

G:GENESIS



**THE ROLE OF STATE OWNED ENTITIES IN SOUTH AFRICA
A SUBMISSION PREPARED BY BUSINESS UNITY SOUTH AFRICA
TO THE PRESIDENTIAL REVIEW COMMITTEE ON STATE OWNED ENTITIES
SEPTEMBER 2011**

Document Reference: DRAFT
Date: **21 September** 2011

Contact Information
Business Unity South Africa
1st Floor, 3 Gwen Lane
Sandton, 2196
South Africa

Post to: PO Box 652807,

G:ENESIS

Benmore, 2010
South Africa

Tel: +27 11 784 8004 11 784 8000
Fax: +27 11 784 8004
www.busa.org.za

BACKGROUND TO BUSA

BUSA is a confederation of business organisations including chambers of commerce and industry, professional associations, corporate associations and unisectoral organisations. It represents South African business on macro-economic and high-level issues that affect it at the national and international levels. BUSA's function is to ensure that business plays a constructive role in the country's economic growth, development and transformation and to create an environment in which businesses of all sizes and in all sectors can thrive, expand and be competitive.

As the principal representative of business in South Africa, BUSA represents the views of its members in a number of national structures and bodies, both statutory and non-statutory. BUSA also represents businesses' interests in the National Economic Development and Labour Council (NEDLAC).

EXECUTIVE SUMMARY

BUSA welcomes the opportunity to make its first submission to the Presidential Review Commission on State Owned Entities. To best leverage the opportunity to contribute to the broadly scoped work of the Committee within the available timeframe, BUSA in this submission focuses on large national-level state owned *enterprises* (as opposed to state owned *entities*) that provides key infrastructure and goods, services and finance to the private sector and citizens. For purposes of clear distinction they are referred to as government business enterprises (or “GBEs”). Examples of these large GBEs are Transnet, Eskom, the Development Bank of Southern Africa (DBSA), South African Airways (SAA) and Telkom.

BUSA believes much work remains to be done to create a firm framework for GBEs in particular, as well as a process to review the rationale of existent entities. There are undoubtedly valid and appropriate reasons to have state owned entities in the South African economy, provided their role and mandate are clear. It needs to be especially clear why any particular GBE should exist if there are private operators willing and able to provide the same goods and services. Accordingly, this paper advocates that where GBEs are active in competitive markets in particular, a disciplined approach to the use of public finance is needed for these entities.

As a broad principle, BUSA believes that GBEs should fill gaps created by market failure in non-competitive markets. Even so, the decision to establish or maintain GBEs should still only be considered as part of a suite of alternatives, which could include:

offering defined subsidies, preferably mediated on a competitive basis, to private companies to deliver services in commercially non-viable markets;

promoting the separation of economic bottleneck activities, whether this be done by way of accounting practises or structural separation; or, to

levelling the playing fields for public-private partnerships to be considered, by applying the similar regulatory rigor in assessing the need to establish or maintain GBEs

Considering South Africa's unemployment challenge, it is critical that the economy continues to be competitive on global terms. However, comparative data is clear that, when looking at South Africa's level of competitiveness, the network infrastructure operated by GBEs remains a constraint on the competitiveness of the economy rather than an enabler. This suggests that, in general, the GBEs are not sufficiently acting as facilitators of a more competitive economy and often not providing South Africans with the price, quality or reliability of service that is necessary to grow the economy, compete more effectively and create more jobs.

To address this situation, there needs to be targeted efforts to address, amongst other, the lack of critical planning in providing a connect between the long-term mandates, strategic plans, indicators, targets and incentives of GBEs; as well as problems of accountability, and the incoherence of the fiscal frameworks under which the GBEs function. To this effect, this BUSA submission provides substance to the following key recommendations:

1. Planning for GBEs should be made more integrated and long-term through a National Integrate Planning system, which should join with other over-arching policy initiatives such as those driven by the National Planning Commission, and should inform the mandates, strategies, performance contracts and incentives for each GBE and its leadership;
2. Efforts should be directed at making this planning process more transparent and consultative, informed by the strengthening of oversight opportunities through greater insistence on rigorous and more timeous financial reporting, and the establishment of an independent third-party review mechanism.
3. Whereas GBEs operating in competitive markets should compete in respect of the price for finance for these parts of their business on market terms, without government loan guarantees and grants, BUSA believes monopoly GBEs would be funded best by rigorously regulated and benchmarked, cost reflective tariffs.
4. Finally, BUSA believes that political interventions should be limited to, within rationally defined parameters, setting the desired outcomes for GBEs, and not interfering in the management or management appointment procedures of these entities.

BUSA holds the view that by including these and other more detailed recommendations contained in this submission in its final report, the Presidential Review Committee could significantly strengthen its package of proposals to ensure that our state owned entities make their full contribution to placing South Africa on a higher, job-rich growth path. BUSA looks forward to further opportunities to engage with the Presidential Review Committee in this regard.

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5. INTRODUCTION

In his Budget Vote speech to parliament in May 2010, President Zuma announced his intention to establish a Presidential Review Committee (the PRC) on State Owned Entities (SOEs) to advise on the appropriate role for SOEs in the South African economy. The PRC report is likely to have significant bearing on the existence, purpose and structure of SOEs, impacting trajectory of the economy and business environment as a whole.

The PRC has called for public comment as part of a stakeholder engagement process. This paper is an input prepared by Business Unity South Africa (BUSA). The scale and scope of the PRC's task is large and complex, and the time allowed for public input has been relatively short. Thus, **BUSA has taken a focused approach in this submission, looking only at the role played and to be played by large national-level state owned enterprises (as opposed to state owned entities), which for purposes of clear distinction will hereinafter be referred to as government business enterprises (or "GBEs") in the provision of key infrastructure and goods, services and finance to the private sector and citizens.** Examples of these large GBEs are Transnet, Eskom, the Development Bank of Southern Africa (DBSA), the South African Airways (SAA) and Telkom. The GBEs impact greatly on the cost of doing business in South Africa, which is of direct and primary concern to BUSA's members. Moreover, they account for the lion's share of assets, turnover and employment in state owned entities. It thus makes sense for BUSA to focus a time-constrained study on their role in the economy. The narrow focus in no way detracts from the importance of other national state owned entities, or from entities that reside in the provincial and municipal spheres of government, or from the value of a deep analysis of the state of some of the large GBEs. BUSA would be happy to make a further submission on these entities if the time is made available.

The BUSA submission does not include analysis of any particular GBEs except where this helps to illuminate a principle.

The BUSA submission comprises two broad parts. The first part considers a most fundamental question facing the PRC, namely, when are interventions in the economy through GBEs necessary within the South African context? The paper lays out a conceptual framework to assist the PRC in answering this question.

The second part, which addresses those instances where GBE's may be appropriate, considers how well GBEs have been performing in general. It diagnoses at a generic level the challenges facing the large GBEs that have resulted in generally poor performance, and goes on to suggest key principles, the application of which will improve regulatory oversight, governance and management, and introduce more appropriate funding models. It is BUSA's view that the application of the principles set out in this paper will greatly help to improve the performance of the GBEs. The principles are drawn variously from guidelines produced by the OECD, World Bank¹, the National Treasury and Department of Public Service and Administration (DPSA), other sources as noted and from BUSA's own understanding of the role GBEs should play. BUSA respectfully requests that the PRC consider these principles when embarking on its work to rationalise and strengthen the performance of GBEs.

1 OECD Guidelines on Corporate Reform of SOEs, OECD 2005; and World Bank - Kessides

BUSA has also provided the PRC with a list of references as a research database for the convenience of the PRC (Appendix 1). Finally, it should be noted that BUSA is willing and able to assist the PRC with further research and input should be it be needed and the time be made available for it.

6. DEFINITIONS AND CATEGORISATION

The area of state owned entities is awash with acronyms and abbreviations, which often leads to definitional confusion. For clarity at the outset the BUSA submission uses the following definitions throughout.

State-owned entities (SOEs): This is a catch-all term for all the entities in which government holds partial or full ownership. SOEs make up the entire universe of entities included in the PRC's terms of reference.

Large government business enterprises (GBEs): As noted, these are the focus of the BUSA submission. GBEs are those SOEs primarily listed in Schedule 2 of the Public Finance Management Act (PFMA); they are also sometimes called "state owned enterprises" and/or development finance institutions (DFIs). Examples of GBEs are Transnet, Eskom, the Development Bank of Southern Africa (DBSA), the Industrial Development Corporation (IDC), the South African Post Office and Telkom.

The definition is made clearer in figure 1 below (on pp. 9), which provides a simple but useful categorisation of all SOEs.

The diagram shows that at a national level SOEs can be categorised into three broad groups:

- Constitutional Institutions (listed in Schedule 1 of the PFMA), for example the Municipal Demarcation Board or the Commission for Gender Equality;
- Public entities including Statutory Corporations (listed in Schedule 3A of the PFMA), which includes stewardship bodies, regulators and advisory bodies, for example, museums, the National Energy Regulatory and the Human Sciences Research Council; as well as statutory corporations such as Rand Water and the South African Bureau of Standards;
- **Government Business Enterprises or GBEs**, which include State Owned Companies in which the state is the sole shareholder, for example Transnet and ESKOM; State Interest Companies in which the state owns a partial share, for example, Telkom; and the Development Finance Institutions – for example the Development Bank of Southern Africa or the Industrial Development Corporation. These are listed under Schedule 2 to the PFMA.

As noted, this submission focuses on the last category only – Government Business Enterprises or GBEs. Importantly BUSA acknowledges the work that has been undertaken to date (primarily via the PFMA and related public entity regulation) to establish a more coherent framework for the classification of SOE's, noting that many entities are inheritances from the pre-1994 government. This includes a framework for the definition of powers and functions and the general relationship of entities to the fiscus – i.e. entities required to generate their own income with borrowing powers (mainly GBEs) and others that are reliant on annual transfers.

Nevertheless it is BUSA's view that much work remains to be done to create a firm framework for GBEs in particular as well as a process to review the rationale of existent entities. The next section starts by considering the fundamental question to be answered by the PRC, namely, when is it appropriate for the state to introduce and maintain a GBE, and when is it not.

Figure . A Categorisation of State-owned Enterprises

Source: Genesis Analytics, 2011, PFMA

7. WHEN IS A GBE APPROPRIATE?

BUSA's starting view is that there are undoubtedly valid and appropriate reasons to have state owned entities in the South African economy, provided their role and mandate is clear. This is most obvious where there is a constitutional mandate or regulatory function to discharge (as only a neutral public agency can fulfil this mandate). However, even where the role of an entity is to provide infrastructure and to sell goods and services to the public, there is unquestionably an appropriate role to be played by some GBEs. BUSA's concern is in those instances where this is not the case.

Much of the thinking done to date on SOEs (including by National Treasury, DPSA and DPE) tries to bring greater order and consistency by providing guidelines on how GBEs should be managed or regulated. The PFMA itself is an instrument that tries to impose regulatory structure on an unwieldy grouping. Likewise, much of the PRC's terms of reference centres on restructuring and reshaping the existing group of SOEs.

In BUSA's opinion, this approach starts from the wrong position, as it implicitly assumes that the existing groups of SOEs are appropriate and valid. ***In BUSA's opinion the PRC's task needs to start with a much harder question, namely, why should any particular GBE exist in the first place – especially when there are private operators willing and able to provide the same goods and services?*** In other words, BUSA would prefer the PRC to start not with organising and reshaping the existing world, but first by rigorously rationalising the reasons for and the state of GBEs.

This section sets out BUSA's thinking on when a GBE is an appropriate vehicle to deliver sellable goods and services to the public and when it is not. Consider the diagram below (Figure 2, pp. 11).

The diagram shows that, presently, GBEs operate in two types of markets, competitive markets and non-competitive markets. A competitive market is one where the market for goods and services is well established, there is a demand from consumers that can be met on commercial terms, and there is healthy competition amongst providers to deliver goods and services. There are a number of GBEs operating in competitive markets. For example, ESKOM both generates power and purchases power from independent power producers; Telkom, with the 8-ta cell phone products competes directly with private cell phone providers; SAA competes directly with private airlines, while the DBSA and the IDC, at times, compete with private financial service providers to finance infrastructure and commercial enterprises.

The second type of market is a non-competitive market. Here the provision of goods and services cannot be competitively provided on commercial terms, essentially, because there is a market failure. The most common reasons that market forces fail are:

Figure . Defining a Place for GBE's - a Conceptual Framework

Source: Genesis Analytics, 2011

- **Where the provision of goods and services take place under a natural monopoly.** A natural monopoly normally occurs in the so-called network industries – like railways and power distribution – industries that require a single network only rather than competing networks, or which have such high barriers to entry that only one network can be cost-effectively established. It is not possible or desirable for a single private firm or group of firms to own such a network. Not only would it require a balance sheet too large for private actors but it would be inappropriate for private actors to hold monopoly power over an essential, single network service. In such a case it is appropriate for the state to hold the monopoly (which should still be subject to independent regulation and administration).
- **Where the provision of goods and services will not naturally be taken up by the private sector.** There are markets where even sizeable demand from consumers may not be serviced by the private sector. If the affordable price of the good or service is below commercial terms, then it will not be provided by the private sector. A good example is the provision of drugs. If it costs R100 a month to produce a drug with a profitable margin but most consumers can only afford R80 a month, then large parts of demand (which is associated with the fulfilment of an important social and economic goal) will go unmet. Alternatively, the risks of providing these goods and services may be too high to be attractive to private entrants.
- **Where the provision of finance for long-term infrastructure, socially-valuable innovation and the creation of new markets may not naturally be taken up by the private sector.** Private providers of capital are unlikely to participate in markets where the return on investment is perceived as too low, the investment too risky, or where the tenure to yield is not matched to shorter private incentives. This may be the case even where the investment can bring significant socio-economic benefits to the society at large, e.g. key bulk infrastructure or large scale job creation. In such cases the development finance institutions like the DBSA and IDC are specifically mandated by government to accept these returns, risks, and longer-term repayment profiles in order to secure the socio-economic benefits. This role extends to operating in and lending to emerging market segments about which little is known, where formal market instruments such as asset-based lending is not feasible and perceptions of risk are consequently very high.

Most GBEs in South Africa operate simultaneously in both competitive and non-competitive markets; some GBEs in competitive markets are also tasked with fulfilling a public mandate in non-competitive markets requiring the GBE to provide certain goods and services that would not necessarily be provided by the private sector. So, the SABC operates in competition with private Pay TV operators with regards to sports and entertainment content, but is also required to provide universal access through the provision of radio and television services to isolated communities, at a specified level of local content. The DBSA provides loans at close to commercial rates for some borrowers but also makes loans for socially desirable investments

available on concessionary rates and terms. Telkom competes in the competitive commercial cell phone markets but also has a developmental mandate to deliver fixed line services in unprofitable rural areas. The South African Post Offices supplies non-reserved services, such as logistics (express and courier services) and financial services in competition with private sector entities; but also receives government subsidies for the fulfilment of its universal service obligations, involving the provision of universal access to postal services.²

As a general principle, BUSA believes that more careful consideration needs to be given by the PRC for the justification for GBEs to operate in competitive markets where private providers are already active and competitive. In particular, a disciplined approach to the use of public finance is needed for such GBEs.

The reasons for this principle are the following: unless there is an explicit market failure – and a clear accompanying developmental objective – it is questionable whether public resources should be used to deliver goods and services that could be provided as, or more, efficiently by private sector players. A case in point is when the developmental mandate of say a DFI is compromised by the pursuit of lending in market segments that could be served by private players. While the reasons for such behaviour typically lie in funding policy constraints or misaligned incentives, the impact can be to drive private players from the market and redirect state resources to more lucrative market segments, where there is no shortage of supply. The impact is negatively double – failure to address the market failure or developmental need as well as the undermining of private market participation. A case in point is the pursuit by the DBSA of less risky municipalities for its lending operations at the expense of targeting higher need and higher risk municipalities. As a consequence private players – especially smaller niche municipal infrastructure funders – are squeezed out of the commercial market, and DBSA's developmental resources are misallocated to commercially viable municipal borrowers.

As a broad principle the use of public money to enable GBEs to compete directly with the private sector is not an efficient use of funds nor is it equitable. Additionally, it should be noted that in the case where GBEs compete directly with private players without any developmental objectives additionally, scarce capital and other funding that could have been used to enable access to critical goods and services for the poor is lost.

An appropriate role for GBEs is to fill gaps created by market failure in non-competitive markets. There are many instances where market failure or limited market provision exists for particular goods and services. The reasons range from the high cost of servicing particular markets, the cost of raising capital in the private market, or the inability of the private sector to undertake a particular intervention because of the scale, uncertainty and risk thereof. In such instances the state has a duty to intervene in the interests of society – the broader public good – rather than in its intermediary's narrow commercial interests. In effect, the state operates as a market maker to establish the feasibility of economic activity in historically excluded segments, or to create precedent and other institutional requirements for private sector entry. Often the critical decision comes when the services of the GBE are no longer required – all too often the rationale for its on-going existence is determined by personal and institutional incentives and/or political imperatives rather than an on-going market failure or developmental need.

² Core postal services are also known as “reserved” services, and for large parts of the country where the price of sale is insufficient to cover the relevant operating costs.

Where there is an appropriate role for a GBE to play, the question must still be asked as to whether a GBE is the most appropriate mechanism to meet the non-competitive market demand. The starting position in each case should be to ask whether another form of government intervention is more appropriate – a departmental role or a government component – for instance. According to National Treasury's guidelines a GBE is only valid if the application of business principles and government-independent incentive structures will make service delivery more efficient and effective than could be achieved through government departments, and there is a clear need for objectivity and operational autonomy in the entity. BUSA agrees with National Treasury's formulation.

It may also be more efficient and cost-effective in certain circumstances to offer defined subsidies, preferably mediated on a competitive basis, to private companies to deliver services in commercially non-viable markets.

Another measure that would enhance regulatory certainty and promote competition in markets operated by monopoly GBEs is the separation of economic bottleneck activities (for e.g., transmission and distribution of electricity) from those activities that are relatively contestable and open to competitive forces (generation and retailing of electricity). There are various separation options. This easiest and least costly form is accounting separation, which requires the accounts (costs, revenues, assets and liabilities) for the different monopoly GBE activities be reported to the regulator separately. At the other extreme is structural separation, where different monopoly GBE activities are split into separate companies and ownership. Separation enables regulators to develop more flexible regulation that is better targeted at activities where there is little prospect of competition, and to support the introduction of private sector participation in the contestable parts of the markets. Separation is a common regulatory feature in Europe for energy, railways and telecoms markets, which has facilitated the privatisation of government-owned assets in these industries. This in turn has alleviated the funding pressures on governments, particularly in relation to the upgrading of infrastructure assets.

A GBE is not appropriate where it is created as a substitute for the failings of a government department. Where a mandate accurately resides in a government department, the performance of the department should be improved rather than establishing a new GBE. The existence of GBEs can for instance not be justified for the purpose of strengthening service delivery where they operate, if the danger is that this may be done at the expense of strengthening the relevant municipalities who are supposed to be responsible for the improved service delivery. Often a consequence is that stronger capacity is attracted to such entities from the public sector (not least because many of these entities are not bound by the pay and performance scales applicable to the broader public service), thus exacerbating the skills crisis within government. Coupled with different and unaligned incentives, such entities do not necessarily address the service delivery failure that was used to justify its establishment, and may even add to the original problem.

Before a GBE is established or extended, BUSA would prefer due consideration to be given to the efficiency and cost-effectiveness of a partnership approach with the private sector. Typically in South Africa a GBE is established and ensconced before due consideration has been given to other delivery models, particularly partnerships with the private sector. Where competitive private providers are active in a sector, it can be more efficient and cost effective for the state to enter into a partnership with the private sector to provide goods and services in the non-competitive markets through a range of contracting mechanisms that could

include formal public-private-partnerships, management contracts or simply by requiring (for instance through incentives and/or regulation) private providers to support delivery of a non-commercial goods or service, or a commercial good and service to a non-commercial market, and then subsidising the loss-making service or part of the business. This obviates the need for the state to enter the market as a player itself where it is competing with the private sector for scarce skills and capital, and effectively duplicates the systems and skills that already exist in the private sector, as well as preventing the distortion of private markets. BUSA contends that greater balance would be obtained in respect of the increased utilisation of public-private partnerships (PPPs), if the level of rigor applied in terms of the framework for PPPs (as it relates to extensive feasibility studies, etc.) were equally applied to the establishment of new GBEs.

Another concern regarding the establishment of, and role of GBEs, is that their purpose should be guided by social or economic goals and not by political imperatives.

GBEs should be established or maintained to productively support the notion of a “developmental state” insofar this concept has been clearly defined. BUSA understands and supports the general *goals* of a developmental state but believes extensive further debate is required around this concept. This will ensure that the role of the GBEs is aligned with SA’s development goals in a sensible and realistic way.

In summary, BUSA’s respectfully presents the following framework to the PRC as a means of testing when a GBE is an appropriate vehicle for the delivery and sale of goods and services:

1. There is a clear, stated and economically justifiable mandate for the state to intervene in a competitive market to address needs which are not being met, or to deal with economic market failure in a non-competitive market.
2. Economic market failure occurs when:
 - a. There are natural network monopolies that need to be standardised;
 - b. There is a clear socially-desirable goal that will not be met by the private sector; or
 - c. New markets, innovation and socially beneficial aims will not be developed by the private sector (in the case of the DFIs).
3. IN ADDITION, the application of business principles and government-independent incentive structures will make service delivery more efficient and effective than could be achieved through government departments or other public agency; AND/OR
4. There is a clear need for objectivity and operational autonomy.

This section has provided a framework and principles for guiding the establishment of GBEs. The next section considers the performance of GBE’s and what can be done to improve the performance.

8. THE RECENT PERFORMANCE OF GBES

This section provides a brief assessment of the performance of large GBES in recent years. It is hard to comprehensively assess the performance of the diverse and numerous GBES in South Africa in a short document. However, even a narrower consideration of *large GBES providing key infrastructural services* provides strong evidence that performance with respect to prices, reliability and quality of infrastructure services has been weak and, worryingly and with some notable exceptions, *is getting worse rather than improving over time*.

Whether measured in terms of cost of service, reliability or quality of supply, South Africa's GBES (and particularly those that dominate the major infrastructure industries – i.e. electricity, telecommunications and transport) have not performed effectively when compared to global comparators or in relation to public expectations. Electricity supply, although better than that during the era of load-shedding in 2008, remains unreliable in many parts, is still a constraint on output and investment and prices are set to double over a three-year period from 2011 to 2014. Rail and port inefficiencies and costs continue to constrain export growth, and undermine South Africa's global competitiveness. The continued monopoly of Telkom on connections in the local loop (or 'last mile' connections) and the limitations of SA's broadband technology and capacity impose a high cost of doing business across the economy. While there have been operational successes (SANRAL for instance), the overall performance of the large infrastructure GBES in South Africa requires much improvement.

The key purpose of infrastructure services is to improve the competitiveness of the economy. A competitive economy can produce more; it grows and creates sustainable jobs. An uncompetitive economy produces less; it shrinks in the face of competition and sheds jobs. ***Considering South Africa's unemployment challenge, it is thus critical that the economy continues to be competitive on global terms.***

However, comparative data is clear that, when looking at South Africa's level of competitiveness, the network infrastructure operated by GBES remains a constraint on the competitiveness of the economy rather than an enabler. Each year the World Economic Forum constructs a Global Competitiveness Index that ranks about 160 countries for competitiveness (defined as "*the set of institutions, policies, and factors that determine the level of productivity of a country*"). In the 2006/2007 ranking, South Africa was rated as the 34th most competitive economy out of 122 countries; alarmingly, by 2010/11, South Africa was ranked 54th out of 139, a relative fall and an absolute fall of 18 places in five years. Put simply, the general competitiveness of South Africa has been falling relative to other countries – see graph below (the rising score means South Africa's general competitiveness ranking has been falling). ***It is incongruous that the 28th³ biggest economy in the world ranks 54th in the world for competitiveness.***

3 Ranked by nominal GDP in 2010, World Bank, World Development Indicators database. 6 August 2011. <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf>.

Figure . Global Competitiveness Index, South Africa (2006-2011)

Source: World Economic Forum, 2011

An important part of the overall Global Competitiveness Index is a ranking the Infrastructure pillar, which measures the competitiveness of various forms of hard infrastructure including rail, roads, ports, air transport, electricity, fixed line and mobile communications. In South Africa these services are generally provided by dominant or monopoly GBEs. Thus the performance of this index can be seen as a rough proxy for the performance of GBEs – see graph below.

Figure . Global Competitiveness Index on Infrastructure, South Africa (2008-2011)

Source: World Economic Forum, 2011

The graph shows that, while there have been some improvements over the period (last three years) notably in the quality of air transport infrastructure and electricity supply the ranking of **the quality of South Africa's overall infrastructure fell from 46th out of 134 countries in 2008/9 to 56th out of 139 countries in 2010/11** (see left hand column). Again, this constitutes an absolute and relative fall in infrastructure competitiveness. **What is more concerning to BUSA, however, is that the trend over the last three years has been towards infrastructure getting worse, and not better.** The ranking of South Africa's quality of road, railroad and fixed line telecommunications has been downwards. The ranking of the quality of ports has shown no absolute improvement. Although the quality of electricity supply has improved, the absolute ranking still places South Africa in the bottom third of the world (94 out of 139 countries) and this reflects a period of recovery from rolling black outs in 2008, when endemic power supply problems did huge damage to the economy. Other evidence suggests the rails system is also in a poor state - freight transport in South Africa increased by only 14% between 1995 and 2005 compared to 50% in China, India and Russia, while freight tariffs per ton/km in South Africa are estimated to be three times higher than in the US and Canada.⁴ Telkom still has a monopoly of fixed telecommunications and South African households pay some of the highest local rates in the world. Research in 2005, showed that a three minute local call in U.S. cents is one of the most expensive in the world in South Africa (15 cents), three times the cost in South Asia, more expensive than the sub-Saharan African average and equal to the high income OECD countries (see table below).

Figure . Cost of Local Phone Call (US cents/3 minutes)

Source: Bogetic and Fedderke (2005).

4 OECD, 2008

Although this is hardly a comprehensive assessment of performance of South African GBE's, the global comparative data taken together, does strongly indicate that ***South Africa's infrastructural capacity is weakening, and as a result the economy is losing competitiveness. This suggests that, in general, the GBEs are not acting sufficiently as facilitators of a more competitive economy and not providing South Africans with the price, quality or reliability of service that is necessary to grow the economy, compete more effectively and create more jobs.*** In the sections that follow BUSA respectfully suggests why this is the case and how performance might be improved.

9. A DIAGNOSIS OF MAIN PROBLEMS

This section sets out a high level diagnosis of the key challenges that, in BUSA's opinion, account for the poor performance of GBEs described in the previous section. Some of these challenges have already been identified by the PRC (as noted in the explanatory material distributed to BUSA ("*Some Critical Observations*" PRC presentation, May 2011)) while others have already been identified by National Treasury and DPSA. BUSA believes that the identified problems are worth restating and consolidating with others.

First, there is a lack of integrated planning and critical thought about the purpose of GBEs. BUSA believes that a more coherent policy approach is needed that clearly defines the objectives of GBEs and an appreciation of the purpose, pros and cons of using a GBE for delivery, or that determines where and when a GBE may be warranted, and where not. ***Nor is due consideration presently given at a centralised, integrated level as to the role that is best played by the public sector, the private sector, or a partnership between the public and private sectors in the delivery of key GBE services, which may result in far more efficient delivery.*** Much of the current portfolio of GBEs was inherited from the apartheid government by default, rather than established by design. This has led to an environment that persists simply because it exists, rather than by carefully thought through design and strategy. There is no overarching integrated vision or plan that establishes the need for, purpose, and core mandate of the GBEs. In particular, little critical thought has been given to why GBEs should compete in markets which are adequately serviced by private operators.

Second, there is a disconnect in the governance framework between long-term mandates, strategic plans, indicators, targets and related incentives. Without clear thinking about the purpose of a GBE it is difficult to formulate a clear operating mandate; without a clear mandate it is difficult to draft a clear strategic plan, and, in turn, effective performance contracts.

Third, there is weak accountability for poor performance, including ineffective monitoring and evaluation. Performance contracts for GBE managers are often poorly drafted and not effectively or consistently monitored. This is partly because of the natural principal - agent and asymmetry problems where executives, who have more information than owners, can negotiate targets that are easy to achieve or hard to measure. ***This suggests the need for a much more transparent, rigorous, logical structure that links the highest level mandate to specific performance indicators, and in which an independent board has a bigger say.*** Moreover, the lack of clarity and consistency in the provisions of different shareholder compact arrangements (which define the performance and reporting arrangements between GBEs and the Ministries to which they report) result in weak evaluation frameworks, the definition of clear targets and the measurement of their achievement. Poor performance is made worse by a lack of independent monitoring and evaluation of performance, while the lack of accountability for poor performance is sometime exacerbated by political interference in the appointment and protection of underperforming executives.

Fourth, there is an inappropriate focus on short-term goals. Performance has also been weakened by a standard 'five-year contract' mentality, where executives are employed for limited-term contracts. Naturally, their incentives are aligned to short term fixes, not long term performance, and are not conducive to the calibre, focus and continuity of management and professionals needed for the long term. This results in the definition of multiple, short-term and frequently changing performance targets linked to indicators and performance incentives link to

a narrow range of operational indicators rather than *impact* indicators, and which do not foster the long-term fulfilment of development goals.

Fifth, lacking is a coherent fiscal framework that imposes discipline on GBE state financing, or limits unduly favourable state funding and guarantees. Favourable access to and terms of finance for GBEs, based on an explicit or implicit assumption of a state guarantee on their debts, leads in many instances to over-indebtedness, the misallocation of resources and a distortion in the operating environment of private service providers. In instances where GBEs compete with private providers, this has serious implications for the displacement of private investment and job creation and for undermining competition. ***The ability to go to the state for a subsidy when performance is weak, undercuts incentives to improve performance.*** Particular risks and conflicts accompany relations between state-owned development finance institutions (DFIs) and GBEs, especially where the parties are acting under pressure to conclude loan agreements in pursuit of programmes relevant to government's objectives. This leads to undue pressure for the issuance of loans and guarantees, and may undermine the sense of obligation by end-borrowers to repay such loans. Guarantees and favourable financial terms of this kind shelter borrowing GBEs from a crucial source of market monitoring, can distort their incentive structure and displace competition. ***As a principle, GBEs operating in competitive markets should face competitive conditions regarding access to finance.***

Finally, there has been too much political interference in the operations of GBEs, and the imposition of too many conflicting political, social and economic objectives. In practice, GBEs are frequently forced to pursue multiple, changing and often conflicting objectives (e.g. job creation, training, social goods versus cost-effective service delivery). In some instances (e.g. Eskom prior to the supply crisis in 2008), GBEs have been used as instruments of macro-economic stabilisation policy, adhering to price controls and investment targets, without due regard for their long term performance or sustainability. Senior management must be appointed substantially on the basis of proven professional competency. Similarly, in the DFIs, evidence is emerging that non-core business related objectives (i.e. regarding job creation, training, green economy investments) are beginning to drive the allocation of investment funds, in potential downgrading of sustainability criteria. Together, these factors inhibit the ability of the executive authority, in the form of the relevant line Ministry, from acting decisively to address non/under-performance, and detract from the principle and discipline that non-performing GBEs be closed, or that underperforming management be removed.

10. A FRAMEWORK TO IMPROVE PERFORMANCE

Following on from the themes identified above, this section sets out a basic improved framework with regards to the governance, management, regulation, and financing of GBEs. It is BUSA's contention that the adoption of this framework will greatly improve the performance of GBEs.

10.1. GREATER INTEGRATION OF PLANS, MANDATES AND PERFORMANCE

At a national level, a more coherent, strategic, considered and integrated plan for GBEs is needed, one that feeds logically into the mandate, strategic plan, performance expectations, and performance indicators.

The logical progression is captured in the following diagram:

Figure . Governance and Oversight Arrangements

Source: Genesis Analytics, 2011

National Integrated Plan: The starting point in a more logical governance framework is the design of a coherent National Integrated Plan for GBEs, informed by policy and white papers. A natural home for the development of this plan would be the National Planning Commission, Presidency or the Ministry of Public Enterprise and Administration. The key idea here is to move from an ad hoc framework to one of integrated planning and design. The purpose of the National Integrated Plan would be:

- To match the roles of GBEs to a larger national plan;
- To consult, adjudicate and justify the need for GBEs and to publicly and transparently communicate the justification to the public;
- To clearly delineate the roles of government as shareholder, policy maker and regulator and how these roles should be allocated to particular ministries;
- To give clear guidance on the long-term mandate of the GBE – including the mix of economic and social goals;
- To justify the objectives and clarify the operating mandates by GBEs who operate in direct, frequently subsidised, competition with private sector players;
- To bring a coherence to the GBEs universe regulatory environment by deciding on most appropriate reporting lines (to DPE or Line Ministry);
- To ensure that the regulatory function is clearly established and separate from the GBE in regulated markets where GBEs and private companies compete (for example in the telecommunications sector) and to ensure there is a clear separation between the Government's ownership function and its regulatory function (or in others words in governments role as a player and as a referee);

- To prevent gross regulatory distortion in markets where GBEs and private companies compete arising from an unclear separation between the Government's ownership function and its market regulatory function – providing for unfair competition by incumbent GBEs in relation to private service providers;
- To assess whether the GBE function is best conducted by a government department, the private sector with state subsidy, in partnership with the private sector or by a GBE.

From the National Integrated Plan a mandate for each GBE is drawn: This is primarily the role of the Minister of Public Enterprises in consultation with the relevant line Minister. The Ministers must decide where the mandate lies, taking into consideration the three way trade-off between financial sustainability, the achievement of developmental outcomes and achievement of key economic outcomes (there may be others), and clearly specifying the prime mandate for the each GBE.

From the Integrated Plan and Mandate, the Board in consultation with the Minister should draw a strategic plan for the GBE. This is the core business, financial and operational plan for each GBE to achieve the mandate it has been set by the political executive. The strategy should be clearly aligned to the explicit socio-economic objectives of the shareholder. Therefore, it is imperative that the shareholder describes in as much detail as is reasonably possible, the roles and responsibilities of the board and the individual directors and/or accounting officers in developing a coherent strategic plan.

From the mandate and strategic plan a performance contract is drawn up. It should draw down the clear indicators that show the achievement of the mandate (acknowledging trade-offs) accompanied by ***clear time-bound and measurable indicators and targets*** for achieving the performance mandate. In addition to the performance contract the senior managers and board should agree to a Code of Conduct.

Incentives for management are then set against achievement of these targets and nothing else. Contractual tenures and performance incentives for senior management positions must be aligned and matched through the logical process to the long-term mandate and strategy of the GBE. This means more focused indicators that are measurable and linked to the mandate and strategy of the GBEs.

10.2. MORE TRANSPARENCY AND STAKEHOLDER INPUT

The setting of the National Integrated Plan for GBEs as well as their long-term mandates and performance contracts would benefit from far more open consultation and involvement than is currently the case, involving all potential stakeholders and interested parties. Setting the integrated plan and performance mandate should draw on greater oversight and input from the social partners, business and the general public through consultative parliamentary processes. Also important is a much stronger insistence on timeous and audited annual reports and financial statements. Government should also make the mandates and performance contracts of managers publicly available and publish the results of performance evaluations.

10.3. MORE EFFECTIVE MONITORING AND EVALUATION OF PERFORMANCE

BUSA would like to see the introduction of an independent or third-party review mechanism of performance. This mechanism should function independently, in the manner

of the Chapter 9 institutions, to advise and make recommendations to the relevant Ministries and the Presidency, as well as making representations to Parliament. The performance of GBEs should be subject to public scrutiny and require parliamentary reporting on primary indicators which are defined by the mandate of the GBE.

Government should also make the mandates and performance contracts publicly available and publish actual performance measures achieved. Any obligations or responsibilities that a GBE is required to undertake in terms of public service beyond what is defined in their shareholder compacts should be clearly specified and mandated in terms of laws or regulations, the terms and costs of which should be made public.

Benchmarking to international standards and customer satisfaction surveys should also be published so that consumers are better able to hold the GBEs to account for delivery.

Where the GBE's mandate has both a core economic function, and a public goal, performance should first be measured against the core function and secondly the public goals. The balance of indicators used to measure and gauge the performance of GBEs should therefore speak to their core functions where development indicators, while important, become secondary indicators of performance. For example, Eskom's primary mandate is to ensure reliable electricity distribution throughout South Africa. Thus the performance of Eskom should be measured in its ability to 'keep the lights on'. Objectives of training up engineers or supplying electricity to Mozambique, while included in Eskom's mandate, are secondary objectives.

10.4. APPROPRIATE AND DISCIPLINED FUNDING

10.4.1. GBES OPERATING IN COMPETITIVE MARKETS

Where GBEs operate in competitive markets, BUSA's view is that they should compete in respect of the price for finance for these parts of their business on market terms, without government loan guarantees and grants. Subsidies for GBEs in competitive markets have the potential to distort or restrict competition (also known as 'crowding out' the private sector) by giving unfair cost advantages to GBEs operating in price competitive markets (such as telecommunications, media and passenger air services). The ultimate effect of this is to destroy sustainable private sector jobs in favour of jobs in GBEs that must effectively be sustained by the tax payer.

Subsidies for competitive activities also increase the fiscal burden on the taxpayer, drain public finances, and raise the contingent public debt burden. In BUSA's view these subsidies would be better spent directly on free provision of critical government functions like health, education and security to the poor.

Accounting separation measures should be implemented more effectively on all vertically integrated monopoly GBEs to ensure that government subsidies or regulated tariffs are not used to subsidise commercial activities in competitive markets. Competitive market and non-competitive market funding should be kept separate and ring-fenced. For example, SABC operates in competition with private Pay TV operators with regards to sports and entertainment content, but is also required to provide universal access through the provision of radio and television services to isolated communities, at a specified level of local content. The government provides direct grants to SABC for the provision of

these services, amounting to over R300 million for the year ended March 2010.⁵ BUSA supports the provision of these subsidies. However, these services do not appear to be accounted for separately from SABC's commercial activities, which give rise for the potential of cross subsidisation between mandated and commercial activities. ***Ideally, mandated services in a GBE should be effectively ring-fenced so as to ensure that resources are not being used unfairly for the provision of commercial content at the detriment to private competitors.*** The ideal is for government grants and loans to be used to provide important social services and on to subsidise loss- making commercial activities (which distorts competition and can put private companies out of business).

10.4.2. GBES OPERATING IN NON-COMPETITIVE MARKETS

For monopoly GBES, cost reflective tariffs rather than government funding or subsidies is the preferable method of funding. Pricing of services in non-competitive markets should be at full economic-cost, and service costs should be recovered on a user-pays basis (at full economic cost), not from government. Several GBES such as Transnet and Eskom are monopolies that operate in markets categorised by high entry barriers and capital intensive activities. Historically, such entities have priced their services well below full economic costs, which have resulted in inadequate investments in capital expansion. More specifically, pricing below economic cost has resulted in some GBES not accumulating sufficient funds to replace depreciated assets, and not being able to attract external financing for investments in new capacity. Accordingly, these GBES have relied on direct funding from government, either through capital injections or government guarantees. The approach of allowing GBES to fund their operating and capital expenditure through cost reflective tariffs rather than government grants and guarantees encourages a more efficient use of resources, particularly with regards to the allocation of scarce capital.

Proper regulatory oversight with regards to tariff setting is essential for all monopoly GBES. However, it takes a strong and competent regulator to ensure that costs are not being recovered at more than economic costs, particularly in the absence of competition. In order to prevent such an outcome, ***robust price cap reviews*** must be undertaken by regulators for GBE monopolies including Eskom, Transnet and ACSA, where prices should be set to allow the recovery of efficiently incurred, mandate appropriate operating costs and a reasonable return on assets. Currently, regulators such as NERSA do carry out regular price cap reviews, but it is far from certain whether their scrutiny of GBE operating costs are done with sufficient robustness.

More specifically, all price cap reviews should draw on a benchmarking analysis of comparable network operators to judge levels of efficiency. NERSA's analysis of Eskom's operating cost concluded with only modest adjustments to Eskom's revenue allowance application and allowed full inflationary increases for major cost categories, including corporate overheads. NERSA's review process contrast markedly with OFGEM (UK's energy regulator) operating cost reviews, which involve a detailed benchmarking analysis of the operating costs of all distribution network operators in the UK⁶.

5 2010 Annual Report

6 See Ofgem's DPCR5 document, paragraphs 3.10 to 3.22

In addition, regulators must ensure that GBE monopolies only derive a reasonable profit margin on an appropriate level of operating assets, and that customers do not carry the cost of unnecessary investment in excess capacity. In setting the appropriate rate of return, consistency must be applied across all GBE monopolies, that is, a consistent application of an established pricing methodology (for e.g. Capital Asset Pricing Model (CAPM)) for all price reviews.

A consistent application of the ‘allowable returns’ methodology by regulators, and recognition that GBEs should be able to derive market related returns on assets, would go a long way of reducing the uncertainty for funders and overall funding costs. Such inconsistency in the application of the market risk premium creates regulatory uncertainty, particularly with regards to the level of economic costs GBEs are allowed to recover. This inconsistency is likely to add to the financing costs of GBEs, particularly as providers of finance would set their prices according to the perceived credit risk. If GBE monopolies are only required to recoup 1.9 per cent return on equity capital, then banks are more likely to require government guarantees. A consistent application of the allowable returns methodology by regulators, and recognition that GBEs should be able to derive market related returns on assets, would go a long way of reducing the uncertainty for funders and overall funding costs. This should ensure that GBEs are less reliant on government guarantees, which in any case should be phased out over time given their potential distortive effects on capital allocation.

10.5. ENSURING THE OPERATIONAL AUTONOMY OF GBES

Once a plan and mandate has been set for each GBE and a business strategy and performance contract approved, government should not interfere directly, in the operation and management of GBES. Governments focus should be on setting the desired outcomes, not the management. The appropriate level for political input is policy setting, the framing of the National Integrated Plan the setting of long term mandates and performance contracts with specified economic, financial and/or performance requirements. Thereafter the responsibility for management shifts to the Board of the GBE. The Minister/s as shareholder representative has the power to remove non-performing managers (and boards) who are poorly rated in an independent evaluation, but there should be no other interference from other political powers. GBES can be usefully strengthened if the role of stakeholders who have a direct stake in more commercial behaviour and improved performance of the GBE is given more weight – for example opportunity for more public input and parliamentary participation throughout the logical process described above.

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