework makes visible repeating trends in the three case studies:

- **Weak governance** is a stand-out feature; with many senior appointments over the last decade for political ends, or as part of party system of cadre deployment. A revolving door of senior appointments between business and government and party has not ensured the accountability of senior executives.
- Boards have not been resourced sufficiently with **technical skills** for the sector in which the SOE operates.
- A pattern of financial distress is obvious, caused by **inadequate and opaque funding models, ad hoc funding decisions;** poor demarcation between commercial and non-commercial activities; and **cross-subsidisation** between profit-making and loss-making entities.
- **Institutional accountability is confused**: Shareholders compacts serve different roles in different SOEs; are packed with KPIs for non-core functions; are sometimes incomplete; and are not always publicly available. As a result, accountability for non-performance is weak. It is hard for government (and parliament, regulators, the press, civil society and the electorate) to hold SOEs to account for poor core performance.
- **Partnerships with the private sector have been ad hoc and modest:** The NDP expressly exhorts SOEs to have a framework in place to partner with the private sector but the achievement of partnerships has been disappointing across the board.
- The **focus on internal transformation programmes** suggest that transformation is seen more as an internal human resourcing issue rather than an external role that can be achieved through execution of the core mandates

Specifically, the performance for each of the case study entities is summarised below; for fuller analysis please refer to Part 1 in this series.

ESKOM

An Eskom that fulfils its mandate under the NDP would *"provide a reliable electricity supply in a sustainable and efficient manner in order to assist in lowering the cost of doing business in South Africa and enabling economic growth, by being well governed and remaining financially viable, while meeting a developmental mandate and transitioning to a low-carbon economy".*[24]

Eskom has successfully supported a developmental agenda through increased access and grid connections: According to the General Household Survey published by Statistic SA, access to electricity has increased from 76.7% in 2002 to 84.7% in 2018 (Stats SA). South Africa's household electrification rate remains above the average in sub-Saharan Africa.

Eskom is struggling to fulfil a core economic mandate, which is to provide electricity supply in a reliable and efficient manner. Eskom has not fulfilled its responsibility to support growth in the economy and has increased national fiscal and credit-downgrade risk. While electricity is supplied at affordable levels in comparison to international benchmarks, load shedding and distributional losses significantly constrain Eskom's ability to supply electricity reliably and efficiently. This has severely impacted the manufacturing, mining, agriculture, and small business sectors.

The establishment of Kusile and Medupi power stations required significant capital expenditure, which added considerably to Eskom's current debt burden of R400bn. Long delays in completion of Kusile and Medupi, combined with design and structural concerns have impeded electricity generation at these plants, thus the ability to generate revenue from the operation of these plants has been constrained.

Eskom is currently not financially sustainable, particularly due to a debt burden. Interest-bearing debt increasing from R41billion to R400billion from 2006/2007 to 2017/18. The severity of its precarious financial position is demonstrated by Eskom having to borrow in order to make interest payments on its debt.

Eskom is unable to reduce costs in response to falling demand and is susceptible to a utility debt trap. Although Eskom has faced falling electricity volumes, it should be able to scale down costs by closing old power plants, at least in in the long term. The avoidable costs of supply are greater than the current regulated tariff level so Eskom should benefit from decommissioning. However, due to the delays in completing Medupi and Kusile, it has been unable to decommission old inefficient plants and realize cost savings.

Eskom is unable to attain a level of investment to conduct much-needed maintenance. There are significant maintenance backlogs: over R35bn in power plant infrastructure maintenance overdue. Eskom is currently distressed by an unsustainable debt burden.

Eskom is not sufficiently promoting the transition to a low-carbon economy, and continues to expend significant carbon pollution externalities. Compliance with the Department of Environmental Affairs (DEA) emissions standards is costly to the extent that Eskom cannot afford to incur these costs to be in line with DEA requirements. This cost is estimated at over R300bn. This means that negative externalities in the form of non-compliant emissions are not being priced in the current tariff. DEA has instead granted five year rolling exemptions, due to the financial strain on the SOE.

[24] Partly from Eskom, Integrated Report, 2019 p25; partly from assessment of NDP

There have been significant governance and organisational culture concerns: These are now being attended to with the recent appointment of a new Board and stronger technical executive leadership.

TRANSNET

A Transnet that contributes to the goals of the NDP would lower the cost of doing business and ensure security of supply by providing appropriate port, rail and pipeline infrastructure in a cost-effective and efficient manner, within acceptable benchmarks.

Transnet has shown progress in meeting the requirements for specific projects mandated to it in the NDP.

The performance of Transnet pipelines demonstrates reliability and efficiency – approaching aspirational levels to achieve NDP-standards.

Transnet has demonstrated a strong commitment to racial transformation and the empowerment of historically disadvantaged groups in internal operations.

Transnet is meeting its core mandate in respect of heavy commodity export lines; it is not in respect of general freight: There are concerns about the cost efficiency and reliability of the general freight network. This is evidenced by the poor market share of rail for moving general freight domestically: presently rail accounts for 15% of logistics market share when logistics models suggest a 40% would maximise logistical efficiency.

Service has been skewed towards the easier-to-service extractive economy, perpetuating minerals-dependency in the economy: Far greater efficiency is realised on export lines which demonstrate densities up to six times that required to break even yet general freight line densities are only half that required to be a self-funded entity. Tariffs levied demonstrate a favouring of trade in commodities. In 2018, port tariffs were almost 200% higher than the sampled international average on containers yet they were over 90% lower than the sampled international average on coal.

A strong focus on commodity export lines perpetuates the resource-dependent and extractive economy. While commodities can drive economic growth, the NDP expects this growth to drive a diversification of the economy away from resource-dependence.

Transnet does not promote effective intermodal linkages to support an integrated logistics network. Intermodal linkages that allow for efficient trans-shipments between modes is prohibitively expensive at 130% above the benchmark target. The poor performance in intermodal connectivity is evident in just over 50% of target intermodal market share. Palletised goods, which are easily transhipped between modes and predisposed to intermodal hauling, only have 0,1% market share captured by Transnet.

Rural economies are not adequately serviced by Transnet: According to the framework, Transnet provides limited and decreasing connectivity with rural markets. Presently Transnet accounts for about 22% of rural freight logistics market share, and just 5% of agricultural freight market share. Many of the branch lines originally built to develop rural areas have been discontinued. Branch lines are seldom profitable but as Transnet is classified as a commercial entity, subsidies for sub-commercial operations are not provided. As a result of deteriorating branch lines, most farmers have opted to move agricultural produce by road – this has degraded the state of the road network, is more expensive, has a worse carbon footprint, and has made roads more dangerous for cars and pedestrians.

Transnet demonstrates financial sustainability in its balance sheet although questions have been raised about the ability to maintain and expand operations. Transnet has consistently reported strong financial sustainability. Despite a year-on-year decrease, Transnet still reported a positive cash balance and generated approximately R23 billion from operating activities in 2018. Recent qualified audit raises concerns about Transnet's creditors pulling its debt facilities which would result in Transnet potentially ceasing to be a going concern.

Cross-subsidisation between operations injects opaqueness into the financial viability of different units and limits the ability to develop funding models appropriate to commercial and sub-commercial activities. Further, the ratio of resourced to theoretical capacity, aged locomotives and signaling systems indicate a serious underinvestment in maintenance.

According to the framework, Transnet is failing to promote the transition to a low-carbon economy by providing legitimate alternatives to transport by road. Emissions from the transport sector account for almost 11% of total greenhouse gas emissions; and road transport accounts for 91% of this.[25] The current road-rail balance for freight results in a carbon "overspend" of approximately two million tons of carbon per year. Positioning rail as the competitive alternative to road would reduce this overspend.

There have been significant governance and organisational culture concerns: These are now being attended to with the recent appointment of a new Board and stronger technical executive leadership.

PRASA

A PRASA that contributes to the goals of the NDP will position rail as the backbone of public transport within an integrated transport network, by providing quality and affordable rail transport services that satisfy the commuter, intercity and international travel needs of households, and especially lower-income households."[26]

If PRASA were able to recover its core mandate successfully, it could play a transformational unlocking social, economic and environmental value. However, the framework assessment is clear that the current state of commuter rail replicates previous patterns of inequality and exclusion of low-income households.

The failure of PRASA directly impacts economic and social development goals of the NDP: PRASA underperforms across indicators relating to its core operational objective, financial stability, investment related to maintenance and expansion of current operations, corporate governance and public interest objectives. This means few low-income citizens can get to work reliably, safely and cheaply. Unsafe and unreliable service has forced commuters to opt for expensive alternatives, with transportation accounting for 40% of household spending in some cases. PRASA's failing service is a critical impediment to South Africa realising the equitable and inclusive society envisioned in the NDP.

There has been a dramatic loss in customers: In the period between 2011 and 2017 PRASA lost 46,1% of passenger kms. Metrorail passenger trips reported fell from 650 million in 2009/10, to 213 million in 2016/17. The low and falling passenger numbers indicate that PRASA is not achieving the core mandate of providing transport that gives (predominantly low-income) households preferred public transport alternatives. Mini-bus taxis have become the

[25] Department of Transport (2018), *Green Transport Strategy for South Africa (2018-2050),* p3.
[26] PRASA (2018) *Corporate Plan (2019/2021).*

preferred mode of commuter transport – for every train commuter there are nine commuters using mini-bus taxis – despite minibus taxis being 80% more expensive.

The low scores in the safety of commuters and reliability of trains are a deterrent to many customers. Passengers are not assured of their safety and security when using PRASA rail services. The evidence collated from the 2018/19 Annual State of Safety Report by the Railway Safety Regulator indicates that for the period 2018/19, 284 fatalities occurred in relation to the rail service.[27] Moreover, the train service in unpredictable and prone to delays from mechanical, electrical, perway and signal failures. In a service that is primarily responsible for getting people to work, unpredictable timing and delay is a prohibitive barrier evidenced by the willingness to spend on more reliable options.

PRASA is unable to generate sufficient investment to fund its current operations. Commuter rail, with few exceptions, is unprofitable the world over. The importance of PRASA for economic transformation and inclusive growth should be recognised and reflected through adequate state assistance. The PRASA group reported a loss of R928 million in 2017/18, a 68% increase to the previous financial year. This liquidity crisis has flagged PRASA group's ability to operate as a going concern. A reduction in the rail operational subsidy by 1.7 billion over the 2019 MTEF is set to worsen an already constrained financial position. A reliance on ageing infrastructure increases the potential for operational failures and safety incidents. There have been indications of wasteful budget expenditure; slow roll-out of capital investment programmes and insufficient asset management (lack of security, repair and maintenance) leading to asset degradation which has ultimately impacted on the reliability and safety of PRASA's services.

There have been significant governance and organisational culture concerns: Opaque institutional relations and lack of reporting have enabled a culture of maladministration. The Shareholder's Compact is not in the public domain, with the Auditor General reporting that PRASA is unable to report on KPIs as the current compact was not concluded in consultation with the executive authority and therefore has no binding status. Chronic leadership instability severely limits the agency's ability to commit to and execute on a long-term strategy or deliver on operational performance.

In summary, the varying degrees of under-performance across of the case study SOEs directly impacts on the achievement of the NDP. Unless strong action is taken on SOEs and the systems in which they function it is inconceivable that the inclusive growth and economic transformation, envisioned in the NDP, will be realised.

Thus, the NPC's view is thus that underperforming SOEs cannot be tolerated in perpetuity. Where a SOE is failing persistently to achieve its core economic mandate, reform must be undertaken to improve performance.

There are two types of reform available to government for course correction: organisational reforms and structural reforms. Organisational reforms centre on improving operations and are normal part of improving any business.

Where organisational reforms render little improvement in performance, it is incumbent on government to make structural reforms. Structural reforms mean changing the market structure so that other forms of provision of the good or services, besides state-provision, can arise.

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[27] Note that the RSR factors weighted injuries into its reporting of fatalities. Fatalities are the sum of actual fatalities and weighted injuries (where 10 injuries = 1 fatality).

OPERATIONAL REFORMS TO IMPROVE PERFORMANCE

Where there is evidence that a SOE is failing persistently to achieve the core economic mandate, organisation reforms can first be implemented. Organisational reforms make no attempt to change the market structure or the ownership structure of SOEs; they centre on making the SOE run better. Organisational reforms can include, from lightest to heaviest, any combination of corporate governance, financial, and process reforms.

GOVERNANCE REFORM

A narrowing in the mandate of the SOE by cutting non-essential activities. Refocusing the mandate of SOEs is a main recommendation of this paper: three priorities should be the basis of performance assessment:

1) delivery of a core economic mandate on commercial terms;
2) strong governance standards, and
3) financial sustainability.

These three categories should carry 70% to 80% of weighting in the Shareholder Compact KPI framework.

As used in this sense, the core mandate of Eskom is to provide electricity supply in a reliable and efficient manner; to invest in and procure adequate capacity to meet demand; to produce electricity on a cost-effective basis; and to sell electricity on a cost-reflective basis.[28].

Transnet's core economic mandate is to provide for the movement of goods in a reliable and cost-efficient manner; to contribute to growth through trade by providing efficient export lines and ports; and to promote effective inter-modal linkages to maximise freight hauling and distribution efficiency.

PRASA's core economic mandate is to provide rail transport that gives predominantly low-income households preferred public transport alternatives; meaning trains must be affordable; accessible; reliable and safe.

Changes in management and Board leadership: This has been a preferred first route to date in trying to improve performance. It involves the replacement of Board and senior executives at underperforming SOEs. Certainly, this is a necessary step in any returning any SOE to operational performance, and in cleaning out corruption. Yet the replacement of leadership without addressing fundamental systemic issues is of limited value, and overly-common changes in management and leadership can frustrate the execution of strategy.

Improving corporate governance, organizational culture; and developing skills: Improvement in corporate governance might include more public disclosure of corporate governance policies, board charters, and board committee terms of reference to enhance transparency on governance practices. Training for all Boards and Executives on the NDP and core mandate outcomes that must be prioritised can be a mandatory part of onboarding.

[28] As the price of electricity is regulated, this is not a performance metric that is the control of Eskom.

Improving internal accountability. Accountability for poor performance is generally weak in the SOEs. Internal accountability can be improved by narrowing performance management indicators to only the core outcomes sought by the NDP. The second way is to link executive remuneration to the *outcomes* achieved by the SOE, rather than to the measurement of activities, inputs or outputs, which are typically easier to achieve. Third, is to mandate more systematic public disclosure of the main objectives from SOE Shareholder Compacts, as well as of an assessment of the achievement of these annual objectives in public reporting and to Parliament, to facilitate public scrutiny. Including the use of independent experts or external committees in the performance evaluation will improve independence of the process.

FINANCIAL REFORM

Provide the SOEs with clear instruction on the balance between commercial and developmental objectives and clarify process on the costing and funding each. SOEs globally typically face multiple objectives with unfunded mandates being a common cause of under-performance.[29] Government should consider review of the overall mandate in conjunction with line department, shareholder department, SOE and National Treasury agreeing on the costing and allocation of the funding model.

Separate the accounts and reporting of commercial and sub-commercial activities to improve transparency of cost allocation. About 60% of surveyed countries in an OECD study require SOEs to separate the accounts of commercial and sub-commercial activities to ensure transparent cost allocation. In most OECD countries, direct state support for SOEs is provided for sub-commercial public mandates. Removal of cross-subsidisation allows for direct state support on a transparent basis.

Approving additional budget support with conditionality. This has also been widely adopted to date but with limited success. The funding is often needed at a crisis point when National Treasury is faced with financial crisis of an SOE that is “too big to fail”; and conditionality appears rarely applied or adhered to.

POLICY AND PROCESS REFORMS

Introduce a single state ownership policy. A single state ownership policy is a standard benchmark of OECD countries. This allows standard policy to be applied consistently to all SOEs regardless of ad hoc crises, or shareholder pressures. The consistent application of policy and procedure would improve transparency, accountability and co-ordination.

The policy would need to provide general principles and a unified approach to the elements of SOE governance, the structure of oversight entities, the roles of the ownership entity towards individual SOEs, as well as the framework for board appointments and their accountability. It should also set out the director nominee process, including required skills, diversity, and balance of state representatives; guidance on the appointment process for SOE CEOs. It can also establish a publicly open directors’ pool from which new external directors for SOEs are drawn. Finally, the policy should provide a process for the periodic review by the holding company of the rationale for the State’s ownership of SOEs and examine options for asset divestment.

Introduce mechanisms of compulsory consultation on mega-transactions. Given the widespread abuse in the last decade in SOE procurement, government needs should consider

[29] See Paper 3/4: Institutional Governance, p10.

additional oversight of large procurement transactions either at management-committee, independent audit committee-level, or at the national level with the appointment of oversight at the level of National Procurement Office.

Improve transparency and provide greater powers of oversight to stakeholder forums. The operation of large SOEs in strategic sectors impacts directly or indirectly on the lives of millions of South Africans. Yet the service delivery of these SOEs (especially in the case of natural monopolies) are not typically rated by consumers or businesses which depend on the quality and price of the services. Government can improve oversight of SOEs by systematically referring to stakeholder forums (including stakeholders from industry, consumers, civil society, labour, creditors and affected communities) in the evaluation of SOE performance. This would be particularly important in evaluating the fulfilment of public mandates as well as the SOE contribution to wider societal goals set out in the NDP.

Strengthen or introduce new sectoral regulation, or improve regulatory capacity. Subsidies/taxes and regulation can address issues of competition and externalities. For instance, in the case of Transnet, a transport regulator could help to address issues of cost efficiency and reliability, and would be in line with rail regulators in China and UK, who set technical standards, monitor performance, review and set prices on a cost-plus basis; conduct extensive strategic reviews every five years and determine appropriate penalties for breach. Likewise, Eskom’s performance could be improved by amending regulatory process to ensure tariffs are cost-reflective, and that municipal tariffs are not excessively marked up.

STRUCTURAL REFORMS TO IMPROVE PERFORMANCE

If there is a persistent failure to improve operational, governance or financial performance, then structural reforms must be considered. This means changing the ownership structure or the market structure so that other forms of provision of the good or services, besides state-provision, can arise.

STATE OWNERSHIP REFORMS

Redirect the SOE to another part of government. An example would be decentralising control of PRASA from DOT to municipalities. This already been proposed in the Draft White Policy paper.[30]

Create a separate ownership entity: Three options are put forward in this respect:

- ***Option 1: a comprehensive "SOE holding company".*** The creation of a state holding company could help address excessive politicisation, and weak coordination and accountability. A comprehensive HoldCo under a commercial company structure, staffed with high-calibre resources (including those with private sector/commercial experience) could also allow for more results-based accountability than a public sector organisation. The holding company Board would be comprised of the Presidency, National Treasury and relevant line departments to improve high-level inter-ministerial cooperation - with a minority of technical appointments from the private sector and key stakeholders. The holding entity will appoint and dismiss SOE boards and ensure professionalism and the right skill-set in board appointments. The management of the company would be by professional staff from government departments and qualified personnel from the private sector. The appointment of the holding company Board would be a publicly scrutinised process similar to the appointment of judges though the Judicial Service Commission, or through the parliamentary process.

- ***Option 2: a pilot holding company.*** The DPE's remit would remain for the bulk of the companies while a "pilot" holding company would be assigned stewardship of selected strategic companies including Eskom and Transnet. Main governance characteristics would be the same as in option 1, but the DPE would play a leading role on the board.

- ***Option 3 (closer to the current institutional arrangements with enhanced professionalisation and accountability):*** A third option would be for DPE to retain ownership oversight over its current portfolio under the coordination and oversight of the Presidential SOE Council. It would assign some of its current functions related to board appointments and evaluation to a subsidiary staffed with skilled professionals drawn from the public and private sector.

The board representation on any holding entity must be widely inclusive and transparent. The appointment of representatives to the Board of the state holding company should be a public process, subject to oversight by Parliament and public hearings.

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[30] Department of Transport. 2017. White Paper: *National Rail Policy*.

Any alternative state ownership structure must be interrogated against the Constitutional framework. Structural changes to SOE stewardship may result in significant cost which must be balanced against the potential value arising from proposed new structures.

MARKET STRUCTURE REFORMS

Structural reforms of SOEs usually fall into binary debates about privatisation v. nationalisation. Yet there are a range of arrangements along a spectrum which stop short of either which can improve performance by partnerships between the SOE and private sector.

Structural reforms can include any combination of*:*[31]

- ***The removal of a statutory monopoly to allow private sector providers to enter the market and compete with the SOE.***
- ***Outsourced service contracts*** *w*here the private sector is contracted to fulfil a specific task for the SOE. This is suitable where the service is clearly defined, demand levels are relatively certain and it is easy to monitor performance. An example is Eskom contracting meter-reading or bill payment collection to a private company. The SOE retains the primary responsibility for overall delivery of the service to users, associated operational risk, and maintenance of the underlying assets.[32]
- ***Short-term management, franchising and leasing contracts*** where a private entity manages a government-owned facility for a longer period (two to five years). Most management contracts involve the private operator being paid a fixed fee by the awarding authority for performing specific tasks. The remuneration does not depend on collection of tariffs and the private operator does not typically take on the risk of asset condition. For example, international experience in commuter rail reveals management contracts are sometimes employed for the operations and maintenance of ticketing and signalling equipment.
- ***Concessions over parts of SOE infrastructure:*** These contracts give a concessionaire responsibility for operation and maintenance of an agreed set of assets, for financing and managing all needed investment in the asset. The facility will usually revert to the public sector at the end of the project term. Long-term concessions operate under a "user-pays" model in which the private sector party is allowed to charge the general public user fees for access to the facility. Under the right conditions, concessions can improve efficiency, lower government exposure to risk, and protect against monopolistic behaviour. A concession allows for private operation of public assets where full private ownership may not possible politically. However, concessions also require complex monitoring systems to ensure that the public asset is able to deliver against the mandate. Concessions have been used widely in the transport, water, and energy sectors.[33]
- ***Formal public/private partnerships:*** PPPs are a procurement mechanism in which the public and private sector typically share the risks of project implementation of a new asset. There are various examples already in place in the health sector including at Inkosi Albert Luthuli Hospital in KZN; Universitas and Pelonomi hospitals and a 15-

[31] Please see Paper 2/4: Suitability review for more detail on structural reform options.
[32] Operational risk refers to the uncertainties faced by an entity in its in day-to-day activities
[33] A variant of this arrangement is the "franchise" model where the facility already exists and the private party is allowed to operate the asset for commercial benefit.

year contract signed in 2008 to design, finance, upgrade and maintain the Phalaborwa Public Hospital.

- ***Subsidisation of private participation in the market:*** Where private participation in the market would improve outcomes but returns are sub-commercial, government can encourage private entry by way of subsidy. For instance, a private company can run commuter rail services; as these are usually sub-commercial, a subsidy would make the contract more attractive.

- ***Closing parts of the SOE:*** Where loss making or operationally non-performing parts of the SOE can be separated, it is an option to close these parts.

- ***Selling parts of the SOE to equity partners:*** Here a minority or majority shareholding is sold to private interests, an approach common in aviation and telecoms. This has the advantage of raising needed capital, of bringing in new technologies and operating models, and of improving governance and financial discipline in the SOE, without fully relinquishing state control.

- ***Allowing private entry in parts of the value chain:*** For instance, in electricity while it would be advisable to retain full SOE monopoly in distribution and transmission, private entry would make economic sense in the generation of electricity. An independent systems operator would then buy electricity at an arm's length basis from both the SOE and other independent power producers.

- ***Privatising the SOE wholesale; or liquidating the SOE:*** This involves the sale of a public enterprise to the private sector, or closing down the SOE. It means a wholesale change in the ownership and management structure. The sale of assets or larger scale privatisation comes with high transaction costs and execution risks. Therefore, it is typically only preferable if it is clearly optimal or if all other solutions are not viable. Historically, there are examples of privatisation or partial privatisation including ISCOR, Telkom and Sasol. Liquidation may occur when there are sufficient alternatives in the market and state provision is no longer beneficial.

Government can use an analytical tool, like the one below, to test for the most appropriate options for reform in any given circumstances.[34] This tool should be used to critically review the suitability of new and existing SOEs. The three case study entities were put through this framework which has informed reform recommendations – most notably the market structure reforms:[35]

Step 1: Test the ex-ante justification for current SOE to identify market failures and potential for market provision

Step 2: Assess performance and define concerns

Assess performance against the NDP expectations for delivery. Prioritise problems or areas of non-performance in terms of their overall impact on the SOEs ability to deliver its mandate.

The overarching thematic framework from paper 1 can be used to assess performance and identify areas for concern.

Step 3: Identify organizational reforms to be implemented in the first instance

Organisational reforms include addressing:

- Corporate governance issues
- Funding models and financial issues and;
- Institutional structures.

If systemic failure persists despite organizational reforms then structural interventions must be examined.

Step 4: Identify appropriate options for structural reforms

- **Outsourcing**
- **Short term management, franchising or leasing contracts**
- **Concessions**
- **Public private partnerships**
- **Subsidisation of private participation in the market**
- **Closure or sale of state assets or liquidation**

The complexity of structural reforms increases from left to right. Consideration must be given to the potential impacts of interventions across the entire industry and society at large.

All structural interventions require effective contracting and/or regulatory frameworks to safeguard the interests of the public and the economy.

[34] See Paper 2 in series for full description of Suitability Framework.
[35] See Paper 2 in series for detail of the application of Suitability Framework to Eskom, PRASA and Transnet

Using this framework, the report provides the following reform options for Eskom:[36]

There are several significant market failures related to electricity supply, which provide an *ex ante* justification for the existence of a SOE.

But a SOE owned monopoly approach is no longer suitable along the value chain: It is doubtful that government monopoly in the electricity generation market is needed, as costs of production have fallen and private competition is now viable in this area. This suggests a deregulation of the generation sector is overdue.

In transmission and distribution, an SOE is still needed to the extent that performance supports it. An SOE in transmission and distribution must have an incentive to increase rather than restrict access to the grid therefore stronger regulation is also required.

An alternative would be private provision plus improved regulation across the entire supply chain (generation, transmission and distribution).

Regulation of emissions through mandating new technology or applying taxes can help to mitigate negative pollution externalities.

Using this framework, the report provides the following reform options for Transnet:[37]

There are several significant market failures, which provide an *ex ante* justification for the implementation of a SOE in the provision of rail infrastructure and services.

But the current SOE structure is no longer suitable: Transnet must be better regulated given monopoly concerns that emerge under current market structure, particularly with respect to general freight rail and ports authority. Market provision plus regulation may be more suitable in specific areas if the private sector can become involved in specific parts of the value chain where competition is possible. There is scope for the benefits of competition to be realised to varying degrees in the provision of train operations, and port services including terminals.

Using this framework, the report provides the following reform options for PRASA:[38]

There are several significant market failures, which provide an ex ante justification for government intervention in commuter rail.

There is limited scope for competitive market provision across the value chain given sub-commercial returns for the private sector and would therefore likely result in under provision. Other forms of government organisation could be more effective. There is potential scope for private sector involvement alongside government intervention in the long-term but there is currently too much uncertainty and risk to attract private entry in the commuter rail market.

[36] A more detailed discussion of optionality can be found in Paper 2/4 in this study.
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RECOMMENDATIONS

The following recommendations are made:

The strategic mandate of SOEs should be narrowed to three priorities – delivery of core economic mandate, improved governance, and sustainable funding. These three should carry 70% to 80% of the weighting in a shareholder compact.

It is the underlying nature of the market conditions that must guide the decision to create or retain an SOE. Technology will constantly change market conditions and therefore periodic reassessment of the need for an SOE should be undertaken. As a general principle established in economic theory and in the NDP itself, SOEs should not be used as a substitute to provide government services; ***nor should SOEs be used in markets where private enterprise can create competitive outcomes.*** It is hard to see on either constitutional or efficiency grounds why the state should use public resources to intervene with an SOE in private commercial activities where the market is competitive and produces outcomes that both sellers and buyers are happy with, or where light failings can be regulated. Scarce resources would be better directed to where markets do not operate efficiently.

Where there are repeated failures in operational performance, or where fiscal and credit risk starts to outweigh benefits, government has a duty to implement organisational reforms. These include corporate governance, funding, and policy and process reforms.

Where chronic operational, governance and financial underperformance continues, and organisational reforms are inadequate, structural reforms should be introduced – this means opening the provision of the service or infrastructure to other economic actors besides the state and/or changing the structure of state ownership.

The debate about structural reforms must move away from the unhelpful binary privatise/nationalise discourse. There are a range of partnership options between the SOE, the government and the private sector. The design of these partnerships would be an opportunity around which to design a social compact between government, big business, labour and civil society interests.

The institutional governance of SOEs can be strengthened. There are three outcomes that an improved institutional framework must achieve 1) improved accountability for performance; 2) the inclusion of checks and balances and oversight mechanisms to ensure "capture" of the SOEs en masse cannot occur; and 3) the introduction of shareholders who have a shared interest in the performance and sustainability of the SOEs.

To this end government should consider the options for a holding entity. The representation on a holding entity needs to be set in law to be widely inclusive. The appointment of representatives to the Board of the state holding company should be a public process, subject to oversight by Parliament and public hearings.

The performance of any SOE should be judged against the outcomes sought by the NDP. There should be a consistent performance framework applied to all SOEs aligned to the NDP framework. A consistent performance framework will not only ensure the NDP become more manifest in the operations of the SOEs but will also diminish opportunities for political interference.

The framework should measure outcomes, rather than inputs, activities or outputs of the SOE. Ongoing and regular assessments of performance are needed to understand where outcomes are being achieved, because a key determinant in the decision to retain or reform an SOE is its de facto performance of outcomes sought by the NDP.

The shareholder compact should be a binding contractual agreement. The absence of legal weight diminishes consequence management for non-performance and therefore, the accountability of the entity and shareholder.