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Case Study (Full Report)

State-Owned Enterprises and Quasi-Fiscal Activities in South Africa

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Introduction

Good governance and improved delivery of public services are becoming increasingly important as citizens demand more transparency and accountability from state bodies. Governments often respond to this demand by creating dedicated institutions that act as service-delivery agents for the main state bodies. In the case of South Africa, a distinction can be made between oversight and regulatory institutions on the one hand and service-delivery entities on the other. Both tend to be called either "public entities" or "government business enterprises," depending on whether they also have a profit motive.[1] The most important characteristic of oversight and regulatory institutions is that they are independent, at least operationally, in fulfilling their mandates

Some of the entities are provided for in the South African Constitution, such as those established under Chapter 9. Others are created through separate initiatives within state bodies and have legislation that establishes them and guarantees their existence, such as the National Electricity Regulator of South Africa (NERSA). Such service-delivery agencies are common in all three tiers of government in South Africa.[2]Recently, guidelines were developed detailing circumstances under which public entities or service-delivery agencies should be established. However, a plethora of service-delivery agencies in all three tiers of government still have governance frameworks that are not clearly defined. Service-delivery agencies generally have shareholder compacts with parent departments. Nevertheless, the overall impact of these agencies in achieving government outcomes remains to be seen.

This report examines the governance and oversight arrangements of state-owned enterprises (SOEs) and quasi-fiscal activities (QFAs) in South Africa. These two focus areas are distinct, yet also interrelated, with the establishment of some SOEs primarily geared toward noncommercial transactions. This research forms part of a broader research agenda by the International Budget Partnership (IBP) to extend its current work on the Open Budget Survey into areas of budgetary and

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[1] The large national state-owned business enterprises are referred to as state-owned enterprises (SOEs) in South Africa.

[2] The South African Constitution created a unitary state with three levels of government: national, provincial, and local/municipal.

fiscal activities that are not so neatly captured in budget documentation, although these activities form an integral part of state operations.

The report consists of six sections. Section 1 sets the context by defining the objectives, methodology, and categories of public entities in South Africa. Section 1 also includes a review of the performance of SOEs in general. Section 2 maps the legislative, policy, and regulatory terrain governing SOEs in South Africa to evaluate general ownership arrangements, legal edicts, and any noncommercial transactions that entities may be engaged in. The policy assessment also examines the issue of public participation and the extent to which the legal framework accommodates this. Section 3 examines the governance arrangement, oversight, and reporting responsibilities of SOEs, bothin general and within the context of noncommercial transactions in South Africa. Section 4 examines three case studies and addresses the issues of governance arrangements and noncommercial transactions. After the conclusion in section 5, section 6 proposes questions on SOEs and QFAs for the Open Budget Questionnaire.

Approach

The governance framework for any service-delivery agency should consist of a clear mandate, adequate capacity, and independence. Independence, in particular operational rather than complete independence, of regulatory agencies is crucial, as interference by politicians can severely compromise the effectiveness of the agency. Public entities are natural extensions of government departments and should contribute to the achievement of objectives detailed in the shareholder compact with the parent department. As such, this report focuses on a general survey of the legislative and policy frameworks that govern national public entities. The following documents serve as the foundation of the current governance framework of national public entities in South Africa:

- Protocol on Corporate Governance for the Public Sector (this might have to be revised in light of the King III Report);
- King II and III Reports on Corporate Governance;
- Public Finance Management Act (PFMA);
- Companies Act; and
- Various laws that establish and guarantee the existence of such entities.

These documents will be examined to determine the separation of functions between the entity and the owner, oversight mechanisms, and the level of public disclosure of financial and governance information related to the entity's operations. The review also aims to identify any noncommercial transactions that state entities and public corporations are generally involved in, either with targeted beneficiaries (e.g., low-income earners) or between state entities; how such transactions are handled; and if this conforms with the existing governance framework.

Sometimes the policy and legal framework does not address the different types of QFAs explicitly, and instead these transactions are subsumed into the entity's daily operations. Noncommercial transactions by national entities, therefore, will be detected primarily through internal documentation or by researchers investigating these types of non-fiscal activities. The research consisted of a review of existing literature on QFAs in South Africa and interviews with selected academics and public officials to gain a broader perspective on the nature of these QFAs, who benefits from them, how they are regulated, and the level of disclosure and public participation.

Three national public entities were selected for case studies to examine more closely key governance, legislative, and oversight issues, as well as public participation, noneconomic transactions, and disclosure requirements. The case studies were selected based on the scope and size of economic activities, ownership arrangements, and their level of significance in the South African context. The following are the key governance criteria used in the case studies:

- Mandate of the SOE as defined in both relevant laws and shareholder compacts;
- Preparation and approval of the SOE's strategic and operational plans;
- In-year management of the SOE's activities (frequency of oversight activities and reporting);
- Annual reporting processes
    - Are annual reports made public?
    - When do annual reports get published?
    - Is there freedom to decide on the content and level of detail in annual reports?
- Transparency and accountability
    - Are the SOE's reports audited by external auditors and who appoints auditors?
    - To whom and for what is the SOE accountable?
- Noncommercial transactions
    - Is the SOE involved in any noncommercial transactions?
    - What is the extent of these transactions?
    - Who benefits from these transactions?
    - Is any oversight and reporting framework in place that governs these transactions?
- Financial independence:
    - What are the funding sources for the SOE (user fees or budget allocation or both)?
    - Is the SOE allowed to retain excess funding?
    - Does the SOE have freedom to allocate financial resources across activities?
    - Are the user fees or tariffs and proposed budgets subject to approval by the relevant National Treasury/Minister of Finance?
    - Is the SOE subject to the normal tax code, and, if it has tax arrears, is it treated like any other taxpayer?
    - Is there a common dividend policy across SOEs?
- Operational independence:
    - Is the SOE free to choose the method of service delivery?
    - Is the SOE free to choose the activities it engages in to deliver on the mandate?

- Does the SOE have the freedom to access information required to conduct its regulatory activities?
  - Does the SOE undertake regulatory activity, or is there a separation between the SOE and the regulator?
  - Does the SOE enter into confidentiality agreements with regulated entities and the National Treasury/Minister of Finance regarding the information provided to or received by it?

- Managerial autonomy:
  - What are the powers of the SOE with regard to hiring, firing, contracting with external firms, etc.?
  - Does the SOE have the power to decide on conditions of employment, salary scales, etc.?
  - Does the SOE have the power to decide on internal organizational arrangements?

- Checks and balances:
  - Are the SOE's decisions open to review by courts of law and other oversight bodies, such as parliament, the National Treasury/Minister of Finance, and the public?
  - What parliamentary oversight are SOEs subject to, and is there an opportunity for the public to participate?
  - Are SOEs subject to the Official Information Act, and can refusal to provide information be challenged by an ombudsman?
  - Do SOEs have to comply with regulations concerning social and environmental impacts of projects and activities, including public consultation requirements?
  - What is the relationship between the SOE and the parent department with regard to reporting and accountability?

The list of questions constitutes the framework used in the case studies to assess the governance arrangements for selected entities. The results of these assessments will be used to review the current Open Budget Survey questions on SOEs and QFAs and to inform efforts to draft a set of questions with a wider coverage of this area.

Background to Public Entities

Currently, the Public Finance Management Act (1999) classifies public entities into schedules, according to their nature and degree of autonomy. This section will describe the different public entity schedules.[3]

[3] A complete list of national and provincial public entities is published as an annex in the Public Finance Management Act (1999).

Schedule 1 entities

Schedule 1 entities are commonly referred to as Constitutional Institutions. The overall objective of Constitutional Institutions is to promote constitutional democracy in South Africa, and they are listed in Chapter 9 of the country's Constitution. Constitutional Institutions are directly accountable to parliament, rather than through line departments. The most important characteristic of these institutions is that they are independent, at least operationally, in fulfilling their mandates. The intention is for them to act in the public interest in all their activities. Examples of Schedule 1 entities are the Public Protector, the South African Human Rights Commission, and the Independent Electoral Commission.

Schedule 2 entities

Schedule 2 entities are major public entities that produce outputs that are sold in the marketplace. They are largely self-financed from the revenue that they generate from the sale of goods and services. They deliver outputs that contribute to the achievement of policy objectives of specific government departments. These entities have the most autonomy of all the public entities. In terms of Section 66(3)(a) of the PFMA, Schedule 2 public entities may also borrow money through their accounting authority. The Public Investment Corporation, the Development Bank of Southern Africa, the Land Bank, and Eskom are examples of Schedule 2 national entities. In total, 21 Schedule 2 entities produce between 6percentand8percent of the total GDP.[4] (DPE, 2005).

Schedule 3B and 3D entities

Schedule 3B and 3D entities are referred to as government business enterprises. These entities generate income, but they may be either substantially self-funded or substantially government-funded. They produce non-marketable outputs and are substantially smaller in size than Schedule 2 entities. As a result they have less autonomy than the Schedule 2 public entities even though they are still run in accordance with general business principles. These entities also have limited borrowing powers. Examples of Schedule 3B and 3D entities include the Public Investment Corporation, the *Umsobomvu* Youth Fund, and Provincial Development Corporations.

Schedule 3A and 3C entities

The remaining public entities are classified as Schedule 3A and 3C entities. These are normally extensions of a department, with the mandate to fulfill specific economic or social responsibilities of government. They rely on government funding and public money, either by means of a transfer from the Revenue Fund or through statutorily appropriated money. As such, these entities have the least autonomy. Examples of Schedule 3A and 3C entities are the Accounting Standards Board, the Competition Commission, and provincial gambling and liquor boards.

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[4] "*An analysis of the financial performance of state owned enterprises*," Republic of South Africa, Department of Public Enterprises, 2005.

Case Studies Selected for Analysis

The case studies selected for analysis here are all classified as Schedule 2 entities, commonly referred to as state-owned enterprises (SOEs).[5] They are the Development Bank of Southern Africa (DBSA), the Land and Agricultural Bank of South Africa (LABSA), and Eskom, an electrical utility. SOEs — not to be confused with state-owned *entities* and sometimes referred to as government business enterprises — play a significant role in infrastructure development, the provision of goods and services, and financing the private sector and citizens. This role greatly affects the cost of doing business in South Africa. Moreover, SOEs account for a significant share of assets (especially Eskom), turnover, and employment. The two financial service providers selected (i.e., DBSA and LABSA) play an instrumental role in the development mandate of government and are good case studies to examine possible QFAs on the part of the state

Aggregate Performance of State-Owned Enterprises

The latest findings available show that total portfolio revenue for SOEs grew from R98.3 billion in 2003-2004 to R101.7 billion in 2007-2008. Eskom and Transnet contributed 44 percent and 33percent of total revenue, respectively. Earnings before interest and tax (EBIT) increased from R12.1 billion in 2003-2004 to R18.4 billion in 2006-2007. In 2007 EBIT fell by 19 percent to R15.4 billion, while net profit fell by 66 percent to R45 billion due to reduced profitability of some of the major SOEs and increased losses at South African Airways (SAA). Portfolio assets increased from R192.1 billion in 2003-2004 to R298.2 billion in 2007-2008, with asset growth recorded across all SOEs.

SOEs continued to strain their balance sheets, with net financial liabilities up by R33.5 billion between 2003-2004 and 2007-2008, reaching R175.1 billion in 2007-2008.[6]

In 2006 to 2007, the Economic Forum's global competitiveness index (GCI) ranked South Africa as the 34th most competitive country out of 122 countries. In 2010-2011, South Africa dropped to 54th position out of 139 countries. An important dimension of the GCI is its ranking of the infrastructure of a country, which includes railroads, roads, ports, air transport, electricity, and fixed-line and mobile communications. In South Africa, these services are generally provided by SOEs. The performance index for infrastructure can therefore be used as a proxy for the performance of SOEs in South Africa.[7]

South Africa's ranking for the quality of its infrastructure overall fell from 46th out of 134 countries in 2008-2009 to 56th out of 139 countries in 2010-2011. When the infrastructure index was disaggregated by sector, South Africa's ranking for roads, railroads, and fixed-line and telecommunications dropped. The ranking of South African ports remained unchanged, while the quality of the electricity supply improved. Although South Africa is still in the bottom third in electricity supply (94th out of 134 countries), there was an improvement from 2008 after South Africa went through a period of power supply problems that hurt the economy. Further, Telkom, a telecommunications SOE, still has a

[5] Case studies from among Schedule 2 entities were selected for further investigation because their size is significantly larger than Schedule 3B and 3D entities and because their overall economic and developmental impacts are much greater.

[6] "*Strategic and performance plan 2009/10 – 11/12*," Republic of South Africa, Department of Public Enterprises, 2009.

[7] Business Unity of South Africa, "*The role of state-owned entities in South Africa*," 2001, available at www.busa.org.za

monopoly on fixed communications, and South African households pay some of the highest rates in the world (BUSA, 2011).

The Auditor General of South Africa is an office established in Section 188 of the Constitution and acts as the external audit for all state entities in South Africa. The Auditor General conducted an assessment of the performance of national public entities between the 2002/03 and 2003/04 fiscal years. The study is now nearly 10 years old, and as such the results should be treated with caution. Nevertheless, it is the only available governance assessment of all national public entities, and it is presented here as a baseline of the general quality of performance of public entities at the time.

When the Auditor General audits the financial statements of an entity, the audits are accompanied by one of four possible opinions, namely unqualified, qualified, adverse, and disclaimer of opinion.[8] The Auditor General assessed the audit opinions of 157 public national entities. Unqualified (the best rating) audit opinions increased from 54 percent in 2002 to 66 percent in 2004, showing an improvement in the quality of financial information provided by entities. For three consecutive years, 2002 to 2004, 12 public entities received a qualified opinion, of which six related to the Department of Arts and Culture, implying that the Auditor General had serious reservations about the authenticity of some aspects of the department's finances. The major issue raised was the lack of internal controls in place. The results show an increase of 19 percent for entities that reported on performance information as required by Section 55(2) (a) of the PFMA. The Auditor General also discovered that entities were not reporting consistently on performance information, fruitless and wasteful expenditure, and irregular expenditure (Auditor General, 2004/2005).[9] This makes interagency comparisons on performance and due diligence with regard to spending very difficult.

The disclosure of director and executive member emoluments in the Annual Financial Statements (AFS) is required by Treasury Regulations 28.1.1. Despite this requirement, 24 percent of entities did not disclose this information. In addition, there was a lack of consistency regarding the level of disclosure made. The Auditor General also noted, quite alarmingly, the exorbitant fees and bonuses that were being paid to directors and executive members (Auditor General, 2004/2005).

The economic slowdown has prompted the South African government to adopt a conservative countercyclical fiscal policy to buffer the impact of a shrinking economy. With the fiscal space constrained at the macro level, the government's strategy to bring the economy out of recession and grow employment has been to invest heavily in strategic infrastructure development projects that have a combined value of R845 billion over the medium term.[10] (The government's approach has been to fund these projects largely off the balance sheets of SOEs, using a combination of development finance and private lenders. The recent downgrading of South Africa by rating agencies could have a significant impact on the cost of borrowing by SOEs on the open market. In its attempt to make

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[8] The definition and a brief explanation of each opinion is presented in Appendix 1.

[9] Auditor General, "*Review of National Public Entities*," Republic of South Africa,2004-2005.

[10] Republic of South Africa, National Treasury (2012). *The Medium Term Budget Policy Statement. South Africa*. Government Printers.

infrastructure financing affordable, government may be tempted to use the LABSA and DBSA as a vehicle to administer preferential interest rates to SOEs.

Legislative and Policy Framework

National public entities

These are governed and regulated by several pieces of legislation. The Constitution is the overarching architecture that establishes the higher-order legal framework that brings entities into existence. Corporate governance is also exercised through various legislative requirements of the PFMA (1999), SOE-enabling legislation, the Companies Act, the Protocol on Corporate Governance, and the King Report on Corporate Governance (II & III). The latter is a code of good practice that large entities are encouraged to prescribe to.

The Constitution of South Africa

It is the Constitution that empowers the National Assembly (parliament) with the power to oversee all national government activities, while provincial legislatures exercise similar powers at a provincial level. Parliament exercises its oversight function of SOEs by examining their annual financial statements. The current challenge facing members of parliament and portfolio committees that scrutinize SOE reports, such as strategic plans, budget documents, and annual reports, is the capacity of members to examine these documents. The situation has improved over the years, and parliament has also established a Budget Office to play a more active role in the budgetary cycle of government departments and SOEs. The Budget Office was established through the Money Bill Procedures and Related Matters Act (2009) to give teeth to parliament in its role as watchdog of national departments and public entities.

Section 56 of the Constitution also empowers parliament, or any of its committees, to summon any person or institution to appear before it and give evidence, produce documents, or advise on matters where more information is needed. The Auditor General acts as a watchdog body over functions of the State, including SOEs, and can therefore be called before a committee to provide it with information not derived from the executive branch. Similarly, the National Treasury can be called to give testimony and provide information to assist with a committee's oversight function. Quite often, presentations by Treasury are technical and not well understood by the committees.

Public Finance Management Act (1999)

National and provincial departments, including public entities that report to these departments, have to comply with the provisions of the PFMA, which sets the financial management framework and governance arrangements for public entities. Treasury regulations issued under PFMA go into more detail on the specifics, such as the powers and duties of the board of directors of SOEs, corporate plans, systems and processes that must be in place in SOEs, reporting that must take place, and the fiduciary responsibilities of the executive authority or minister responsible for the SOE.

Protocol on Corporate Governance

This is a code of good practice similar to the King Report on Corporate Governance. All public entities, including SOEs, must comply with the Protocol. The Protocol is aligned with the principles in the PFMA, while striving at the same time to maintain the independence of SOEs. The purpose of the

Protocol is to guide the relationship between the minister as the executive authority and the SOE. The guiding principles of the Protocol are as follows.

The executive authority should exercise policy control over SOEs consistent with the executive authority's accountability to parliament and the public:

- The executive authority should set clear objectives for SOEs.
- Any social service obligations that the SOE undertakes should generally be specified through a shareholder compact.
- The directors of SOEs should ensure the development of business strategies, adherence to policies and procedures, and the monitoring of management in implementation.

In line with the precepts of the PFMA, the Protocol states that the relationship between the executive authority and the board of an SOE should be governed by a shareholder compact. The Protocol goes further to say that the executive authority should closely monitor the extent to which the board achieves the objectives and specific performance targets set, and where necessary, effect remedial action.

Table 1 Key Social Service Performance Area from Eskom's Shareholder Compact

Performance area	*Company level performance indicator*	*Target 2012*	*Target achieved*	*Actual 2012*	*Actual 2011*	*Actual 2010*
Supporting South Africa's developmental objectives	*% local content in capital expansion contracts placed*	52	Yes	77.2	79.7	73.9
	Total learners in the system (engineers)	1800	Yes	2273	1335	955
	Total learners in the system (technicians)	700	Yes	844	692	681
	Total learners in the system (artisans)	2350	Yes	2598	2213	2144

Source: Eskom, Integrated Annual Reports 2008-2012.[11]

Auditors of SOEs need to state in their Auditor's Report whether the SOE has complied with the PFMA and the Protocol on Corporate Governance.

Policy and regulatory regiments for SOEs

A policy applicable to an SOE is approved by the cabinet and directed through the appropriate policy department to the applicable executive authority. Both the policy department and the executive authority must ensure that appropriate structures and processes are in place at the SOE to implement the policy. The policy department's role would then be to monitor, review, and oversee service delivery of the SOE to ensure that it is consistent with the goals of the policy. The challenge is often that the

[11] See http://www.eskom.co.za/c/84/annual-report/

Treasury regulations state that the SOE must submit quarterly reports to the executive authority for monitoring and oversight purposes, but quite often the policy department is not the executive authority. Moreover, policy directives may affect the viability of the SOE, which affects the financial performance and shareholding by the executive authority.

The government's role as regulator is more concerned with the industry in which the SOE operates. The regulator would be responsible for pricing and for consumer and industry interest. While the regulator is a government agency, the regulator and SOE can and should be in an independent and arms-length relationship, which is unlike the relationship between the executive authority and the policy department, which play a more direct oversight role. For example, the National Energy Regulator of South Africa (NERSA) approves annual electricity tariff increases. Eskom is currently requesting a 16percent increase in electricity tariffs for the next five years. Before NERSA can formally approve any tariffs, it has to go through a public participation process. NERSA has requested comments from the public on Eskom's application and is organizing public hearings in each province to take feedback from communities.[12]

Quasi-fiscal activities

QFAs are any activities undertaken by state-owned enterprises, at the direction of the government, in which the prices charged are less than usual or the market rate and where the shortfall in revenue is not financed by government.[13] The recent increase in the importance of balanced budgets and low levels of debt increased the incentive for government to use noncommercial activities that mask the true cost of their policies, thus artificially improving their fiscal position.[14] In light of this, it is important to analyze the activities of state-owned enterprises in South Africa as they are the main conduit for quasi-fiscal activities.

Understanding and quantifying quasi-fiscal activities. When a public corporation conducts a fiscal activity on behalf of government for which it is not compensated, this constitutes a QFA. If the government fully compensates the entity for the cost of the activity, then it is no longer a QFA but rather a fiscal activity, because the cost of the activity is included in the government's budget. If the government's compensation is less than full, there is a remaining element of a QFA.

Governments may also use "nonfiscal" institutions to raise revenue. For example, an SOE with monopoly power may levy charges that are more in the nature of taxes and transfer the revenues to the government's budget, either directly or in the form of higher dividends over time. This is a non-transparent form of taxation that has not been authorized by the legislature. Even if the policy of charging above commercial prices is official and open government policy, it still constitutes a QFA because a nonfiscal institution is being used to conduct and finance a fiscal activity involving charging some consumers more than the commercial price and using the excess revenues to spend elsewhere.

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[12] "NERSA Calls for Public Comments on Eskom Price Increase," *Bizcommunity*, 6 November 2012, available at http://www.bizcommunity.com/Article/196/377/84801.html

[13] The government may at times impose such transactions on private-sector companies.

[14] International Budget Partnership, *Guide to Transparency in Public Finances: Looking Beyond the Core Budget: Quasi-Fiscal Activities*, 2010.

An example of this in South Africa is Transnet.[15] For a long time Transnet has used South African ports as a cash cow by levying high port tariffs in order to subsidize its loss-making operations. Historically, port tariffs in South Africa were increased to support the country's import substitution strategy, and, to date, they are still built into the current port tariffs. The artificial increase in port tariffs has continued with the present government. For example, port tariffs for container vessels in Durban, South Africa's second-largest port in terms of cargo handled, are twice as high as the average tariffs for 12 international ports.[16] High port tariffs therefore act as a concealed import tax. This concealed tax also acts as a nontariff barrier to trade, and as such Transnet is to some extent used as a trade policy instrument. The high tariffs came to light in 2011 after industry lodged complaints. The Ports Regulator of South Africa commissioned a port benchmarking study that looked at global port tariffs compared with those of South African ports. At the time Transnet National Ports Authority had requested a port tariff hike of 18.06 percent. Informed by the results of the study, the regulator subsequently ruled that a tariff increase of 2.76 percent was reasonable for the 2012-2013 tariff year.[17]

Another area in which noncommercial transactions are conducted is cross-subsidization in the provision of electricity. The cost of supplying electricity invariably differs significantly from one customer group to another. The cost of supply to small rural users can be up to five times higher than to urban users (Eberhard, 2001). Extension of the electricity grid into rural areas in South Africa, for example, has been funded by Eskom via implicit cross-subsidization that entailed charging tariffs below cost-recovery levels in rural areas, while recouping the losses by charging higher tariffs in urban areas.[18] This is now being funded through an annual subsidy of US$400 million.

Extension of electricity to rural areas is funded by the national government via the State electrification capital fund. Electrification funds are therefore allocated annually from the Treasury to utilities. The total average cost per connection for 2010-2011, as reported by municipalities, was R13,019.03. The Integrated National Electrification Planning (INEP) subsidizes a portion of the capital costs of connections made towards meeting the electrification targets, since electrification does not make commercial sense (at the most it can be a break-even venture). Capital subsidies have gradually increased over the years and have more than doubled in the past four years. The need to support municipalities facing funding constraints has necessitated an annual review of the subsidies. In instances where the cost per connection is higher than the approved subsidy, municipalities are expected to top up funding for those connections. However, in instances where municipalities are not able to top up, further funding can be availed from the Department of Energy on a case-by-case basis (Department of Energy, 2012).

[15] In most cases it is difficult to identify these noncommercial activities since they are not reported.

[16] Terry Hutson,"Cape Town Chamber of Commerce Looks at High Cost of Tariffs," *Ports and Ships Maritime News*, 3 November 2012,available at http://ports.co.za/news/news_2011_11_03_01.php#five

[17] Ports Regulator, "Port Tariff Application Determination Statement, 2012/13 Tariff Year," available at http://www.portsregulator.org/20122013_tariff_determination_statement.pdf

[18] "South Africa – Report on the observance of standards and codes –fiscal transparency module." International Monetary Fund, Fiscal Affairs Department, 2002.

Table 2	Subsidy Levels for 2012-2013
Type of connection	*Subsidy paid by INEP*
Rural connection	R11,000
Urban connection	R10,000
Infill/post connection[19]	R3,500

Source: "Suite of supply policy guidelines for the Integrated National Electrification Programme (INEP) 2012/13," Department of Energy, 2012.

The figures in Table 2 are subject to a 6 percent upward review in the 2013-2014 and 2014-2015 financial years and suggest that the government is not meeting the full cost of electrification in South Africa. For a rural connection, the remaining QFA is about R2,000 per connection, and this cost has to be borne by the municipalities. The remaining QFA amount for post connection is about five times greater.

Another area of cross-subsidization still currently practiced is between different customer groups. In 2001 Eskom incurred losses in its electricity sales to rural and residential customers. The total annual cross-subsidy to the two categories exceeded R1 billion at the time, and the actual figure could have been closer to R2 billion. However, there appear to be some remaining QFAs related to tariff cross-subsidization.[20] The current tariffs therefore still have some hidden cross-subsidies embedded within them.

Box 1 Case Study 1: Eskom electricity tariff cross-subsidization

For the purpose of electricity pricing, Eskom classifies different customers into different categories as shown in Table 3, which shows Eskom's subsidy flows between different customer groups. In absolute terms, users of the "Homelight" tariff – mostly in poor, recently electrified areas – receive the greatest subsidy as a tariff group, followed by the "Nightsave Rural" tariff group, and then the "Landrate" tariff group. Together with the subsidy for the "Ruralflex" tariff, this effectively means that rural farming and commercial users receive the greatest absolute subsidy. By far, the largest contribution to subsidies comes from industrial and municipal consumers on the "Megaflex" tariff and the "Nightsave Urban" tariff. Steyn concedes that although these figures give a reasonable approximation of cross-subsidies in the system at Eskom's level, the actual picture is even more complicated and becomes difficult to measure. This is because cross-subsidization exists at various levels, namely inter-tariff, intra-tariff, and geographic

[19] Infill refers to houses that qualify to be electrified through the INEP, but that were not electrified during the electrification of the respective area for several reasons such as the house not yet existing during electrification or being occupied during electrification.

[20] At present, there is no requirement for South African SOEs to disclose any noncommercial obligations imposed on them by government. This has made it difficult to identify QFAs. However, most of them come to light when the SOEs apply for tariff increases through their respective price determination processes, as they have to provide evidence for any tariff increases.

Box 2 Eskom cross-subsidies between consumer groups

Tariff Name	2003 Cost Reflective	Applied tariffs	Difference (Subsidy)	% Difference (% Subsidy)
Megaflex	10 585 346 572	11 884 259 026	1 298 912 454	10,93%
Miniflex	258 771 573	270 666 517	11 894 945	4,39%
Nightsave (Rural)	1 658 670 767	1 054 580 820	(604 089 947)	-57,28%
Nightsave (Urban)	4 275 652 733	4 948 786 829	673 134 096	13,60%
Ruraflex	644 370 777	286 143 135	(358 227 642)	-125,19%
Businessrate	164 766 075	206 079 236	41 313 161	20,05%
Homelight	1 733 518 754	1 114 153 282	(619 365 471)	-55,59%
Homepower	634 072 037	717 810 524	83 738 487	11,67%
Landrate	1 808 772 927	1 296 999 247	(511 773 680)	-39,46%

An important component of Eskom's pricing strategy is the Inclining Block Tariff (IBT) structure that divides consumption into four blocks, with the per-unit tariff stepped up as consumption increases, thereby providing a strong incentive for all households to use electricity efficiently. Given that small households generally have lower electricity consumption, the IBT therefore embodies a built-in subsidy. Currently Eskom estimates the subsidy to be about R4.5 billion for residential customers, and it is set to grow to about R6 billion in 2013-2014 (see Figure 1). Due to lack of transparency in the current tariff structure, Eskom has proposed to unbundle all cross-subsidies in the current tariffs so that they can be shown transparently. In totality, the IBT combined with below-average tariff increases has yielded subsidies of up to 42 percent for all residential customers. These subsidies are currently recovered primarily from Eskom's direct large urban municipal, industrial, and commercial customers, with the direct industrial and commercial customers making the largest contribution to Eskom-related subsidies.

Source: Grové Steyn (see footnote 20).

Figure 1 Current cross-subsidies in Eskom tariffs

Source: Eskom, "Revenue application: Multi-year price determination 2013-14 to 2017-18", October 2012.

Box 3 Justification for cross-subsidization

Eskom argues that in the absence of a national cross-subsidy framework there is need to cushion the poor in society. According to Eskom, scrapping the rural subsidies would entail an estimated doubling of the tariffs to rural customers. This could have a severe impact on already vulnerable poor households and would slow down rural electrification. The Integrated National Electrification Planning unit within the Department of Energy manages the national electrification program. Funding of the program comes from the national budget in the form of an annual subsidy of about US$400 million made available for grid and non-grid electrification projects. While cross-subsidization is important for equity reasons, there is need for careful consideration of the distortions arising from incorrect price signals. The price distortions from cross-subsidization highlight the need for transparency. However, in its recent Mid-Year Price Determination (MYPD), Eskom requested modification to the existing tariff structure and the suggested proposal intends to retain cross-subsidization as a main element of electricity pricing in South Africa.

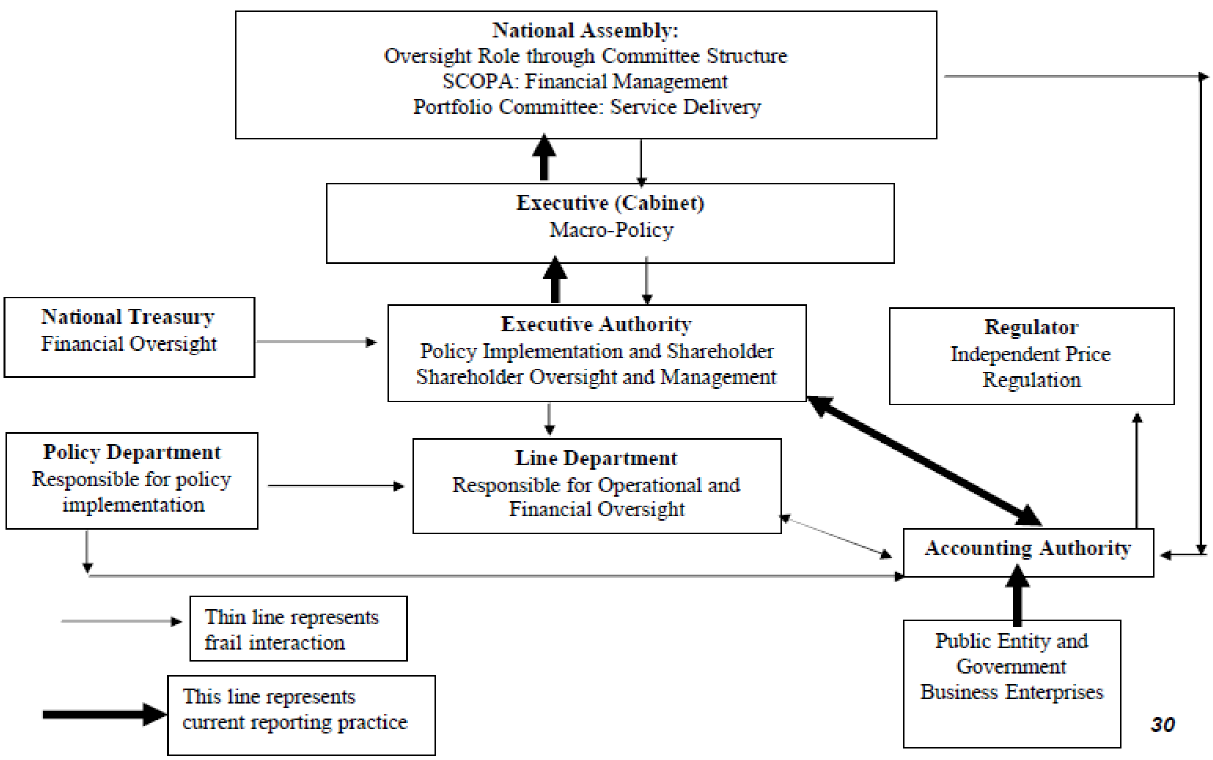
Governance Arrangements, Oversight, and Disclosure

National public entities

The 2010 Open Budget Survey gave South Africa the highest score of 92 among the ranked countries on budget transparency. South Africa's strong ranking is underpinned by a strong budgetary process that also involves the institutionalization of the Medium Term Expenditure Framework (MTEF) principles into the public financial management systems. The MTEF has become the basis of annual budget preparations and the mechanism for disclosing resource and expenditure projections to the legislature.

Governance oversight over SOEs vests in parliament, the executive branch, and the boards of SOEs. Parliament's oversight role is to evaluate the performance of SOEs by examining their annual financial statements. The relevant executive authority acts as shareholder/owner, while the National Treasury is responsible for financial oversight. Figure 2 summarizes the oversight arrangement of SOEs.

Figure 2 Oversight arrangement of State-owned enterprises



Source: National Treasury (2006)

Parliament

The parliament also exercises oversight over the national departments. The work of oversight is conducted in smaller parliamentary committees to allow proper oversight of national departments and public entities to take place.

The Committee on Public Accounts (COPA) reviews the audit reports of the Auditor General. In fulfilling this role, the committee focuses on the issues raised in SOE audit reports, financial probity as noted in the audit reports, as well as financial statements or management reports, and assesses compliance with the PFMA and Treasury Regulations. The committee also examines the issues of corporate governance of SOEs.

Portfolio committees are involved in the budget cycle and exercise oversight over service-delivery performance. They fulfil their responsibility by examining the annual reports of SOEs and analyzing the performance of the SOE in its service delivery. They are also entitled to examine the financial performance of SOEs to get a comprehensive picture of the overall performance of the SOE. Committees deal with detailed reports and can request a member of the executive and employees in departments or SOEs to provide them with any information requested. Committees have no formal decision-making powers and can only make recommendations to parliament on the matters they have considered. If the recommendations by committees are not adopted, parliament cannot take action on the recommendations they contain.

In December 2006 parliament established an independent panel to look into the efficacy and effectiveness of the oversight role it played. Panel findings suggested that parliament's oversight function could be improved in a number of areas. It was noted that due to a lack of administrative support, responses by the executive to COPA reports were not adequately tracked. The panel also found that in recent years, the oversight role of parliament was seriously undermined when COPA investigated government's arms purchases, and allegations were made that the executive interfered in the committee's oversight function. In 2009 parliament passed the Money Bills Amendment Procedure and Related Matters Act that conferred on parliament the power to amend money bills.[21] This piece of legislation theoretically strengthens parliament's perceived oversight role, although it is too early to judge the likely impact of the Act.

Executive authority

The minister responsible for an SOE's delivery of a public service is referred to as the "executive authority" in the PFMA. The executive authority is the shareholder of the SOE who has the responsibility to ensure the commercial viability of SOEs under its domain. The PFMA invests the executive authority with oversight powers through corporate plans, shareholder compacts, and quarterly reports.[22] The executive authority is supposed to ensure that all the appropriate corporate governance structures, procedures, practices, and safeguards are properly implemented and operating effectively.

[21] Money bills are passed when parliament 1) appropriates money and 2) imposes national taxes, levies, duties, and surcharges. All money bills must go through a public participation process.

[22] The table that makes up Appendix 2 summarizes the reporting requirements of entities in Schedules 2 and 3 of the PFMA.

According to the PFMA, the executive authority must ensure that:

- appropriate and effective planning and budgetary processes are in place (Section 52 of the PFMA);
- the financial management and control structures are accurate and report in a reliable and timely way (Section 51 of the PFMA);
- appropriate financial management systems and controls are in place (Section 51 of the PFMA); and
- the financial performance of SOEs is reported on in an acceptable manner in terms of the corporate plans and shareholder compact.

The executive authority typically sets the dividend policy according to the capital structure of SOEs. The dividend policy is agreed upon annually between the board and the executive authority depending on the optimal capital structure of the SOE. The dividend policy must be reported on in the corporate plan and shareholder compact.

National Treasury

The National Treasury is regarded as the protector of the National Revenue Fund, which is where annual allocations to government departments and public entities come from. The National Treasury exercises its financial oversight through drafting guidelines to promote uniformity in the way information is presented and reported on. The National Treasury must also enforce transparency and effective management of SOEs, evaluate and approve new entities, receive corporate plans and annual reports of SOEs, and prescribe information, returns, documents, explanations, and motivations as required by Section 54 (1) of the PFMA.

South African Revenue Services (SARS) is a Schedule 3 entity that reports to the National Treasury. SARS is responsible for collecting all nationally raised taxes, including income tax. All SOEs are defined by the Companies Act as State Owned Companies (SOCs) that generate income. SOEs must therefore pay the same tax rates as private companies. SOEs are also pay property rates to municipalities. However, it is not clear whether a single regimen applies equally to government property and other buildings.

Board of directors

Referred to in the PFMA as the "accounting authority," the board is the governing body of an SOE. Boards comprise a mix of executive and non-executive directors who carry the full fiduciary responsibilities defined in the Companies Act and the PFMA. The board has absolute responsibility, is fully accountable for the performance of the SOE, and is expected to provide strategic leadership to the SOE. The board is also responsible for ensuring that the SOE complies with all the relevant laws, regulations, and codes of good practice.

According to the regulations from the Department of the Treasury, the board is expected to produce an annual budget and a corporate plan that should contain the revenue, expenditure, and borrowings for the financial year and over the MTEF, and the service delivery plans of the SOE for the next three years. The budget and corporate plan must be submitted to the relevant executive authority and the National Treasury.

The board has unrestricted access to the SOE and ensures that shareholder performance objectives are achieved. The board is also expected to define levels of materiality in consultation with the executive authority to facilitate oversight.

Reporting

The PFMA and the Treasury regulations spell out the various reporting requirements for SOEs. The reporting cycle begins with the development of a corporate plan, budget, and shareholder compact prior to the beginning of the financial year. SOEs also have to produce several In-Year Reports for monitoring purposes. The SOE is expected to report on its activities for the year and the way it spent its funds in the annual report, which includes the AFS. This following section will briefly describe selected reporting requirements that SOEs must meet and reports they must file for oversight purposes. The full list of reporting requirements for SOEs is summarised in Appendix 2.

Corporate plan and shareholder compact

SOEs must submit a corporate plan to the executive authority and the National Treasury on an annual basis. The corporate plan must cover a period of three years and must include strategic objectives and targets, as agreed by the executive authority in the shareholder compact. The plan should also include a risk-management plan, a fraud-prevention plan, a materiality and significance framework, and a financial plan (Treasury Regulations 29.1, 2005).

Box 4 Typical contents of a shareholder compact

- Defining responsibilities of the executive authority, board, and management
- Governance arrangements of the SOE
- Corporate goals, objectives, and key performance indicators
- Reporting and extraordinary reporting
- Supporting documentation
- Policies
- Liabilities
- Penalties and rewards
- Third-party assessment

Source: Republic of South Africa, Department of Public Enterprises (2002). Protocol on Corporate Governance. Governance in the Public Sector. Department of Public Enterprises.

The executive authority must also conclude a shareholder compact with the SOE annually in accordance with Treasury Regulations 29.2.2. The compact represents an agreement between the executive authority and the board regarding the performance expectations. It does not replace the corporate plan, but is rather complementary to it and describes the relationship between the executive authority and the board, which identifies behavior that will support effective management. The shareholder compact comes from the Protocol on Good Governance and is meant to form the framework of objectives for the SOE to pursue in order to achieve the stated objectives and outcomes of the executive authority. The shareholder compact can draw on information contained in the corporate plan.

The regulations do not compel the executive authority or SOE to make the shareholder compact public, although there is nothing that stops either party from doing so.

Annual report

The annual report of the SOE is the main oversight instrument by which the executive authority and parliament are able to exercise due diligence. The annual report must contain a summary of objectives, indicators and targets achieved, a management report on the performance of the SOE, a report from the audit committee of the SOE, audited financial statements, and the audit report of the Auditor General. The report is backward-looking and summarizes the nonfinancial and financial performance of SOEs. The Auditor General must comment on the financial state of affairs of the SOE in the Auditor General report. Recently the Auditor General has started auditing "pre-determined objectives," commonly referred to as nonfinancial performance information. The expected disclosure requirements as stated in the Treasury regulations are the following:

- The AFS must disclose the remuneration of the Board of Directors, Chief Executive Officer (CEO) of the SOE, Chief Financial Officer (CFO), and any persons at senior management level.
- Any material losses through criminal conduct and irregular, fruitless, or wasteful expenditure must be disclosed as a note to the AFS.

The strategic plan and the approved budget for the financial year form the basis for the annual report. The executive authority or parliament may also request additional information from any of the accountability documents, including the annual report.
The Public Service Regulations (PSR) further makes provision for departments to report on human resource information in their annual reports.

Annual reports of the SOEs are not always standardized to allow for ease of comparison across SOEs. In practice, some SOEs do not present information on human resource management, while others do not consistently present information on key deliverables from one year to another, although these are requirements in terms of legislative imperatives. This makes performance tracking and oversight challenging on the side of both the public and oversight authorities.

Public participation

Access to information is a constitutional right (Section 31(1)).[23]Meetings of parliamentary committees where the reports of SOEs are discussed are open to the public, and members of the public may be invited to comment on proceedings through the permission of the chairperson. When parliament passes legislation on SOEs, the legislative process has an inbuilt public participation process whereby

[23] Aida Girna, "Effective Public Involvement in the Oversight process of Parliament and Provincial Legislatures", paper presented at the South African legislative sector Consultative Seminar, Cape Town 14-16 March 2012.

the public is invited to make written or oral submissions. The findings of these submissions are discussed by the portfolio committee, leading to the adoption of recommendations or the submission being noted (RSA, 2009b).
Despite all these safeguards, parliament and legislatures have in recent years been reprimanded by the courts and the press for not allowing active participation as required by the Constitution. Several shortcomings on the part of parliament have been identified:

- Language barriers still play a role in the effectiveness of public participation.
- It has been noted by individuals and organizations that their submissions to the portfolio committees are not taken seriously, as there is little feedback after completion of the public participation process.
- Public organizations making representations do not see their views reflected in the reports of the committees and consequently do not know if their submission impacted on policy or legislation.
- It was felt that written submissions by organizations or individuals are not read and that committees instead rely on oral submissions.
- There is also very little information available on parliament's website, such as reports, committee programs, and guidelines on making submissions.

Recent problems at South African Airways (SAA) have also called into question the way board members are elected. As the major shareholder, the executive authority has unlimited power to appoint board members. A recent media report called for the public to be part of the process of appointing board members to avoid the situation that transpired at SAA where the entire board walked out because of a rumour that the executive authority was going to change half the board without informing them or providing an explanation.[24]

The National Environmental Management Act (1998) and regulations allow assessment processes undertaken by SOEs. However, recent amendments to the act and its regulations were made to take account of strategic integrated development projects and the National Electricity Response Plan by Eskom for the public to participate in environmental impact.

The legislative provisions in the Companies Act (2008) and PFMA do not create space for the public to attend Annual General Meetings. As sole shareholder, the executive authority is expected to act in the public interest. In practice, with limited public-sector governance training and political patronage, good governance at AGM meetings is often compromised.[25]

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[24] "Agent Provocateur. Hands off our Parastatals" Mail & Guardian, 2 November 2011. Available at: http://mg.co.za/article/2012-11-02-agent-provocateur-hands-off-our-parastatals

[25] At a recent Telkom AGM, the Minister of Communications used her proxy vote to remove four non-executive directors from the board, leaving the telecommunications giant with insufficient directors to continue operating effectively. Although Telkom is partly privatized, government still owns a major stake. Telkom has been besieged with leadership problems in recent years, going through five CEOs in the past seven years (*Financial Mail*, 8 November 2012).

Quasi-fiscal activities

Why it is important to disclose QFAs?

The disclosure of QFAs is important for a number of reasons.

- QFAs are often very large, so that the actual size of government, the deficit, and public debt can be significantly understated. For instance, implicit subsidies of petroleum products due to low prices were estimated at 3.5percent of GDP on average in 1999 for a group of 15 oil-exporting countries. In Iran they were estimated at 17 percent of GDP, and in Azerbaijan at more than 20 percent.[26]
- QFAs tend to be hidden. The effects, such as losses suffered by SOEs or public banks, accumulate over time, and they can result in sudden very large increases in public debt as the government is faced with injecting new capital into an insolvent SOE or public bank or taking over responsibility for the debt of such entities. This is so because when SOEs engage in QFAs, conventional measures of borrowing requirements based on financial activities are misleading.[27] (Briceño-Garmendia et al., 2008).
- Furthermore, QFAs often involve redistribution between different sectors in society – sometimes perverse redistribution from poor to rich – and therefore need to be open to public scrutiny. They reduce accountability, both of government for fiscal policy and of SOEs and public financial corporations for the achievement of the objectives of their core business (commercial or monetary activities).

Identifying QFAs in South Africa

Most literature classifies South Africa as a country that does not carry out significant QFAs (noncommercial transactions). However, that these activities have not been identified as such is not surprising given that through its open budget mechanisms, South Africa has enabled SOEs to discontinue all the traditional forms of noncommercial transactions. The current form of QFAs is therefore nontraditional and hence not subject to easy identification. In this section, we give a detailed discussion as to how such non-traditional-QFAs can be identified in the South African context.

In South Africa, all SOEs publish annual reports giving a detailed account of their operations. Identifying discontinued transactions reported in the annual reports and the reasons for such discontinuation is one way of identifying transactions that would otherwise not fall within the mandate of such enterprises as outlined in the acts that govern their activities. SOEs normally discontinue QFAs when they are revealed. The Land Bank's Land for Development loans fall under this category (See below.)

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[26] International Monetary Fund (2007). *Manual on fiscal transparency* (Washington, D.C.: International Monetary Fund p. 24).

[27] Cecilia Briceño-Garmendia, Karlis Smits, and Vivien Foster,"Financing Public Infrastructure in Sub-Saharan Africa: Patterns and Emerging Issues," Africa Infrastructure Country Diagnostic, Background Paper 15 (Phase 1), The World Bank, 2008.

Another important issue is that transactions may be purely commercial, but may in future generate substantial losses that indirectly induce cross-subsidization. An example is the case of Eskom's Special Purchase Agreements (SPAs). A careful study of the major contracts reveals contracts that still bring above-market returns and those that are now bringing negative returns. When this is combined with an understanding of the initial reasons for entering such contracts (most of them are long-term in nature – 25 years), it would appear that on a commercial basis it would have been prudent to build a clause to allow periodic review of such contracts. Where such clauses are lacking, this raises the need for further investigation of the intended beneficiaries and the objectives of the arrangements. It often turns out that most such contracts are intended to incentivize investors. This should be the responsibility of the government through an appropriate ministry.

It also turns out that most noncommercial transactions are reported in the annual reports. While the purpose of reporting is often to justify a performance below expectation, such reporting often sheds light on the magnitude of the noncommercial transactions. The fact that they are not labeled as such means that one has to understand the objective of such activities, most of which can be efficiently imported into the budget. An example is Eskom, where losses from the SPAs were given as losses from "embedded derivatives." This calls for a detailed analysis of the annual reports of SOEs, as such terminology does not give the full details of the transactions involved and the resultant implications on the enterprise's financial position.

Case Study: LABSA

This section discusses the governance arrangements of the Land and Agricultural Bank of South Africa (LABSA).LABSA is an agricultural financial institution and was established under the terms of the Land and Agricultural Development Bank Act (No. 15 of 2002). It has been the leading agricultural financier in South Africa since its inception in 1912. The Land Bank offers tailor-made financial services to established and emerging farmers. Since its beginning, the Land Bank has gone through various transformations. From its 1912 until 1936, LABSA provided mortgage loans to emerging and commercial white farmers. The government provided funding and put in place a number of institutional support mechanisms to augment LABSA's services. With recommendations from the 1997 Strauss Commission's Report on Rural Finance, the Land Bank received a new mandate to de-racialize the agricultural sector and bring farmers from previously marginalized groups into the mainstream of South Africa's agricultural sector. LABSA is wholly owned by government: the Department of Agriculture and Land Affairs was the shareholder until 14 July 2008, when administrative control and shareholding shifted to the National Treasury. The Land Bank is also the sole shareholder of the Land Bank Insurance Company (Pty) Ltd which provides insurance products to its clients.

Objectives and functions

The business of LABSA is to provide agricultural and rural financial services to clients in South Africa. The Land Act (2002) identifies 11 objectives for the Land Bank, two of which pertain to commercial farming. The objectives are support and promotion of the following:

- Equitable ownership of agricultural land, especially increased ownership by historically disadvantaged people;
- Agrarian reform, land redistribution, or development programs aimed at members of historically disadvantaged groups for the development of farming enterprises and agricultural purposes;

- Land access for agricultural purposes;
- Agricultural entrepreneurship;
- Removal of the legacy of past racial and gender discrimination in the agricultural sector;
- Enhancement of productivity, profitability, investment, and innovation in the agricultural and rural financial systems;
- Programs designed to stimulate growth of the agricultural sector and better use of the land;
- Programs designed to promote and develop the environmental sustainability of land and related natural resources;
- Programs that contribute to agricultural aspects of rural development and job creation;
- Commercial agriculture; and
- Food security.

The Land Bank is charged with achieving these objectives by:

- providing financial services to promote ownership of land for the development of farming enterprises and agricultural purposes by historically disadvantaged persons;
- providing financial services in support of its objectives;
- facilitating and mobilizing private-sector financing for the agricultural sector; and
- providing such assistance as is necessary for carrying out the objectives of the Land Bank.

As a financial institution devoted to development, LABSA is also constantly looking for ways to support farmers and contribute to development without focusing on profit as the only motive.

Government arrangements

LABSA is classified as a Schedule 2 entity in terms of the Public Finance Management Act (PFMA 1999). It is exempt from the Banks Act (1990) except in instances where the Minister of Finance, through a declaration in the *Government Gazette*, requires certain provisions of the Banks Act to be implemented. As a public entity, the Land Bank is subject to the PFMA and is held accountable by the terms of this act. Nevertheless, in some instances, poor governance can ensue because the normal regulatory regimen is not allowed.[28] Furthermore, according to the Land Bank Act and Proclamation No.28, the Minister of Finance appoints the members of the Land Bank's Board of directors, which must consist of

[28]For example, the financial statements of the State Energy Fund, a public entity, show that it entered into a R240.7 million interest-free loan agreement with the African Exploration Mining and Finance Company. The transaction represents a restrictive horizontal practice between two state-owned entities.As such it compromises competition and contradicts the spirit of the Companies Act of 2008.

between seven and 12 members. Currently, there are 12 board members, including the chief executive officer.[29]

The board of directors is both collectively and individually accountable to the Minister of Finance and is required to direct the operations of the Land Bank and implement policies and strategies for its sound and sustainable management. The board determines the remuneration structure of LABSA, subject to labor law. Board members are required to declare material interests that might constitute a conflict. Should a board member contravene this requirement of the Act (2002), he or she may be removed by the Minister of Finance. In accordance with the Land Bank Act (14)(1), the Minister of Finance determines the remuneration, allowances, and associated benefits of all board members, including the chairperson.

The board is required to appoint an audit committee and empanel other committees to perform functions as the board directs. At the end of March 2012, the Land Bank had four working committees: audit committee, risk committee, risk credit committee, and human resource and remuneration committee, the latter being a recommendation by the King Report.

The risk management framework of LABSA was developed according to international best practice and in accordance with the King Report; however, its implementation has previously been quite poor, given the deteriorating control environment and the absence of proper policies, procedures, and accountability arrangements. The Minister of Finance approved a turnaround strategy for the Bank in 2008-2009 that has sought to institutionalize a risk-based approach to its operations.

The table that makes up Appendix 2 shows the Land Bank's reporting responsibilities as described in the PFMA. The Land Bank reports to the National Treasury as the executive authority or shareholder; the other situation occurs when the National Treasury receives information from entities, including the Land Bank, and acts on it in its fiduciary capacity as defined in the PFMA.

The Auditor General of South Africa audits the financial statements of the Land Bank and must submit a report to parliament on the financial accuracy and fair presentation of LABSA's financial statements. For the 2011-2012 fiscal year, the Land Bank received an unqualified audit, which is a significant improvement on previous years when the Auditor General picked up widespread corruption at LABSA.

Revenues and expenditures

The funds of the Land Bank consist of capital invested, funds derived from operating activities, interest earned on funds invested, parliamentary appropriations, proceeds of loans it obtained, monies received as donations or grants, and monies received as deposits. Appropriations are typically for recapitalizing

[29] Land Bank Annual Report 2012, available at http://www.landbank.co.za/investor_relations/annual_reports.php.The annual reports contain the audited financial statements, report by the board of directors, and the Auditor-General's report on the Bank. Subsequent references will be done parenthetically.

the asset base of SOEs.[30] Donor funding must be used in accordance with the conditions imposed by the donor but may not be inconsistent with the Land Act (2002). Any surplus funds that are not required for the operations of LABSA may be distributed to the state and deposited in the National Revenue Fund. Before the Land Bank distributes the funds to the State, it must receive the written approval of the Minister of Finance.

The total operating income for the 2011-2012 fiscal year amounted to R708 million, an increase of 2.8percent from the previous year.[31] Total operating expenditures increased by 14percent from the previous year and amounted to R708 million. In total, the Land Bank accrued net income of R207 million for the 2011-2012 financial year (Annual Report, 2012).

Although legislation provides for various revenue sources for LABSA, including parliamentary appropriations, LABSA has not used any parliamentary funding in the 2011-2012 fiscal year. Interest income represents the largest share of income for the Land Bank. Interest income increased from R591 million in 2010-2011 to R673 million in 2011-2012, while investment income also rose significantly from R80 million in 2010-2011 to R125 million in 2011-2012. Interest income consists of interest on loans and advances and interest from the banks.

Reporting

Given the mandate and objectives of LABSA, the following key deliverables should be reported on a regular basis to the National Treasury and contained in the Land Bank's annual reports:

- AFS qualifications addressed;
- filling of critical vacancies;
- sourcing of affordable and/or alternative funds to improve liquidity;
- collection of nonperforming loan book;
- improvement of cost to income ratio;
- financing of field crops and horticulture;
- loans to land reform beneficiaries;
- financing of female farmers;
- provision of managerial and financial skills training to rural farmers; financing of commercial agriculture; post-disbursement support to development clients; capital invested; funds from

[30]Between 2009 and 2011, the Land Bank received R3.5 billion in appropriations via a transfer from the National Treasury, converting previous guarantees that were extended to LABSA (Land Bank Annual Report, 2012).

[31]This represents roughly 3 percent of the total earnings of the four main commercial banks in South Africa. The four commercial banks combined reported a R21.3 billion in headline earnings for the 2011-2012 financial year.

operating activities; interest from funds invested; parliamentary appropriations; proceeds from loans; donations and grants; and deposits.

In addition to the outputs listed above, it is important that the indicators reported in the shareholder compact should also form part of the full set of outputs monitored on a quarterly basis by the National Treasury.

All recent annual reports of the Bank are published on its website.

Noncommercial transactions

The Land Bank's activities are subsidized by the government through the national budget. However, an appropriate pricing policy is necessary for LABSA, given that it also obtains its funding from the capital markets and has to pay market-related rates on the borrowed funds.[32] Thus it makes sense for LABSA to charge market-related rates. However, the bank is also mandated to support the government's land distribution and agrarian reform through its lending function. In order to promote the agricultural sector, the Land Bank's interest rates are therefore significantly lower than the prime lending rate. For example, the short-term (production lending) rates are 0.5 percent below the prime, while the long-term interest rate is 1 percent below the prime. The Land Bank offers concessionary funding to emerging black farmers at very low interest rates ranging between 4 percent and 8 percent.

It also remains unclear whether the bank recoups all the costs associated with its activities promoting the government's agricultural and land reform policy. For example, through its Wholesale Finance Facility (WFF), a partnership with the Department of Agriculture, Forestry, and Fisheries (DAFF), emerging farmers benefit from the more affordable rates offered. This is reported as transfers in the Annual Report for the DAFF. In the Annual Financial Statement for the Land Bank, this is indicated under Statement of Transfers or subsidies to Public Corporations and Transfers. However, there is no breakdown of what the subsidy is supposed to cover.[33]

WFF involves an interest subsidy scheme combined with capping the interest rate that emerging farmers can be charged by the intermediary. If the subsidy is not sufficient to compensate the Land Bank for this activity, then the remaining cost represents a noncommercial transaction. The Land Bank received R20 million from DAFF under the WFF to subsidize interest payable to the Land Bank. The bank receives interest of 4 percent per annum on the loans disbursed, while the farmers are charged 4 percent interest on the loans. This means that the Land Bank gets 8 percent interest from such lending (Land Bank Annual Report, 2012).The concessionary lending rates can therefore give rise to significant costs to the Bank.

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32 How much the Land Bank pays depends on its credit ratings, and these are often not very different from those of the government. So the borrowing rates might be similar.The Land Bank also received R208 million from the Department of Rural Development and Land Reform in 2011 as a guarantee for its lending to emerging farmers (Land Bank Annual Report, 2012).

33 Republic of South Africa, Department of Agriculture, Fisheries and Forestry, Annual Report 2009.

The Land Bank's nonperforming loans and impairment costs can be an indication of its performance. The size of nonperforming loans can be used to determine the extent of the Land Bank's noncommercial transactions embedded in under-collection of loans. Between 2009 and September 2012, nonperforming loans dropped from 20.3 percent of LABSA's loan book to 6.4 percent, owing mainly to collections and restructuring initiatives from its turnaround strategy (Land Bank Annual Report, 2012). During the financial year up to March 2012, the Land Bank's debt book was estimated at R1.4 billion, down from R14.9billion reported on in September 2009.

A recent scheme introduced in 2012 is the retail emerging markets scheme, which is aimed at making direct loans to emerging black farmers that the normal lending market deems high risk. The scheme affords farmers access to loans at preferential interest rates of up to prime minus 5percent, without collateral, but based instead on closely monitored business plans and operations. It is not clear if the Land Bank is fully compensated for this by government funds.

> "Between 2009 and September 2012, nonperforming loans dropped from 20.3 percent of LABSA's loan book to 6.4 percent."

While noncommercial transactions conducted by the Land Bank are prevalent, oversight is exercised regularly by the shareholders of the Land Bank, and this has helped to curb such activities. For example, during 2006-2007, the Land for Development Finance Unit (LDFU) entered into loans that were deemed to be outside the bank's mandate in terms of the Land Bank Act. These activities were identified by an independent forensic investigation by Deloitte & Touche, ordered by the Minister of Agriculture and Land Affairs and concluded in September 2007. The investigation highlighted the alleged irregularities in the origination, management, and administration of these loans. The Land Bank responded in October 2007 by placing a moratorium on the approval of any new loans and payouts on existing loans. The LDFU was subsequently discontinued in July 2008 (Land Bank Annual Reports, 2007 and 2009). Currently, a number of matters are being investigated related to historical irregularities regarding the IT system, AgriBEE and Mafisa funds administered on behalf of the Department of Agriculture, and attempted fraudulent transfer of money from the Land Bank's main bank account (Annual Report, 2012).

Case Study: Development Bank of Southern Africa

This section discusses the governance arrangements of the Development Bank of Southern Africa (DBSA). The DBSA was established in 1983 under the apartheid government as a conduit to make fiscal transfers to the then homelands in South Africa. Between 1994 and 1996, the new democratic government of South Africa streamlined the development funding system, which resulted in refocusing of the five national institutions into a reconstituted development financial system, namely the DBSA (infrastructure), the Land Bank (agriculture), the Industrial Development Corporation (industry), Khula Enterprise (small and medium lending), and the National Housing Finance Corporation (housing). In 1996 the government ceased fiscal transfers to the DBSA and required it to be financially self-financing. In 1997 the bank was reconstituted by the DBSA Act (No. 13 of 1997). For DBSA, infrastructure is broadly defined to include economic, institutional, and social infrastructure.

Objectives and function

The main objectives of the DBSA are the promotion of economic development and growth, human resource development, institutional capacity building, and the support of development projects and programs with the aim of addressing basic service delivery and unemployment in South Africa. The bank's secondary objective is to achieve an integrated financial system for development through involvement in initiatives with international, national, and regional agencies. Initially, the Development Bank tried to achieve these objectives by being predominantly a debt provider, with emphasis on infrastructure assistance to those physical and institutional infrastructure projects that could not receive funding from government, other development finance institutions, or the private sector. DBSA's lending and investment operations extend to other Southern African Development Community (SADC) countries, but with an overall exposure limit of one-third of its total portfolio. The bank's operations in SADC countries are not all guaranteed by the respective governments, nor does the bank enjoy preferred creditor status. It operates through Memorandums of Understanding (MoUs) and within the context of treaties and other bilateral agreements between South Africa and those countries.

The infrastructure projects supported by the DBSA can be roughly classified into three categories: economic, institutional, and human and socially oriented infrastructure. The economic infrastructure includes eco-tourism and enterprise infrastructure. Institutional and human support is provided based on program and project-related activities and building capacity in certain strategic focus areas. Given the developmental mandate assigned by the Constitution to municipalities and public entities, it is not surprising that this sector forms the DBSAs largest client base in South Africa. In 1996 DBSA established its private sector partnering for development projects. This is one of its fastest-growing parts of the business.

The instruments the DBSA provides to support infrastructure development are:

- making direct loans available for infrastructure at market-related interest rates;
- taking an equity stake in infrastructure development where appropriate;
- providing guarantees, where appropriate, to leverage private-sector support by reducing the perceived risk of investment;
- acting as a merchant bank to package risk appropriately, as well as the consequential investment and returns, in close collaboration with the private sector, government, and other agencies; and
- providing technical assistance, both financial and expertise, to clients and potential clients in order to build capacity, thus maximizing the development impact of infrastructure investments e.g., economic programming and policy development support, financial modelling such as the CSM and DCSM integrated environmental management capacity, and the establishment of billing and collection systems).

DBSA also assists its clients through its Development Fund, a non-profit company, to address sustainable capacity building at municipal level and to support municipalities in enhancing service delivery and local economic development. The main objective of the fund is to maximize the impact of development finance through grants that address various constraints on rural and urban development.

While the objectives and mandate of the Development Bank are clearly developmental, tensions exist between the need to keep favorable credit ratings and the need to deliver developmental outcomes, such as combating poverty and creating employment. Thus the challenge is the need to strike a balance between investments with high returns and less secure and less attractive investments in pursuit of government's developmental agenda.

Governance arrangements

Governance of DBSA is discussed in Sections 5-10 of the DBSA Act. Ten to 15 directors are appointed by the Minister of Finance and are responsible for controlling the business of the Development Bank and directing its operations. Drawing on the 2008-2009 annual report, the DBSA had 13 members from the private sector and two from the public sector, indicating the arms-length transaction of the South African government as the shareholder of the bank.[34] The board is assisted in its oversight responsibilities by functionally allocated subcommittees, such as the Audit Committee, Credit Committee, Knowledge Strategy Committee, and Remuneration Committee. The Audit Committee (AC) is a statutory requirement of the PFMA regulations. The chairperson of the AC must be independent and cannot at the same time be chairperson of the board of directors. DBSA is classified as a Schedule 2 entity in terms of the PFMA and has its own board, also referred to as the Accounting Authority in the PFMA. The Accounting Authority is directly responsible to the executive authority (shareholder), which in the case of the DBSA, is the National Treasury. The table in Appendix 2 describes the DBSA's reporting responsibilities as described in the PFMA. The DBSA reports to its parent department (i.e., the National Treasury) in its capacity as the executive authority or shareholder; the DBSA's other responsibility lies in its fiduciary role as defined in the PFMA. The chart below represents the structure of the DBSA and shows the various committees that constitute the board and the executive committee of the bank.

Figure 3 The Development Bank of Southern Africa at a Glance

Source: www.dbsa.org

[34]The annual reports for the past two financial years were not published on the DBSA website, although in terms of the PFMA (1999), the DBSA is expected to do so.

Revenue and expenditures

The Development Bank received capital equivalent to R3.79 billion from the South African government in 1994. Since then, it has received no further funds. However, the bank is negotiating with the National Treasury to recapitalize it by increasing callable capital to R20 billion. If this is done properly, DBSA will be able to provide over R100 billion in additional loans within three to five years. The National Treasury has already approved a global guarantee of R15 billion on DBSA's balance sheet to help meet future demand.

Interest income represents the largest share of revenue for DBSA (79 percent in 2009). This income increased by 18 percent from R2.85 billion in 2008 to R3.3 billion in 2009. The increase is mainly the result of a growth in disbursement due to increased demand for infrastructure spending. However, interest income dropped marginally as a share of total income from 80 percent in 2008 to 79percentin 2009. This drop reflects a squeeze on interest margin caused by competition, the increased cost of borrowing due to a general increase in market liquidity, and an increase in investments in equity, which yielded capital gains and dividends, but not interest income.

Total assets of the Development Bank increased by 21 percent from R33 billion in 2008 to R40 billion in 2009. Development loans represent the largest share of total assets and increased by 26.5 percent from R23.3 billion in 2008 to R29.5 billion in 2009. The municipalities are the largest beneficiaries of development loans and also represent the largest client sector for the Bank in South Africa. Investment securities decreased by 12 percent from R2.9 billion in 2008 to R2.55 billion in 2009.

The liabilities of DBSA increased from R17.5 billion in 2008 to R23 billion in 2009, representing a 32.5 percent increase. Medium- to long-term debt securities make up the largest share of liabilities at 64 percent, followed by the credit funding lines at 26 percent.

Reporting

Given the mandate and objectives of DBSA, the following key reports must be produced by the bank and submitted to the shareholder (i.e., the National Treasury):

- monthly reports;
- quarterly performance reports;
- annual financial statements; and
- annual report, including audited financial statements.

Currently, there are no indications whether quarterly performance reports are submitted to the National Treasury. Targets in the annual report are also not disaggregated by quarter. There is no evidence of a shareholder compact between the Development Bank and the National Treasury. It appears that performance is assessed based on the corporate plan. While this is a necessary requirement of the PFMA, it does not replace the need for a shareholder compact.

Quasi-fiscal activities (noncommercial transactions)

Since DBSA is a financial institution, its quasi-fiscal activities would be mostly in the form of directed lending to specific clients or at subsidized, lower-than-market rates; provision of credit to other government-owned entities(e.g., SOEs) on easier terms than to similar private companies; and capital transfers between different SOEs as a means of cross-subsidization. For example, DBSA recently approved a R15 billion structured facility loan agreement to the national electricity enterprise, Eskom, another state-owned entity, for its capital expansion project and has also availed funds to Transnet in the past.[35] This funding is reported in the DBSA 2010-2011 and 2011-2012 annual reports. The loan was advanced at an interest rate of 10.13 percent.

DBSA makes use of borrowed money from the market (about 70 percent to 80 percent of its funds are borrowed from the domestic market) and therefore should be entitled to charge market-related interest rates on its loan advances. This is important since unlike other banks, DBSA does not accept deposits from the general public, while it also does not get the funds from the government. However, DBSA admits to advancing loans to poor municipalities at a significant discount.[36] This is necessary since poor municipalities face a challenge in raising funds on the open market because of their inability to guarantee repayment, and therefore advancing loans to them is in line with the mandate of DBSA. However, in most instances, DBSA subsidizes the non-recovery of the interest and recovers only the principal of the loan. For example, the South African government pays about 70 cents in every R1 of costs, while DBSA covers the other 30 cents.[37] In such a case, DBSA is not able to recoup all the costs associated with advancing the loans, and so there is a remaining noncommercial transaction from its activities in addition to the sacrificed potential earnings from interest. In most cases, government's subsidy contribution is reflected as a transfer in the national budget, but what this would be spent on is not indicated, and in most cases the annual reports for the SOEs do not indicate how the transfers are used. There is therefore a strong need for more information to be reported for transparency and accountability.

Eskom

In 1923 Eskom was established by the South African government as the Electricity Supply Commission. In July 2002 it was converted into a public, limited liability company, wholly owned by government. Eskom supplies approximately 95 percent of South Africa's electricity, and its electricity exports make up approximately 45 percent of the electricity used in Africa. The distribution of electricity is done partly by Eskom (45 percent of all end-users in South Africa), and the rest is distributed by redistributors including municipalities that factor in their own mark up on the price. In 2005 Eskom embarked on the largest capital expansion program in South Africa, estimated at R340 billion. It is expected to add 17 gigawatts of electricity to the national grid by 2018-2019.

[35] DBSA) and Eskom,"DBSA Supports Eskom's Build Programme with a R15 Billion Loan," Joint media statement by DBSA and Eskom Holdings Ltd, 2010, available at http://www.dbsa.org/Mediaroom/Documents2010/2010.11.4percent20DBSApercent20percent20Eskompercent20mediapercent20releasepercent20abf.pdf

[36] The South African municipal sector constitutes 50 percent of DBSA's loan book. DBSA uses a different rating methodology for SADC countries, resulting in different rates being charged in these two different markets. While a higher rate for the SADC market can be justified by the level of risk involved, it is not clear how DBSA offsets the losses that it makes in the South African market. Understanding such operations is crucial in order to identify any cross-subsidization between the two markets.

[37] This was disclosed by Mr. Paul Baloyi, Chief Executive Officer, Development Bank of Southern Africa, in his 2009-2010 Annual Report, brief before a parliamentary committee (Parliamentary Monitoring Group, 2011).

Governance arrangements

Beginning 1 July 2002, Eskom was converted from a statutory body to a public company as Eskom Holdings Limited, under the terms of the Eskom Conversion Act, No. 13 of 2001. The two-tier governance structure of the Electricity Council and the Management Board was replaced by a Board of Directors.

With the exception of certain clauses, which Eskom is exempted from, the public utility is subject to the Companies Act (2008), which governs the operations of all private firms in South Africa. While not ideal from a governance point of view, the Companies Act contains checks and balances to ensure that this exemption is not exploited.[38] The Conversion Act states that the minister of a State enterprises must enter into a shareholder compact which must take into account the developmental role of Eskom, the promotion of universal access to and provision of affordable electricity, the cost of electricity, financial sustainability, and the competitiveness of Eskom. The compact clarifies the respective roles and responsibilities of the board and the shareholder, setting out the circumstances when shareholder approval is required, when the shareholder needs to be consulted, and the remaining areas where the Board is duly empowered to direct the organization. Every year, the minister and Eskom agree on the performance measures and targets that must be achieved for that year.

The board is also responsible for providing strategic direction and leadership, ensuring good corporate governance and ethics, determining policy, agreeing on performance criteria, and delegating the detailed planning and implementation of policy to the Executive Management Committee (EXCO).

The board must meet quarterly and monitor management's compliance with policy and its achievements of its objectives. The board is responsible for ensuring that proper internal controls are in place and that Eskom is managed effectively.

As a state-owned enterprise, Eskom must also comply with the Code of Corporate Practices and Conduct, contained in the King Report on Corporate Governance III, as well as the Protocol on Corporate Governance in the Public Sector 2007. Eskom states in its annual report for 2012 that most of the guidelines in the King III report were adopted, except the ones that cannot be adopted due to the public nature of the entity.

Revenue and expenditures

Eskom's net profit for the year to end of March 2012 was R13.2 billion, up from R8.4 billion in 2010-2011. The significant increase was due to the steep rise of 25.8percent in electricity tariffs approved by the energy regulator, NERSA. Eskom paid a total of R46.3 billion in energy tax in 2010-2011, compared with R35.8 billion in 2011-2012, which includes an environmental levy of R6.2 billion paid to the State.

Electricity debtors increased from R11.5 billion in 2010-2011 to R14.6 billion in 2011-2012, largely as a result of private consumers. Total assets increased from R328 billion in 2010-2011 to R382 billion in

[38] The Companies Act (2008) states that any exemptions must be gazetted by the relevant minister after consulting with the Commission on Companies and Intellectual Properties. The Companies Act further states that these exemptions can only be issued if the regulatory scheme governing Eskom achieves the objectives of the Companies Act; otherwise exemptions must be subject to limitations necessary to achieve the purpose of the Companies Act.

2011-2012. The largest share of assets is property, plant, and equipment, at around 70percent. Total liabilities also increased over the period, rising from R240 billion in 2010-2011 to R279 billion in 2011-2012. The largest share of liabilities is debt securities at 32percent and borrowing at 27percent).[39]

In 2011 and in October 2012, rating agencies downgraded South Africa's sovereign rating, which also affected Eskom's sovereign rating, which was downgraded to negative. It is not yet clear what the future impact of the rating will be on Eskom, except that it might make future borrowing more expensive, which in turn could be passed on to consumers as hefty tariff increases. The likelihood of this happening is not immediately clear as the Eskom annual report indicates that 77 percent of funding required for its capital expansion program has already been secured.

Noncommercial transactions

While Briceño-Garmendia, Smits, and Foster estimate that the hidden costs arising from Eskom's noncommercial transactions are zero, as it does not engage in any such transactions, it is important to note that in the past the range of noncommercial transactions conducted by Eskom has been difficult to identify for two reasons: namely nonreporting and their nontraditional nature.[40] Prior to its commercialization in 2002, Eskom mainly provided electricity to rural areas at a lower price than to urban areas, and this form of cross-subsidization has continued in the absence of a national cross-subsidization framework. However, when there is transparency in a SOE's transactions, this can help in analyzing its activities. For example, in 2012 Eskom disclosed in its annual report that its supply of electricity to certain large energy-intensive mining companies through Special Purchasing Agreements (SPAs) was below cost. These SPAs were brokered as part of South Africa's industrial policy strategy to attract direct foreign investment through cheap energy in the 1990s. This was at a time when Eskom possessed excess capacity in its national grid. Low electricity prices were then seen as a quick route to guarantee South Africa a competitive advantage to attract foreign capital investment, create jobs, and improve the country's external position through the resultant increased exports. The beneficiaries included international corporations such as BHP Billiton and Anglo American.

At present, the structure of the SPAs has resulted in BHP paying as little as 8.8c/kWh-10c/kWh at a time when the average price for electricity is 120c/kWh.[41] The implication of this is that other electricity users are effectively subsidizing the large international corporations. Given that the SPAs emanate from the government's policy of industrialization and that Eskom is not compensated for this loss, this makes the SPAs a special form of subsidy Eskom is paying to the large mining companies for which it is not compensated by government. An analysis of Eskom's revenue in 2010 showed that Eskom was undercharging industrial electricity users to the tune of R112 million.[42] While Eskom's bottom line has

[39]Eskom, "Summary of Main Performance Areas of Shareholder's Compact," 2012, available at www.financialresults.co.za/2012/eskom_ar2012/integrated -report/shareholders-compact.php

[40] Garmendia, Smits, and Foster, op. cit.

[41]Democratic Alliance MP, Pieter van Dalen, cited in Vecchiatto (2012). The exact details of the Special Purchasing Agreement are, however, not known to the public.

[42] SEECP (2010) "Sustainable Energy Briefing 22: BHP Billiton, Oil and Eskom Revenue". Earthlife Africa. Available at www.earthlife.org.za/wp-content/uploads/2010/12/Sustainable-Energy-Briefing-22-Dec-2010-FINAL.pdf

improved, this is due to increased tariff rates from redistributors, residential, commercial, and agricultural users. The SPAs are recorded as embedded derivatives in Eskom's annual reports.

Box 5 Eskom Case Study: Special Purchasing Agreements

Eskom previously entered into four agreements with electricity-intensive customers to supply electricity to them. The revenue for these contracts was based on commodity prices, foreign currency rates, and/or foreign production price indices. The present value of these prices gave rise to differences when compared with the present value of the forecast revenues if the standard megaflex tariff rate was charged.

In terms of IFRS the difference needs to be accounted for on the balance sheet as either an asset or liability, with the resultant movement being credited or charged to the income statement.

Original intent. In the early 1990s large electricity contracts with specific pricing arrangements were concluded between Eskom and major clients. A consultative process was followed between government, the customers, and Eskom in setting up these contracts. The contracts were approved by the relevant council governing the industry at the time. The rationale for entering into these contracts was fourfold: to stimulate the economy; to use Eskom's excess capacity; to supply electricity to energy-intensive industries and align with their pricing requirements; and to align with the government's growth objectives for the SADC region.

Contract performance. Since its beginnings and up until recent years, the contracts have delivered revenues in excess of cost and enabled Eskom to use its excess capacity. However, due to the decrease in the aluminum price during 2009, coupled with the 31 percent increase in tariffs given by NERSA, valuation of the embedded derivatives at the end of March 2009 showed a loss of R9.5 billion. As a result of the current negotiations and the expected outcomes of such negotiations, the net liability of the embedded derivatives has reduced to R4.6 billion as of the end of March 2010, resulting in a gain in the income statement of R2.3 billion.

Going forward. Eskom is renegotiating contracts in an attempt to remove the commodity-linked pricing element, which will in turn remove the embedded derivative. Eskom will not be entering into contracts of such a long term in the future. The pricing arrangements on the contracts may give rise to profits or losses on the fair valuation of embedded derivatives in the future.

Source: Eskom (2010).

Similar to all other State-owned enterprises, Eskom is also mandated to assist the government in fulfilling its local economic empowerment initiatives through affirmative procurement. Affirmative procurement means that price is no longer the sole criterion in procurement. The costs of affirmative procurement include longer tendering periods to secure procurement from designated groups, training on emerging businesses, and administrative costs to do with policy enforcement.[43] To this end, Eskom has the additional obligation of supporting the electricity supply and value chain of the economy aimed at creating new jobs and industries. For example, between 2001 and 2005, Eskom procurement from black-owned enterprises totaled R27.6 billion.[44] Given that alternative cheaper procurement channels exist, procuring from uncompetitive suppliers in the name of empowerment has cost implications that Eskom is not compensated for.

Overall Findings and Conclusion

The findings of this report suggest that the institutional, legislative, policy, and governance infrastructure of SOEs is very well developed and sets the basis for active oversight by parliament and the executive authority. Yet, despite this sophisticated and at times elaborate oversight regimen, SOEs are still struggling to remain viable entities, as the recent South African Airways crisis revealed. SAA is expected to register a loss of R1.2 billion in the 2011-2012 fiscal year. The CEO, the chairperson of the board, and several board members have also stepped down, creating a leadership, governance, and sustainability crisis in the SOE. The question arises: What if any gaps in the oversight mechanism of government are causing the disastrous state of this and other SOEs? A backdrop to this is the current public policy debate on whether the mines in South Africa should be nationalized, with the surplus earned from mining activity funneled into social welfare projects. Furthermore, the economic recession, increased fuel prices, and the current union strikes are all negatively affecting the performance of SOEs in South Africa. Both the internal and external shocks bedeviling SOEs will force the executive authority and board of directors of SOEs to take a radical approach to make SOEs financially viable. The fine balance will be to achieve the developmental objectives that many of these SOEs are expected to attain, coupled with achieving sufficient return on their investment.

Furthermore, the present report managed to identify a range of noncommercial transactions imposed on SOEs by the government. For nonfinancial institutions, it appears that noncommercial transactions often take the form of underpricing through the extension of favorable pricing contracts, while for financial institutions, the most common forms are directed at lending and concessionary loans. In all these instances, some form of cross-subsidization is unavoidable. The report also identified lending by one SOE to another as another form of noncommercial transaction by state enterprises in South Africa. The absence of official reporting on noncommercial transactions makes quantification of the costs involved from such activities difficult, nor is it possible to quantify the remaining part of noncommercial transactions imposed on the state enterprises where they are partially compensated. In terms of a mandate to conduct such activities, the report found that in some cases noncommercial activities fall within the mandate of the SOE — but the SOE is not compensated — while in isolated cases, activities outside the mandate of the SOE have been identified. The case studies also demonstrated that nontraditional noncommercial transactions, such as those reported here, require expertise to be identified. The general public, and even the oversight bodies, often lack such expertise, which might lead to proliferation of such activities. There is therefore a need to develop such expertise.

[43] Ron Watermeyer, "The Use of Targeted Procurement as an Instrument of Poverty Alleviation and Job Creation in Infrastructure Projects," *Public Procurement Law Review*, 9 (5), 2000, pp. 226-50.

[44] "Strategic and performance plan 2009/10 – 11/12," op. cit.

However, while noncommercial transactions result in inefficiencies, not all such activities result in net a loss of societal welfare as most of the identified transactions are directed at developmental projects that have the capacity to stimulate the South African economy. However, the lack of transparency of such transactions remains a major issue and suggests the need for them to be covered by the budget.

Review of OBI Questions

In the following section, a few questions on SOEs and QFAs are suggested for inclusion in the Open Budget Index Questionnaire.

State Owned Enterprises

- Do the government's Executive Budget Proposal and Mid-Year Reviewinclude a section on the overall financial and service delivery performance of State-Owned Enterprises?
- Do the government's Executive Budget Proposal and Mid-Year Review capture all sources of revenue for State-Owned Enterprises?
    - Yes, internal and external sources of revenue are reported on in the budget documents.
    - Yes, only internal sources of revenue are reported on in the budget documents.
    - Yes, only external sources of revenue are reported on in the budget documents.
    - No, there are no sources of revenue reported on for SOEs in the budget documents.
    - Not applicable/ other (please comment).
- Do the government's Executive Budget and Mid-Year Review capture all main expenditure items for State-Owned Enterprises?
    - Yes, all line-item expenditure and program expenditure are reported on in the budget documents.
    - Yes only line item expenditure is reported on in the budget documents.
    - Yes, only program expenditure is reported on in the budget documents.
    - No, there is no expenditure reporting in the budget documents.
    - Not applicable/ other (please comment).

Quasi-Fiscal Activities

- Are quasi-fiscal activities of State-Owned Enterprises reported on in the government's Executive Budget and Mid-Year Review?
- Do government's budget documents and Mid-Year Review estimate the costs of quasi-fiscal activities among SOEs?
- In the Executive Budget or its supporting documentation, is there an explanation of the rationale for engaging in quasi-fiscal activities?

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