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Risks that contingent liabilities are posing to national budgets

A South African case study

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Acronyms and abbreviations

CEO	Chief Executive Officer
CFO	Chief Financial Officer
CRA	credit rating agency
DBSA	Development Bank of Southern Africa
DPE	Department of Public Enterprises
Eskom	Eskom Holdings SOC Limited
Fitch	Fitch Ratings Agency
GDP	gross domestic product
Moody's	Moody's Ratings Agency
NERSA	National Energy Regulator of South Africa
OCGT	open-cycle gas turbine
PIC	Public Investment Corporation
PFMA	Public Finance Management Act
RI	reportable irregularities
SOC	state-owned company
SOE	state-owned enterprise
S&P	Standard and Poor's Ratings Agency
Transnet	Transnet Holdings SOC Limited

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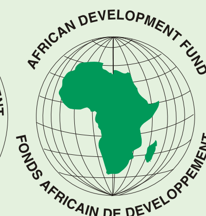


1 Context and overview

This case study on the management of contingent liabilities and oversight of state-owned companies (SOCs) in South Africa seeks to illustrate how national government finances deteriorated over time, in part due to the extent of government support provided – from a fiscal position ably placed to address the global crisis of 2008/09, to the current vulnerable fiscal position, where resources to respond to the current COVID-19 pandemic and other social needs are limited.

To illustrate the impact that SOCs had on public finances, this case study analyses the credit rating action on the sovereign (government bonds) in relation to SOCs, using Eskom Holdings SOC Limited (Eskom) and the Development Bank of Southern Africa (DBSA) as examples. The period 2008/09 to 2018/19 is analysed given the nature of government's response to the global financial crisis. A counter-cyclical fiscal policy stance was adopted to shore up domestic demand as a measure to mitigate the prevailing recessionary global economic environment existing at the time.

Budgetary risks emanating from government contingent liabilities and direct fiscal transfers (equity injection) to SOCs are highlighted. While initially used to facilitate the growing borrowing requirements of SOCs, over time these fiscal instruments were utilised to avoid a default of guaranteed SOC debt due to liquidity and solvency challenges. Eskom's Annual Reports are examined over the specified ten-year period from which various themes emerge, pointing out the potential negative consequences that contingent liabilities pose to national budgets if not well managed.

Over the period 2008/09 to 2019/20, fiscal transfers already provided to Eskom amounted to R132.7 billion. In addition, fiscal transfer commitments to Eskom over the medium term (2020/21 to 2022/23)[1] amounted to R112 billion. In 2019,[2] government committed new fiscal transfers to Eskom of R23 billion per annum over ten years (2019/20 to 2029/30), equalling R230 billion (in nominal terms). Due to the ongoing liquidity challenges at Eskom, future committed fiscal transfers were brought forward as reflected in Table 1 for the years 2019/20 to 2021/22. Therefore, with the earlier than initially committed fiscal transfers to Eskom, the number of years reduced from ten to seven.

As a result, the remaining fiscal transfer commitments to Eskom now amount to R23 billion per annum over the period 2023/24 to 2025/26, i.e. R69 billion. The total fiscal budgetary transfers already provided to and committed for Eskom over the period 2008/09 to 2025/26 now stand at R313.7 billion. When government approved total guarantees to Eskom of R350 billion[3] is added to the direct fiscal transfers of R313.7 billion, the total budgetary fiscal support to Eskom (i.e. government guarantees and fiscal transfers) amounts to R663.7 billion.

The total budgetary fiscal support to Eskom (i.e. government guarantees and fiscal transfers) amounts to R663.7 billion

1 2020 National Treasury Budget Review.
2 2019 National Treasury Medium Term Budget Policy Statement, page 16.
3 Eskom's guaranteed debt stood at R297.4 billion as at fiscal year 2019/20.

Table 1: Total government support to Eskom (guarantees and fiscal transfers)

Fiscal year	Fiscal transfers to Eskom (R' billions)	Cumulative fiscal transfers to Eskom (R' billions)	Cumulative government guarantees (exposure)[4] to Eskom (R' billions)	Cumulative fiscal transfers and government guarantees (exposure) to Eskom (R' billions)	GDP[5] R' billions	Cumulative budget support to Eskom as a percent of GDP
2008/09	10	10	0	10	2 408.7	0.42
2009/10	30	40	46.68	86.68	2 551.4	3.4
2010/11	20	60	67.1	127.1	2 825.0	4.5
2011/12	0	60	77.2	137.2	3 078.4	4.46
2012/13	0.7	60.7	103.5	164.2	3 320.8	4.95
2013/14	0	60.7	125.1	185.8	3 614.5	5.14
2014/15	0	60.7	150	210.7	3 865.1	5.45
2015/16	23	83.7	174.6	258.3	4 124.7	6.26
2016/17	0	83.7	202.8	286.5	4 419.4	6.48
2017/18	0	83.7	250.7	334.4	4 698.7	7.12
2018/19	0	83.7	285.6	369.3	4 921.5	7.50
2019/20	49	132.7	297.4[6]	430.1	5 157.4	8.34
2020/21	56	188.7	297.4	486.1	5 428.2	8.96
2021/22	33	221.7	297.4	519.1	5 759.0	9.01
2022/23	23	244.7	297.4	542.1	6 126.3	8.9
Fiscal commitments beyond the 2020/21 to 2022/23 Medium-Term Framework						
2023/24	23	267.7	297.4	565.1		
2024/25	23	290.7	297.4	588.1		
2025/26	23	313.7	297.4	611.1		
Total	**313.7**	**313.7**	**297.4 (350.0)**[7]	**611.1 (663.7)**[8]		

Source: National Treasury 2020 Budget Review

4 Eskom borrowing with government guarantee.
5 2020 National Treasury Budget Review statistical times series data.
6 Total government guarantee exposure to Eskom as at 2019/20 assumed remaining constant in subsequent years.
7 R350 billion is the total government guarantee framework to support Eskom's borrowing programme.
8 R663 billion is the total package of government support to Eskom (guarantees and fiscal transfers).

The portfolio of government guarantees to SOCs grew steadily since 2005/06 (see Figure 1). Figures 2 and 3 show the significance of Eskom guarantees in relation to the total portfolio of government guarantees, highlighting the concentration risk it poses to national finances.

Figure 2 shows the Eskom guaranteed exposure in relation to total government guaranteed exposures, highlighting the concentration risk it poses to national finances.

In addition to the size, the portfolio composition of government guarantees changed meaningfully between 2008/09 and 2018/19 (see Table 2), with Eskom representing 53.54 percent of total government guarantees in 2018/19.

Figure 1: The guarantee portfolio of the state increased steadily over the period 2005/06 to 2019/20

Source: National Treasury 2020 Budget Review

Figure 2: Guarantees to Eskom dominate the overall guarantee portfolio

Source: National Treasury 2020 Budget Review

Figure 3: Eskom guarantee risk exposure to national finances approaches R300 billion

Source: National Treasury 2020 Budget Review

Table 2: SOC guarantee exposures to the state in 2008/09 and 2018/19 (R' billions)

	As at 2008/09 Exposure	As at 2018/19 Exposure	% of total 2008/09	% of total 2018/19
State-Owned Companies	63.038	555.43	100.00	100.00
of which:				
Eskom	0.00	297.4	0.00	53.54
South African National Roads Agency Limited	6.708	39.9	10.64	7.18
Trans-Caledon Tunnel Authority	19.588	13.5	31.07	2.43
South African Airways	4.46	17.3	7.08	3.11
Land and Agricultural Bank of South Africa	1.5	0.873	2.38	0.16
Development Bank of Southern Africa	12.348	4.48	19.59	0.81
Transnet	12.895	3.8	20.46	0.68
Denel	0.88	6.93	1.40	1.25
South African Express	0.9	0.163	1.43	0.03
South African Post Office	0.4	0.00	0.63	0.00
Industrial Development Corporation	1.446	0.144	2.29	0.03
Other Entities (non-analysed)	1.7	0.8	2.74	0.15
South African Reserve Bank	0.142	0.00	0.23	0.00
Independent power producers	0.00	161.427	0.00	29.06
Public–private partnerships	0.00	8.65	0.00	1.56

Source: National Treasury 2008/09 and 2018/19 Budget Reviews

Eskom is strategically significant and one of the largest parastatals on the African continent. It is one of several SOCs benefiting from budget support in the form of sovereign government guarantees and fiscal transfers constituting a cumulative 8.34 percent of GDP in 2018/19 or R430.1 billion. Operating as a monopoly in the energy sector of South Africa, Eskom is tasked with a clear corporate and policy mandate with its core business to supply electricity to the country.

As a SOC, Eskom supports South Africa's growth and development aspirations by providing electricity to all South Africans, with mutually beneficial arrangements supporting industries such as coal mining and related industries. In the process it drives transformation through its procurement strategy, creating jobs and new industries through 'local content drive' associated with its massive capacity expansion programme. It also continually strives to improve environmental performance, including climate change mitigation.

The DBSA experienced quite different financial performance results over the same period. It is similarly tasked with a clear corporate and policy mandate in the South and Southern African infrastructure financing landscape. Lessons are drawn from these experiences (similar experiences could be drawn from other SOCs in South Africa) to chart a way forward for improved effectiveness of contingent liabilities' risk management practices for a more sustainable fiscal trajectory of national finances in South Africa.

Government's response to the 2008/09 global financial crisis, triggered by the sub-prime housing market in the United States, was to adopt a 'counter-cyclical' fiscal policy stance supported by a healthy fiscal position prior to the crisis. This involved significantly increasing government expenditure in public sector infrastructure with large financial allocations to SOCs. The objective of this policy position was to stimulate the economy (and domestic demand) given the global recessionary environment due to the crisis. Boosting public sector expenditure when fiscal finances are healthy, supported by improving sovereign credit ratings by the major credit rating agencies (CRAs) prior to the crisis, was justified.

The fiscal policy stance at the time included a concerted government effort to utilise state guarantees to keep the cost of public sector infrastructure financing as low as possible. This stance was adopted mindful that SOCs under normal circumstances should operate on the strength of their own balance sheets. Prior to this view, the National Treasury and the Asset and Liability Management Division insisted on the SOCs raising funding in the bond market without the use of state guarantees. A 'guarantee fee' is charged on the amount borrowed by the SOC, which introduces an element of financial discipline leading to greater operational efficiencies. This indeed was evident at the time. The amount drawn on government guarantees reduced from R84.7 billion in 2001/02 to R64.5 billion in 2007/08.[9]

From no guarantee exposure to Eskom in 2008/09, government's exposure to Eskom increased to R46.6 billion in 2009/10. With increasing levels of guarantees and fiscal transfers provided to Eskom and other SOCs, initially to support their planned infrastructure borrowing requirements, gradually deteriorating SOC credit risk profiles started impacting national finances negatively.

Today, all the major CRAs rate government sovereign bonds as 'sub-investment grade' (also referred to as 'junk' status). The dire financial state of many of the SOCs has significantly contributed to the current unsustainable state of national finances. While in 2008/09 Eskom's international credit ratings by the major CRAs – Moody's Ratings Agency (Moody's), Fitch Ratings Agency (Fitch) and Standard and Poor's Ratings Agency (S&P) – were rated above the South African sovereign rating, today all national corporate issuers in the bond market and the sovereign are rated sub-investment grade.

The dire financial state of many of the SOCs has significantly contributed to the current unsustainable state of national finances

9 2009 Budget Review, page 85.

2 Government debt and contingent liability management in South Africa

The South African fiscal position of 2008/09 compared to 2018/19

The state of readiness in 2008/09

Government's response to the global financial crisis in 2008/09 was to adopt a counter-cyclical fiscal policy stance. It included a significant public sector infrastructure investment programme of R787 billion.[10] The two sectors identified as the major drivers of this programme for the delivery of economic infrastructure were the transport and energy sectors. The social infrastructure investments that formed part of this programme were financed on-budget. In 2008, provisional capital investment plans for Eskom were estimated at R342.9 billion, with the focus on electricity generation. For Transnet Holdings SOC Limited (Transnet), a SOC in the logistics and transport sector, the provisional capital investment plans were estimated at R78 billion, with a focus on rail infrastructure and rolling stock.[11]

The shareholder department for both Transnet and Eskom, namely the Department of Public Enterprises (DPE), was tasked to review the provisional capital investment amounts to ensure that the financial sustainability of these entities was not jeopardised in the process. The DPE had at its disposal the following instruments to monitor and ensure effective execution of this ambitious and critical public sector infrastructure investment programme:[12]

- An integrated strategic financial model for all SOCs listed under Schedule 2 of the Public Finance Management Act (PFMA) to ensure that realistic capital structure targets were set, allowing for various funding alternatives to be assessed.
- A Capital Structure and Dividend Policy developed by government to monitor the large infrastructure investments and their impact on affected SOC balance sheets.
- A best-practice template for benchmarking of SOC treasury operations.
- A review of the development finance institutions landscape in South Africa with the objective of ensuring optimal operational efficiency.

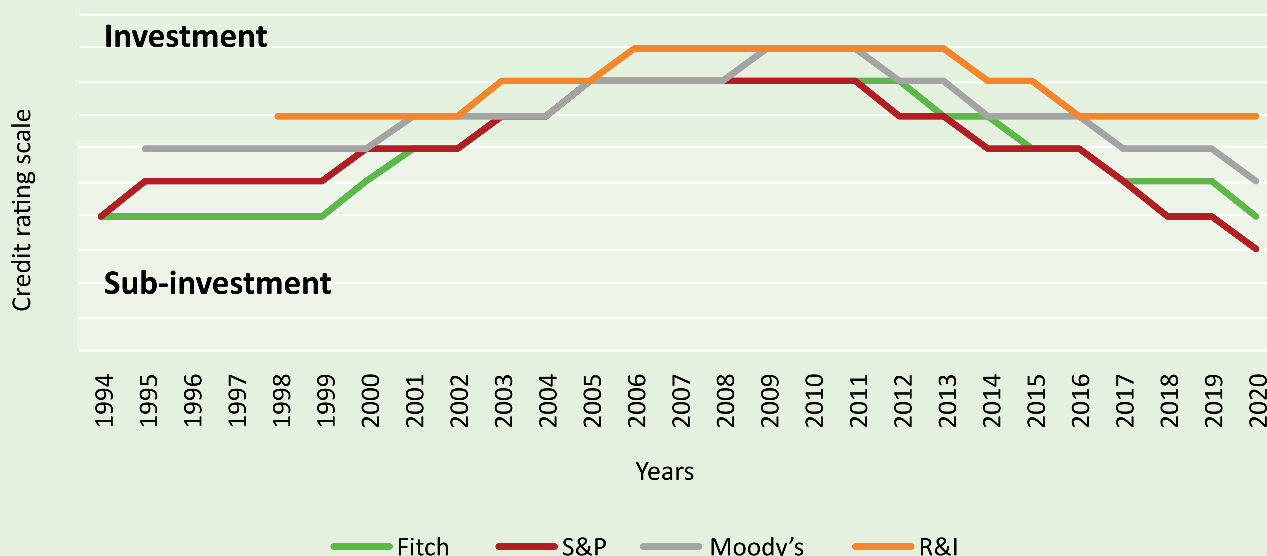
The systemic effect of sovereign credit ratings

Figure 4 illustrates the direction of credit rating action by the major ratings agencies on South African government bonds since 1994. Analysing the credit rating action by Moody's Investors Service on South African sovereign bonds during rating downgrades, two distinct periods can be characterised between 2009 and 2020. Between 2009 and 2014, sovereign credit rating downgrades in the main are attributed to unsustainable government expenditure commitments linked to the counter-cyclical fiscal policy stance and multiple requests for financial support from SOCs. Between 2014 and 2020, fiscal commitments to SOCs generally, and to Eskom in particular, weighed heavily on sovereign credit ratings. Sovereign credit rating downgrades and changes in ratings outlook during this period were always followed by corresponding downgrades and ratings outlook changes of South African corporates.

Between 2014 and 2020, fiscal commitments to SOCs generally, and to Eskom in particular, weighed heavily on sovereign credit ratings

10 2009 Budget Review, page 71.
11 2008 Budget Review, page 90.
12 2008 Budget Review, page 90.

Figure 4: Credit rating landscape in South Africa



Source: Fitch, S&P, Moody's and R&I credit ratings agencies

2008–2011: Rating action on Eskom, DBSA, sovereign rating and South African banks

In 2008, Eskom's credit rating was downgraded to Baa2 on concerns about the size of the public sector infrastructure investment programme.[13] At the time, government had reservations in this regard and therefore identified various risk mitigation instruments.[14] During this period, cognisance must also be taken of the role required of the DBSA, given its infrastructure financing mandate in Southern Africa. The DBSA's A2 credit rating remained in place while that of Eskom was downgraded. The DBSA credit rating was placed on review for a possible downgrade only on 7 September 2009.[15]

On 16 July 2009, Moody's Investors Service upgraded the South African government foreign currency rating to A3 from Baa1. This was the outcome of unifying the local and foreign currency ratings. This upgrade is also attributed to an increase in official foreign currency reserves and good debt management practices that benefit from South Africa's deep domestic capital markets. The rating analyst at the time stated that 'South Africa's growth has been more resilient to the global crisis than many other countries at the same rating level'.[16] An A3 rating was assigned to South Africa's US$2 billion bond issue on 4 March 2010, 'which carried the lowest interest rate ever paid in the dollar market'.[17]

While the sovereign rating was upgraded in 2009, five South African banks were downgraded on 12 November 2009[18] owing to 'the impact of deteriorating operating and macro conditions on the banks' financial fundamentals'. At the time, Moody's stated that, 'in the case of South Africa, the anchor used for measuring the ability of the government to provide systemic support is now the government bond rating of A3 plus two notches, resulting in an A1 input'. This result – the bank's rating versus the sovereign rating – is indicative of the strength of the sovereign bond credit rating at the time.

A Moody's announcement on 17 June 2011 stated that 'government's budget plans involve a substantial increase in outlays on job creation programmes'. These plans were considered important by the rating agency given the country's high unemployment and poverty levels. However, during this announcement, the rating agency stated that 'government debt dynamics are currently not on a favourable trend, which is a significant shift compared to the decade leading up to the 2009 recession'.[19]

13 Government's counter-cyclical fiscal policy stance referred to earlier in this report.
14 Referred to earlier in this case study.
15 DBSA credit rating was downgraded to A3 from A2, one year after Eskom got downgraded.
16 Moody's Investors Service: 'Rating Action: South Africa's foreign currency rating upgraded to A3; local currency rating lowered to A3'.
17 Moody's Investors Service: 'Rating Action: Moody's assigns A3 rating to South Africa's $2 billion bond issue'.
18 Moody's Investors Service: 'Rating Action: Moody's downgrades BFSRs (bank financial strength ratings) of five South African banks'.
19 Moody's Investors Service: 'Announcement: Moody's issues annual report on South Africa'.

2012–2014: Five South African banks, Eskom and the DBSA are downgraded due to constrained public finances

While maintaining the A3 rating on sovereign bonds, Moody's downgraded the rating of five South African banks on 28 February 2012[20] citing 'the impact of the country's increasingly constrained public finances'. Furthermore, Moody's was of the view that the 'authorities would face challenging policy choices if multiple institutions were to need its financial support at the time'. This is indeed what transpired, as reflected by multiple requests for government support from the SOCs, as shall be seen in subsequent parts of this case study.

On 27 September 2012, Moody's downgraded South Africa's rating to Baa1 from A3 with a negative outlook, citing one of the key drivers being 'shrinking headroom for counter-cyclical policy actions, given the deterioration in the government's debt metrics since 2008'. A further 'driver' cited as a rationale for the rating downgrade was 'the more negative investment climate, which has been aggravated in recent years by shortfalls in energy, transportation and other infrastructure as well as high labour costs relative to productivity'.[21]

The negative outlook was maintained on 17 July 2013 citing, amongst others, 'the weakened outlook in the mining sector, which is the country's largest employer and source of foreign-exchange reserves'. The rating agency further stated that the country's gold mines were becoming less feasible due to rising costs of production.[22] In this regard, it is important to appreciate the significant negative impact of unreliable energy supply (due to intermittent load-shedding) and rising energy costs (due to high tariff increases) on the global competitiveness of the mining sector in South Africa.

During the period 2012 to 2014, the sovereign rating was downgraded from A to Baa2,[23] for Eskom, from Baa2 to Ba1[24] and for the DBSA, from A3 to Baa2. This implies that the sovereign and the DBSA credit ratings respectively were downgraded at the same time and remained at investment grade credit rating status during this period. For Eskom, however, the credit rating was downgraded to below investment grade credit rating status, notwithstanding the extraordinary level of government support provided prior to these downgrades.

2014: Moody's downgrades five South African banks due to the weakening of government's credit profile

On 6 November 2014, a further sovereign downgrade rating action to Baa2 (with an outlook change to stable) was announced by Moody's, citing 'structural weaknesses' that are likely to 'hold back growth for a number of years'. The rating agency acknowledged the importance of energy and transportation infrastructure as a key focus of the National Development Plan, but stated that 'energy availability will remain challenging until at least mid-2017, when substantial new electricity generation capacity will come fully on stream'. As a further reason for the downgrade to Baa2, Moody's cited 'the continued deterioration in the government's debt metrics that will occur in the next few years'. The rating agency further stated that 'the successful implementation of planned structural reforms to enhance potential growth' could see the sovereign rating being changed upward. Included amongst these reforms were 'continued restraint in public debt accumulation'.[25]

As a result of the sovereign rating downgrade, Moody's also downgraded five of the largest South African banks on 10 November 2014.[26]

2015–2016: Credit ratings of five South African banks changed to negative following the sovereign rating change

The sovereign credit rating outlook was subsequently changed to 'negative' on 15 December 2015 due to, amongst others, 'shortfalls in both human and physical infrastructure resources as well as political/policy uncertainty'. Further, the Moody's rating action stated that 'prolonged delays in constructing new power generation and transit facilities explain why South Africa was unable to boost production to take advantage of the commodity price boom in the 2000s and also why growth remains severely constrained at present'. Positively, the rating agency noted that 'electricity availability has been steadier in the second half of 2015 thanks to…the inclusion of new renewables capacity into the grid'.[27] As a result of the negative sovereign credit rating action, Moody's also announced a change in the credit rating outlook of the five largest South African banks, on 17 December 2015.[28]

A decision was taken by Moody's on 8 March 2016 to place the sovereign rating 'on review for downgrade'. A major reason cited for the review was 'the deterioration in key fiscal and debt metrics'. As part of this review, the rating agency explored, amongst others, 'expensive schemes such

20 Moody's Investors Service: 'Moody's downgrades South African banks, concluding review focusing on systemic support assumptions'.
21 Moody's Investors Service: 'Rating Action: Moody's downgrades South Africa's government bond rating to Baa1; outlook remains negative'.
22 Moody's Investors Service: 'Rating Action: Moody's affirms South Africa's Baa1 government bond ratings and maintains negative outlook'.
23 The highest credit rating achieved by the sovereign.
24 Into sub-investment grade rating.
25 Moody's Investors Service: 'Rating Action: Moody's downgrades South Africa to Baa2; outlook change to stable'.
26 Moody's Investors Service: 'Rating Action: Moody's downgrades five South African banks' deposit ratings to Baa2; outlook stable'.
27 Moody's Investors Service: 'Rating Action: Moody's changes South Africa's rating outlook to negative from stable; affirms Baa2 rating'.
28 Moody's Investors Service: 'Rating Action: Moody's changes the outlook of five South African banks to negative; affirms deposit ratings at Baa2/P-2'.

as nuclear energy'.[29] In this regard, the rating agencies had full comprehension that nuclear energy plans could only be pursued if accompanied by significant government support (i.e. contingent liabilities).

Following extensive engagements with the rating agency, Moody's subsequently confirmed South Africa's Baa2 credit rating with a negative outlook. This outcome was informed by, amongst others, 'a number of benchmark actions related to matters such as the rationalisation of state-owned enterprises (SOEs)'. Further, Moody's stated that 'it continues to assess South Africa's institutional strength as high, notwithstanding recent corruption scandals. South Africa's monetary and fiscal institutions have proven to be sound over time'.[30]

2017: Moody's downgrades the five largest South African banks following the sovereign rating downgrade

On 3 April 2017, the country was again placed on review for a downgrade by Moody's to 'assess any implications for progress on currently stalled structural reforms in strategic areas such as…reforms to enhance transparency, accountability and good governance in the SOE sector, and to remove structures that encourage rent-seeking over achievement of public policy goals'.[31]

Following this review, Moody's downgraded the sovereign rating to Baa3 and assigned a negative outlook on 9 June 2017.[32] Three 'drivers' were cited by Moody's for this downgrade, all of which involve the state of SOCs in South Africa.

Firstly, Moody's stated 'evidence of systemic weakening of the institutional framework'. It stated that 'the institutional framework has become less transparent, effective and predictable and policymakers' commitment to previously-articulated reform objectives is less certain'. Cited in this regard were commitments to 'embark on reforms of state-owned enterprises'.

Secondly, Moody's cited 'reduced growth prospects reflecting policy uncertainty and slower progress with structural reforms'. It stated that 'medium-term growth will additionally be constrained by mixed progress with structural reforms, including…the governance of state-owned enterprises'.

Thirdly, Moody's cited 'the continued erosion of fiscal strength due to rising public debt and contingent liabilities'. It stated that 'contingent liabilities linked to state-owned enterprises continue to pose a tail risk to the country's fiscal strength. Operational inefficiencies, weak corporate governance and poor procurement practices persist in SOEs, with government guarantees extended to SOEs rising. This has also increased the likelihood of contingent liabilities crystalizing on the government balance sheet. Pressures to further extend guarantees and utilise procurement practices to advance political objectives are sources of additional potential risk'.

Following the sovereign rating downgrade, Moody's also downgraded the five largest South African banks to Baa3 with a negative outlook on 12 June 2017.[33]

2018–2020: Credit ratings of the five largest South African banks are downgraded to sub-investment grade ratings and outlook changes to negative, closely following similar credit rating action on sovereign bonds

Within five months of the previous rating downgrade, Moody's again placed the sovereign rating on a review for downgrade on 24 November 2017,[34] citing that 'South Africa's economic and fiscal challenges are more pronounced than Moody's had previously assumed'. It stated that the review will assess, amongst others, 'improvements to SOE governance that contain contingent liabilities'. In this regard, it stated that 'several risks, if materialised, would lead to even faster debt accumulation than envisaged in the MTBPS [Medium-Term Budget Policy Statement]. Those include risks stemming from the existence of high and concentrated contingent liabilities to creditors of state-owned enterprises (SOEs), some of which are becoming increasingly reliant on public funding for sustaining their operations'. With this review indicating that 'with changes in governance, a number of key institutions, including the Treasury, the South African Revenue Services (SARS) and key State-Owned Enterprises (SOEs) have embarked on the recovery of their earlier strength', Moody's confirmed the sovereign rating of Baa3, changing the outlook to stable on 23 March 2018.[35]

As a result of these rating actions, Moody's similarly put on review for a downgrade of five South African banks on 28 November 2017[36] and confirmed the ratings of six South African banks on 27 March 2018.[37]

The Baa3 sovereign rating position with a stable outlook remained until 1 November 2019[38] when Moody's affirmed the rating but changed the outlook to negative from stable. This outlook change was in part motivated by 'acute financial stress for state-owned enterprises (SOEs), in particular Eskom Holdings SOC Limited (Eskom B2, negative), continues to require sizeable ongoing support from the government'. Moody's further stated that 'continued transfers to SOEs, including the planned capital support for Eskom, and a fast-growing interest bill limit the scope for spending restraint.

29 Moody's Investors Service: 'Rating Action: Moody's places South Africa's Baa2 ratings on review for downgrade'.
30 Moody's Investors Service: 'Rating Action: Moody's confirms South Africa's sovereign rating at Baa2 and assigns a negative outlook'.
31 Moody's Investors Service: 'Rating Action: Moody's places South Africa's Baa2 ratings on review for downgrade'.
32 Moody's Investors Service: 'Rating Action: Moody's downgrades South Africa's rating to Baa3 and assigns negative outlook'.
33 Moody's Investors Service: 'Moody's downgrades the five largest South African banks to Baa3; outlook negative'.
34 Moody's Investors Service: 'Rating Action: Moody's places South Africa's Baa3 ratings on review for downgrade'.
35 Moody's Investors Service: 'Rating Action: Moody's confirms South Africa's Baa3 rating and changes the outlook to stable'.
36 Moody's Investors Service: 'Moody's places on review for downgrade the ratings of five South African banks'.
37 Moody's Investors Service: 'Rating Action: Moody's confirms the ratings of six South African banks'.
38 Moody's Investors Service: 'Rating Action: Moody's changes South Africa's outlook to negative from stable, affirms Baa3 ratings'.

Meanwhile, acute financial stress for certain SOEs, including but not only Eskom, point to likely ongoing sizeable transfers and broader contingent liabilities for the foreseeable future'.

Recognising the significance of SOE governance implications for sovereign ratings and in relation to the previous administration, Moody's stated that 'the legacy that era has bequeathed of poor governance of SOEs, and of Eskom in particular, remains a key drain on fiscal resources and also weighs on South Africa's fiscal strength'. With a negative outlook and subsequent outbreak of the COVID-19 pandemic with severe negative fiscal consequences, Moody's downgraded the sovereign rating to Ba1 (sub-investment grade rating) on 27 March 2020.[39] Subsequently, Moody's also downgraded the ratings of five South African banks to sub-investment grade rating on 31 March 2020.[40]

Sovereign rating downgrades also affect South African corporates and public sector issuers in the bond market

The period 2008/09 to 2019/20 will always be associated with sovereign credit rating downgrades. These credit rating downgrades were also followed by similar credit rating downgrades of many South African corporates and other issuers in the bond market.[41] Initially, adopting a counter-cyclical fiscal policy stance with significant public sector infrastructure expenditure, pressure emerged on maintaining sustainable public finances as SOCs continued requesting financial assistance. Large direct fiscal transfers and guarantees to Eskom and SOCs generally weakened public finances as these were accompanied by an underperforming economy. With sovereign rating downgrades came credit rating downgrades of multiple corporates in the South African bond market, adding to the uncompetitiveness of the economy.

During the period 2015 to 2020, the sovereign credit rating was downgraded from Baa2 to Ba1,[42] Eskom's credit rating dropped from Ba1[43] to B3[44] and the DBSA credit rating from Baa2[45] to Ba1[46] and eventually falling into sub-investment ('junk') credit rating status on 31 March 2020. The sovereign credit rating therefore impacted on both the credit rating for Eskom and the DBSA. With sovereign credit rating downgrades or upgrades, SOC credit ratings and corporate ratings changed in a similar direction. Whenever SOCs experienced liquidity challenges, government always stepped in to provide the necessary support. This weakened public finances further especially when the SOCs were unable to utilise this support to turn their financial situation around.

The state of public finances in 2008/09 and 2018/19

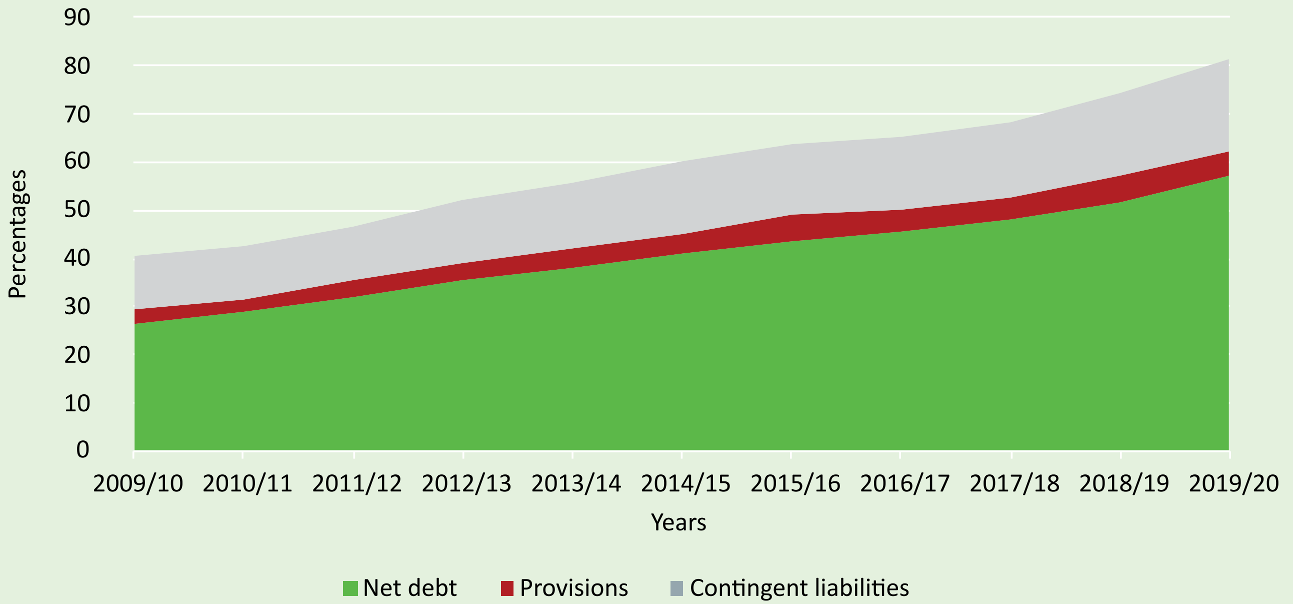
Since the first democratic elections in 1994, South African public finances have never been healthier than during the 2008/09 financial year. On a consolidated basis, the government budget reflected a surplus of 1.7 percent of GDP in 2007/08 and a negative 1 (–1) percent of GDP in 2008/09. Government's counter-cyclical fiscal policy stance fully accounts for this change. Strong economic growth and efficient revenue collection during the preceding years explain this favourable fiscal position.[47] A record low level of net government debt to GDP of only 22.6 percent and state debt cost (interest cost on government debt) to GDP of only 2.4 percent in 2008/09 was very well received in the financial markets.

The total level of contingent liabilities amounted to R160 billion in 2008/09,[48] of which government guarantees constituted R63.1 billion, representing only 39.4 percent (Figure 5). The total of net government debt, contingent liabilities and provisions (i.e. callable capital with the multilateral development finance institutions) amounted to 34.4 percent of GDP in 2008/09, aided by a public sector borrowing requirement of only 3.9 percent. These fiscal achievements, the best since 1994, coupled with key measures introduced to support the SOCs and government (budget) as the counter-cyclical fiscal policy initiatives got under way, were timely for the post-global financial crisis period ahead.

With rising levels of government debt and contingent liabilities, the cost of borrowing increased (Figure 6). Government debt levels rose, in part due to multiple requests for financial assistance by SOCs (Figure 7).

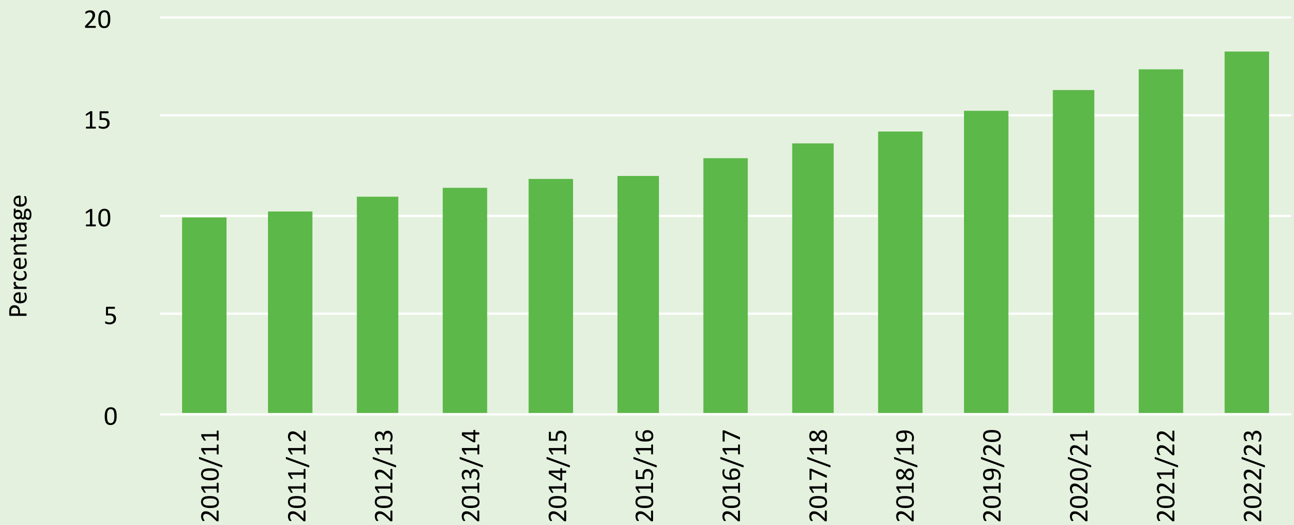
39 Moody's Investors Service: 'Rating Action: Moody's downgrades South Africa's ratings to Ba1, maintains negative outlook'.
40 Moody's Investors Service: 'Rating Action: Moody's downgrades the ratings of five South African banks following downgrade on the South African sovereign. The outlook is negative'.
41 Moody's Investors Service: 'Moody's takes rating actions on South African corporates following sovereign downgrade'.
42 Eventually falling out of investment grade rating status on 27 March 2020.
43 Already in the sub-investment grade credit rating category.
44 Deeper in 'junk' status.
45 Like the sovereign credit rating in 2014.
46 Similarly retaining its investment grade rating status as that of the sovereign rating.
47 2009 Budget Review, page 49.
48 2008/09 and 2018/19 National Treasury Budget Reviews.

Figure 5: Net debt, provisions and contingent liabilities



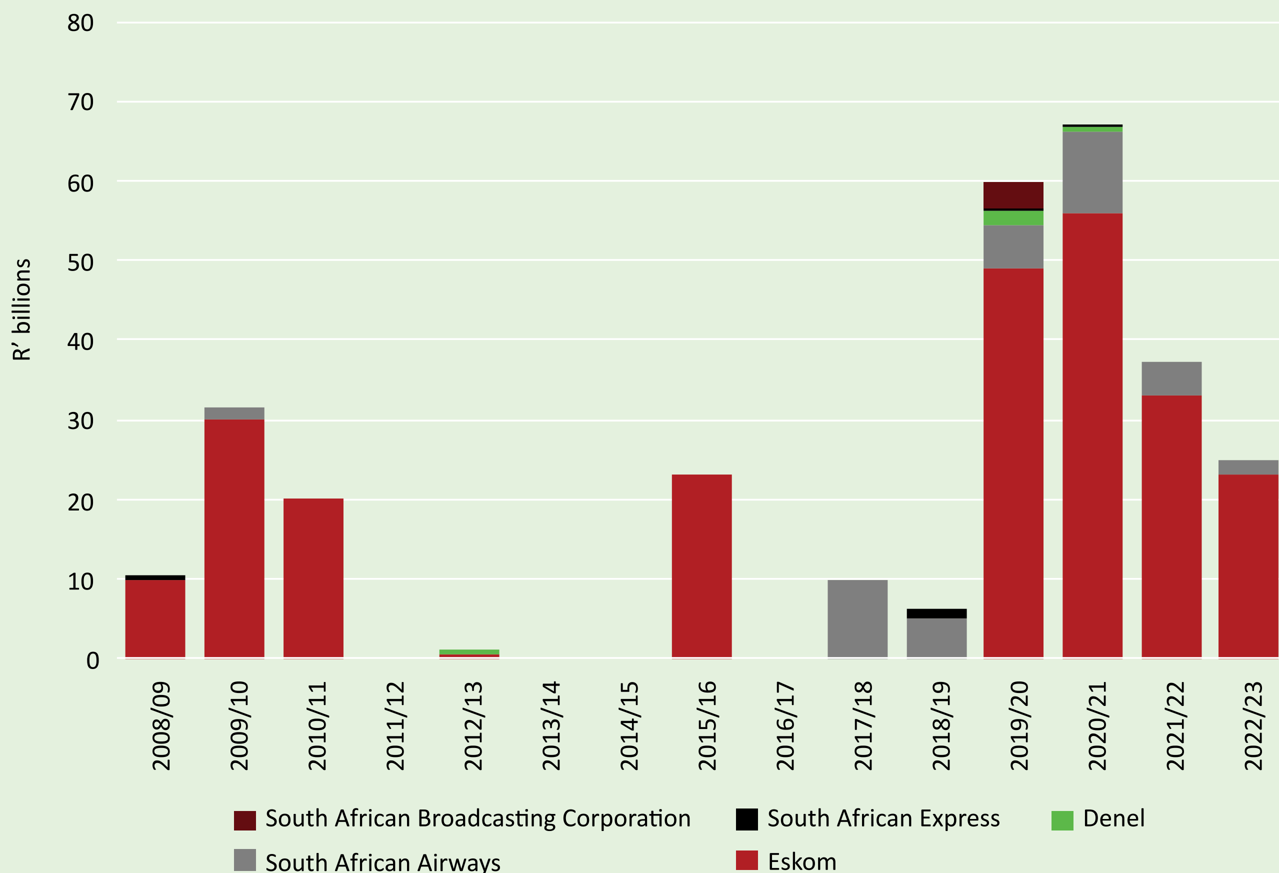
Source: National Treasury 2020 Budget Review

Figure 6: Debt service cost as a proportion of main budget revenue



Source: National Treasury 2020 Budget Review

Figure 7: Financial support provided to SOCs



Source: National Treasury 2020 Budget Review

Public finances deteriorated. This is best illustrated by comparing the 2008/09 and the 2018/19 fiscal positions, a period of only ten years.

- Net government debt to GDP increased from 22.6 percent to 51.7 percent, an increase of 128.8 percent over this period.
- Net government debt, contingent liabilities and provisions to GDP increased from 34.4 percent to 74 percent, an increase of 115.1 percent over this period.
- Government guarantees to GDP increased from 2.95 percent to 10.75 percent, an increase of 264.4 percent over this period.
- Government guarantees as a percent of contingent liabilities increased from 39.4 percent to 60.2 percent, an increase of 52.8 percent over this period.
- State debt cost to GDP increased from 2.4 percent to 3.7 percent, an increase of 54 percent over this period.

The above is a distressing change in the fiscal landscape of South Africa over a relatively short period, with rising levels of unemployment (affecting the youth in particular), growing inequalities and poverty levels deteriorating. The public in South Africa is well informed of the deteriorating economic environment and is becoming more impatient and needs to understand where the country has gone wrong. Furthermore, the public needs to know how the current weaknesses will be resolved to avoid the pitfalls that were so common over the past ten years.

3 So where did it all go wrong?

An analysis of Eskom's performance reveals the faultlines

Prior to the global financial crisis in 2008/09, Eskom had no government guarantees. This changed in 2008 when government budgetary assistance to Eskom took the form of a 30-year R60 billion, deeply subordinated loan (i.e. 'on-lending' to Eskom by government). One of the loan conditions was that interest cost on the loan (i.e. servicing the loan) by Eskom is only paid if it maintains an investment grade rating. This loan was recorded as an 'asset' on government's balance sheet and both the principal and interest cost required repayment by Eskom. Financial modelling performed at the time suggested that Eskom would become cash positive after ten years.[49] Therefore, to encourage earlier refinancing of the loan, a condition was included that the interest rate be 'stepped up' by 25 basis points after year ten.[50] Due to Eskom's deteriorating balance sheet, the loan was never repaid and later it was converted into a grant.

To further underscore the extent of government assistance to Eskom, an Act[51] was passed providing for a multi-year budget appropriation. With this Act, government committed to transfer funding to Eskom as follows: R10 billion in 2008/09, R30 billion in 2009/10 and R20 billion in 2010/11.[52] With no corresponding government revenue raised specifically to finance this additional 'expenditure' to Eskom, government debt increased in line with the committed multi-year funding transfers.

In addition, over this period (2008–2011), government also undertook to underwrite (guarantee) Eskom debt to a maximum of R176 billion initially and later it was increased to R350 billion. Initially, this included R26 billion of existing debt and R150 billion in new debt over the next five years.[53] Government exposure (borrowing against the guarantee facility) to Eskom, through state guarantees, rose from zero to R294.7 billion[54] from 2008/09 to 2018/19.

The extent of state support to Eskom unequivocally linked the 'fortunes' and 'misfortunes' of both Eskom and government finances for subsequent years. Included in the guarantee agreements of SOCs are 'cross-default' clauses, implying that a default on any of Eskom's debt, as an example, triggers a default on all Eskom debt raised within the guarantee framework agreement. These agreements are standard clauses in the SOC guarantee frameworks. Given the size of Eskom's debt, the 'lines' between guaranteed and unguaranteed debt essentially become 'blurred'. As investors increasingly rely on government to 'bail out' SOCs, the pricing of guaranteed debt versus non-guaranteed debt essentially disappears. Investors are therefore incentivised to accept unguaranteed debt, in the case of Eskom, knowing that government will not allow the entity to default on any of its debt, whether guaranteed or not. As a result, investors receive an interest rate on debt that under normal circumstances should be priced at the sovereign risk premium (less expensive to Eskom).

To avoid any possibility of a default occurring on guaranteed debt due to Eskom's liquidity situation, government has made several direct capital injections and budget support payments to Eskom to strengthen its balance sheet. South African budget financial support to Eskom included i) R23 billion from the sale of state assets; ii) R60 billion initial loan converted into a grant (direct fiscal transfer); iii) R350 billion guarantee facility; and iv) R230 billion in tranches of R23 billion annually over ten years. Throughout this period, the credit rating profile of Eskom and government bonds deteriorated markedly. The gradual weakening of Eskom's financial performance, coupled with similar developments in several other key SOCs, played a major role in the current state of public finances in South Africa, as reflected in the prevailing sovereign credit rating. Significant transfers were made from the fiscus to various SOCs, the largest by far being to Eskom, by primarily providing liquidity to avoid defaults on maturing guaranteed debt.

Fortunately, not all SOCs followed this trend. For example, in 2008/09 government's exposure to the DBSA was R12.35 billion, constituting 18.2 percent of total guarantees and 0.54 percent of GDP. In 2018/19, the DBSA guarantee exposure on government's balance sheet reduced to R4.4 billion, constituting 0.83 percent of total guarantees and 0.09 percent of GDP. Indeed, the DBSA is a development finance institution and operates in a different sector to that of Eskom. It is, however, noteworthy, that as the Executive Authority for the DBSA, the National Treasury has been able

49 Coincidentally, the period of this case study.
50 2009 Budget Review, page 85.
51 The Eskom Subordinated Loan Special Appropriation Act.
52 2009 Budget Review, page 85.
53 2009 Budget Review, pages 85 and 86.
54 2009 Budget Review, page 176, table 9 and 2019 Budget Review, page 86, table 7.9.

to perform its oversight responsibilities, in terms of the PFMA requirements, more effectively. As the Executive Authority, the shareholder, i.e. the Minister of Finance, chairs the Annual General Meetings of the Board and is responsible for the appointments of Board members.

Causes of Eskom's financial and credit rating deterioration over the period 2008/09 to 2018/19

In 2008/09, the external auditors issued an 'unqualified audit opinion' for the group with no material irregularities discovered. The group's management was stable, except for the resignation of its Chief Financial Officer (CFO) in 2008. Treasury management within the group was reviewed based on i) the simplicity and nature of the business; ii) the magnitude of current borrowings; iii) the magnitude of expected borrowings; iv) the magnitude of current cash holdings; and v) the use of external experts to assist with the treasury function. With the capital expenditure plans under way, efforts were made to upgrade the existing treasury infrastructure to meet best practice standards. A comprehensive corporate governance structure with experienced treasury professionals was utilised to manage the complex Eskom treasury activities.[55]

Challenges started emerging in 2009/10 when Eskom acknowledged the inadequacy of its 'electricity funding model', aggravated by an unreliable supply of energy. Increasing tensions between the Eskom Board Chairperson and its Chief Executive Officer (CEO) were not helpful. 'Global warming' concerns further limited future funding sources for electricity generation that required an integrated communication strategy with the markets. Such a strategy being absent, increasing reliance was put on tariff increases to finance Eskom's operations.

For the period 2010/11 to 2012/13,[56] Eskom was awarded a price determination of 24.8 percent for 2010/11, 25.8 percent for 2011/12 and 25.9 percent for 2012/13, far below the tariff increases applied for. A new CEO and a new Board Chairman were appointed in 2010 amidst growing tensions between the former office bearers in these positions. It became clear from the multi-year price determination tariff ruling, as communicated in the public domain during April and May 2010, that Eskom would face significant cumulative cash shortfalls over a seven-year period (2010–2017). In 2010, Eskom received R176 billion in guarantees to support its planned borrowing, of which R117 billion was already utilised. In mitigation, collaboration between Eskom and government (National Treasury and responsible department) intensified to i) ensure energy efficiency in commerce, energy and industry; ii) support the rollout of renewable and alternative energies; and iii) roll out solar water heaters. In support of Eskom's financing requirements, the DBSA approved a R15 billion loan facility in November 2010. This loan subsequently formed the basis for pressure on Eskom management to 'get their house in order'. The loan agreement between the DBSA and Eskom included a condition binding Eskom to maintaining a 'clean audit'. If it fails to do so, the loan can be recalled.

As the infrastructure energy build programme got under way, Eskom experienced a number of challenges during 2012, including non-payment for electricity due to tariff increases, power system crises (energy reliability concerns), increased reliance on the sovereign credit rating and uncertainty regarding future tariff increases. With falling revenues, unreliable energy supply and credit rating concerns, Eskom remained determined to 'keep the lights on'. Introducing 'coal haulage' and 'road to rail' migration and pursuing private sector participation through independent power producers, were amongst the risk mitigation strategies.

Poor coal volume performance in 2013, due to, amongst others, extended strikes in the transport and mining industries by some of the contracted mines, led to Eskom purchasing more expensive coal from the short/medium-term market. This, coupled with operational challenges linked to the rail transport of coal, lack of space to do planned maintenance (while 'keeping the lights on') amidst an ageing infrastructure, rising municipality debt, high levels of copper theft resulting in security concerns and rising levels of 'lost-time injuries' of employees and contractors, created a dire situation for the company.

Eskom's financial situation worsened in 2014[57] with a revenue shortfall of R225 billion resulting from the multi-year price determination 3 and increasing payments to independent power producers. With growing pressure on Eskom's credit rating,[58] its inability to recover municipality debt arrears, ongoing energy losses[59] and higher costs,[60] load-shedding implemented for 14 hours on 6 March 2014 was inevitable. The CEO resigned, effective 31 March 2014, and an independent non-executive director was appointed as interim CEO with effect from 1 April 2014. The 2013/14 financial year also saw the resignation of the CFO and the company secretary effective 10 July 2013 and 31 August 2013, respectively. A new CEO was appointed in August 2014 who formerly occupied the position of Director-General for the shareholder department (DPE).[61]

The unfolding crisis at Eskom necessitated the sale of government's 13.91 percent stake in Vodacom to the Public Investment Corporation (PIC). R23 billion was allocated to Eskom from this sale to be transferred in three tranches between 2014 and 2016. This transfer did little to improve Eskom's finances as the National Energy Regulator of South Africa (NERSA) rejected Eskom's request for a 25 percent

55 2009 Eskom Annual Report.
56 2011, 2012 and 2013 Eskom Annual Reports.
57 2014 Eskom Annual Report.
58 Associated with both the sovereign credit rating and Eskom's financial profile.
59 Due to theft and illegal connections (from the 2014 Eskom Annual Report).
60 Due to the increasing reliance on the open-cycle gas turbine (OCGT) fleet, intended only for emergency situations.
61 2015 Eskom Annual Report.

tariff increase. See Figure 7 indicating the extent of fiscal support to Eskom and other SOCs since 2008/09.

Now, in 2015,[62] facing a 'liquidity crunch' due to several operational and financial challenges, Eskom needed to borrow more than initially planned, supported by government's guarantee facility. The decision reached by mutual agreement with the then CEO to 'amicably separate' effective 31 May 2015, after just nine months 'in the job', placed enormous strain on the company's ability to raise the increased borrowing requirement. With the departure of the CEO and three other executives who were removed due to a breach of their fiduciary duties in terms of Section 76 of the Companies Act, the external auditors were obligated, in accordance with the requirements of Section 44 of the Auditing Profession Act, to report this matter to the Independent Regulatory Board of Auditors as a 'reportable irregularity' (RI). New CEO, CFO and Board Chairperson appointments were made in October 2015 when Brian Molefe, Anoj Singh and Ben Ngubane, respectively, joined the company.

In 2016,[63] Eskom's financially deteriorating performance continued amidst declining GDP and the associated declining energy volume sales.[64] The State of Capture Report issued by the Public Protector in November 2016 further suggested possible contravention of the King III Report on Corporate Governance as well as the Companies Act by the entity. While Eskom's excess capacity during 2015/16 allowed for the exploration of other African markets through export sales, the resignation of the CEO following the issuing of the State of Capture Report had a negative impact on the quality of Eskom's management and operational performance.

Eskom's irregular expenditure increased markedly ***in 2016/17***,[65] contributing to the utility obtaining a qualified audit opinion.[66] The external auditors raised RIs in relation to the reinstatement of Brian Molefe to his previous position as the CEO as well as a potential conflict of interest relating to Eskom's interim CEO's stepdaughter's shareholding in Impulse International (Pty) Ltd (Impulse International).[67] The utility's financial performance deteriorated in 2016/17 with its net profit falling to R888 million from R4.6 billion the previous year.

The appointment of a new Board of Directors, new CEO and new CFO in ***2017/18***[68] was instrumental in Eskom securing sufficient short-term funds to address its liquidity challenges. This assisted the utility to obtain a 'going-concern' audit opinion on its interim financial statements, reducing the likelihood of a debt default in the near term. With significant government support, the successful bond issuance in August 2018[69] was an indication of growing investor confidence in Eskom's ability to turn the situation around. During the ***2017/18 and 2018/19***[70] period, significant efforts were made by Eskom management to address maladministration, strengthen internal controls and tighten governance processes.

To conclude on Eskom: What started as an unqualified audit opinion on Eskom financials at the commencement of government's massive and bold capital expenditure plans in 2008/09, ended with a qualified audit opinion in 2018/19 with many reportable irregularities. Challenges started emerging in 2009/10 with an inadequate 'electricity funding model'. Increasing tensions between Eskom management and the bond market, given huge funding gaps, became evident in 2010. As such, a need arose for significant tariff increases. The resignation of both the CEO and the Chairperson in 2010 and their subsequent replacements, coupled with NERSA's decision to partially meet Eskom's tariff application request, worsened the situation.

The DBSA, the PIC, government (budget), and the bond market supported Eskom's growing funding needs. However, operational deterioration dominated the downward financial performance trajectory. Government's continuous support to Eskom, in many forms and over many years of both a financial and non-financial nature, also weakened the sovereign credit rating. As a result, Eskom's credit rating deteriorated. The last of South African sovereign ratings to fall into 'sub-investment grade rating' was Moody's, in 2020. A mild recovery in Eskom finances can be observed from 2017/18, as noted above.

The major causes, therefore, for the financial deterioration of Eskom over the past ten years are material irregularities in their financial statements; an inadequate funding model; poor communication execution with the markets; high tariffs reducing demand for electricity; non-payment for electricity usage, especially by large municipalities; lack of transparency; and high executive and Board membership turnover. These can holistically be referred to as poor corporate governance at Eskom over the period concerned.

62 2015 and 2016 Eskom Annual Reports.
63 2016 Eskom Annual Report.
64 Due to low and declining demand and increasing utilisation of cheaper renewable energy supply.
65 2017 Eskom Annual Report.
66 For inadequate disclosure of irregular expenditure.
67 For having entered contractual arrangements with Eskom.
68 2018 Eskom Annual Report.
69 Given the sizeable unguaranteed portion of the bond (loan).
70 2018 and 2019 Eskom Annual Reports.

4 Important messages from credit rating action in South Africa

The themes highlighted below illustrate the many sources of risk from which government contingent liabilities emanate and give clear direction on the measures required to mitigate these risks.

It is important to acknowledge that rating action on SOCs is either entity-specific or the result of sovereign credit rating concerns. In either situation, political uncertainty is undesirable and worsens the credit rating risk profile if it remains unattended. In the case of the sovereign, public sector finances are viewed holistically by the CRAs. The sovereign rating serves as a country credit rating 'ceiling' that places a 'lid' on all corporate ratings in the country. When the economy underperforms, the fiscal financial position is also likely to underperform. This increases fiscal vulnerabilities.

With regards to administrative prices, high and increasing tariffs may assist the SOC financial position (Eskom in this instance), but it also raises the cost of doing business in the country. While this may be advantageous to Eskom's creditors, it is an undesirable situation for the private sector. For this reason, collaboration between the SOCs and the private sector must be enhanced. The private sector introduces another level of fiscal discipline that contributes to operational efficiencies. The renewable energy programme is one such case that resulted in several societal benefits, amongst others, employment creation, skills transfer, reduced incidence of load-shedding, and lower energy generation costs.

SOC Boards and management must have the requisite skills to deliver on their respective mandates. For example, legal skills are necessary to formulate and argue 'winnable' court cases. In this regard, the shareholder departments must provide the necessary strategic guidance and shareholder monitoring of SOCs, including financial performance monitoring. To perform these functions effectively, officials within government departments need specialised technical knowledge and experience to appreciate the strategic interplay of the respective stakeholders' mandates and functions. Risk mitigation strategies and initiatives and other shareholder support measures must be identified where required and the necessary action must be taken speedily.

The more transparent and clear the fiscal and SOC finances are, the easier investors will find it to take critical, swift and informed investor decisions. When all stakeholders have access to similar relevant data, inappropriate SOC business models and SOC capital structures are easier to detect and operational inefficiencies that introduce unnecessary costs into the business can be avoided.

The experience with Eskom is that, when an entity becomes 'too big to fail', its own failures can have disastrous consequences for public finances.

The more transparent and clear the fiscal and SOC finances are, the easier investors will find it to take critical, swift and informed investor decisions

5 Important lessons and suggestions from the South African experience with contingent liability management

Conditions attached to government (budget) decisions regarding the issuance of guarantees are unfortunately unrelated to reasons (causes) why guarantees are applied for in the first instance. In South Africa, the rapid increase in guarantees over the period 2008/09 to 2018/19 is mainly attributed to poor governance; inappropriate business models; policy uncertainty; costly policy decisions (e.g. earlier rounds of independent power producer contracts); solvency concerns; and liquidity concerns. This is sad considering that the initial rise in government guarantees was in support of a 'public finance' argument.[71] In the case of Eskom and many other badly managed SOCs (not studied extensively in this report), all the factors mentioned have in some way contributed to government being required to provide fiscal support, either in the form of guarantees or direct budgetary transfers. There are, however, exceptions, of which the DBSA is an example. In these SOCs, a vastly different financial performance trajectory prevails that also corresponds to none of the factors referred to above existing.

Failure to address the source of the problem, in a targeted manner, at the time that the financing decisions are made, results in 'misguided' government financing or guarantee support. As a result, government faces successive guarantee applications and financing requests with extraordinarily little to show for it. Government guarantees then continue to rise and SOCs' financial performance continues to deteriorate,[72] further increasing fiscal risks,[73] leading to potentially worse future sovereign and SOC credit rating outcomes.

This unhealthy virtuous cycle then repeats itself as weak SOC financial performance leads to ***more*** guarantees being issued to support SOC liquidity and working capital requirement challenges, resulting in higher fiscal vulnerability, higher financing costs and further worsening credit rating outcomes.

71 To reduce the cost of borrowing for the SOCs.

72 This can be measured using various financial models calculating profitability, unsustainable debt levels, unhealthy liquidity ratios and detecting non-compliance of SOC guarantee conditions.

73 In other words, increasing government and SOC debt levels.

6 So where do South African SOCs go from here?

While correctly linking the approval of guarantees to specific conditions, it is important that the conditions identified are well-researched, measurable and time-bound (SMART) and that the financial analysis undertaken demonstrably illustrates how post-approval project implementation and execution impacts the future health of the SOC. For this to occur, a symmetry (full transparency) of financial and 'other' technical data, at a project level (and sectoral level, where relevant), is required, between those key stakeholders responsible for generating the data[74] and those responsible for making key decisions regarding the issuance of guarantees or 'fiscal bail-outs' (government).[75]

Currently, the only reliable information available to National Treasury officials is Annual Reports (including audited financial statements), corporate (and borrowing) plans and Annual Office of the Auditor-General reports on SOCs. Therefore, while SOC officials are aware of the prerequisites for guarantee applications to the National Treasury,[76] the requirements are generally broad and at an entity level.[77] Further, the conditions that are generally linked to the issuance of government guarantees are project focused and for this reason, government intervention regarding the issuance of guarantees is unlikely to remedy (correct) underlying challenges at the entity (macro-level intervention). This then compromises the sustainability and viability of the critical infrastructure project (micro-level execution) under consideration. Throughout this process, no continuous assessment of post-guarantee approvals is done specifically focusing on how government-guaranteed project financing 'feeds through' into an improved SOC financial performance in future.[78]

The guarantee approval process described above leaves the door wide open for SOCs and their Executive Authorities to 'generously' apply to the National Treasury for government guarantees to be issued. Simultaneously, the National Treasury is ill-positioned[79] and poorly capacitated[80] to effectively assess and analyse project-specific guarantee applications.[81] Besides incorrectly scoping the exact data required to assess guarantee applications, poor advice is also affected by the lack of credible and timeous project-specific data, resulting invariably in guarantee approvals (or non-approvals) being delayed until such time that the required data is eventually obtained. This delay may result in drastic changes (in either direction) of the entire financing landscape and economic factors on which the financing decision was initially made, ultimately impacting the effectiveness of government's guarantee decisions.

While correctly linking the approval of guarantees to specific conditions, it is important the conditions are well-researched, measurable and time-bound

74 In most instances SOCs generate and control critical data required for effective policy decision-making.
75 Who also require access to the data for policy decision-making.
76 For consideration by the Fiscal Liability Committee and subsequent recommendation to the Minister of Finance.
77 In other words, financial statements of the past three years, corporate plans, etc.
78 SOCs will provide the minimum (not more than what is required) information requested by government.
79 Not in the 'advantaged' position of the shareholder department.
80 Access only to 'high-level' data at the 'aggregate level'.
81 Disaggregated micro-level data.

7 Conclusion

Important lessons must be learnt from the South African experience regarding contingent liability management in South Africa. Over the period 2008/09 to 2025/26, cumulative fiscal transfers of R313.7 billion and R350 billion of government guarantees were provided to a single SOC, Eskom. Combined, this amounts to R663.7 billion of budget support to Eskom. As a percentage of GDP, fiscal transfers and government guarantees over this period increased from 0.42 percent in 2008/09 to 9 percent in 2018/19.

Critically, one lesson may be channelling SOC budget support, whether it be government guarantees, on-lending, fiscal transfers or public–private partnerships through an integrated, well-coordinated and capacitated institutional arrangement capable of reversing the current unsustainable fiscal risks to national budgets emanating from ineffective management of government contingent liabilities, as the 'Eskom experience' over the period 2008/09 to 2018/19 shows.

From the outset, thorough strategic planning involving competent, ethical and capable management (and staff) with an implementation-driven focus, is required prior to any significant public investment initiative being undertaken. Underlying any form of budget support must be effective execution of 'shareholder' responsibilities over SOCs, with continuous monitoring, reporting and political guidance where required. Officials within the entities (SOCs) as well as in the shareholder departments and the ministries of finance must take cognisance of possible unfunded developmental mandates that will place a strain on SOC balance sheets, if left unattended. Proper corporate governance principles must be complied with to avoid unwarranted political interference in the day-to-day running of SOC businesses.

In Eskom's case, the initial issuance of government guarantees was justified. Weak institutional arrangements between National Treasury, the shareholder department and the entity resulted in poor monitoring, inadequate risk management and mitigation that affected the quality of reporting to key stakeholders. The role of Parliament, including the Office of the President, with regards to the management of contingent liabilities, should not be underestimated. These important institutions must also have the requisite skills to practise effective oversight and quality assurances for effective decision-making. The role of politicians is particularly important in the context of unsustainable and irrelevant business models in need of being reviewed.

When entities are 'too large to fail', an immediate red flag must be raised given the 'implicit' contingent liabilities associated with such cases. In the case of Eskom, as the quality of government's exposure deteriorated, the level of exposure should also have been reduced. To effectively implement such prudent risk management practices, professional 'healthy' relationships must exist between government and the SOC management as well as between the SOC management and their Boards. A further important relationship is that between government and the private sector. The involvement of the private sector introduces an added level of oversight in technically complex operations. CRAs also play an important role. Excessive exposure to contingent liabilities can result in multiple adverse credit rating action, making South Africa less attractive as an investment destination.

Finally, guarantee conditions must be well researched, targeted, measurable and time bound. Prior to the issuance of guarantees, financial analysis undertaken must adequately demonstrate the 'pass-through' impact of post-approval project execution and completion on the future financial health of SOCs and national finances generally.

The role of politicians is particularly important in the context of unsustainable and irrelevant business models in need of being reviewed

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CABRI Secretariat
Cnr John Vorster & Nellmapius Drive,
Centurion, 0062
South Africa

Telephone: +27 (0)12 492 0022
Email: info@cabri-sbo.org
www.cabri-sbo.org