Managing State-Owned Companies' Debt

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The bailout for Eskom in the 2020/21 budget comes to R56 billion, with an additional R10 billion provided for South African Airways (SAA). These sums will finance restructuring and current losses, due in part to high payments on debt. Taken together, they equal 3.4% of the total budget. But the budget is only increasing by 5.7%, or 1.2% above inflation, so the bailouts absorb two-thirds of the growth in spending in 2020/21.

In effect, the funding for Eskom and SAA squeeze the funds available especially for the major social services, which constitute 45% of total state spending after interest. As a consequence, the budgets for health, education and police foresee a cut in constant rand. Taken together, their resources increase just 2.8% in nominal terms, while inflation is expected to reach 4.5%, and the population is growing 1.6% annually. Since South Africa (SA) remains one of the most unequal countries in the world, constraining social services in this way will inevitably damage social cohesion and economic development.

These realities underscore the importance of a more consistent evaluation of options for managing the financial crisis at the state-owned companies (SOCs). That, in turn, requires an understanding of the extent of their financial losses and what drives them. On that basis, the different possibilities can be evaluated. Every response entails significant direct and opportunity costs; the available options differ, above all, in terms of which socio-economic groups end up bearing them.

The SOCs operate in three main areas: providing infrastructure, producing other goods and services ranging from arms to nuclear medicine to television and radio shows to construction services, and providing development finance. As a group, they account for a fifth of all capital stock, but only a seventh of annual investment and around 1% of employment. Figures for investment and direct employment vastly understate their impact on the economy, however, since several provide inputs that are critical for national growth and job creation.

Moreover, the SOCs vary greatly in size, with a few large companies, led by Eskom, Passenger Rail Agency of South Africa is a South African (PRASA) accounting for the bulk of their resources and losses over the past five years.

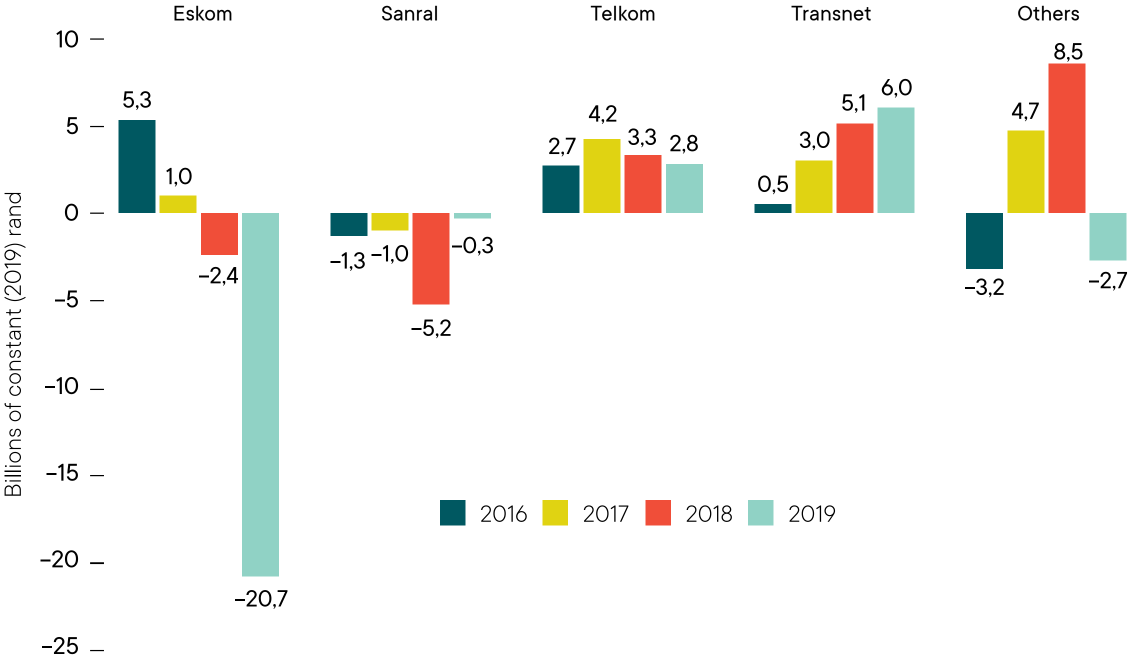
The assets of the top 25 national SOCs approximated R2 trillion in 2019, with three-quarters belonging to just three - Eskom, Sanral and Transnet. The Public Investment Corporation (PIC) manages another R2 trillion in funds, mostly from the Government Employees Pension Fund (GEPF), mostly invested in the stock market and government bonds. The top 25 SOCs employ 175 000 people, of whom four-fifths work at Transnet, Eskom, PRASA and the Post Office.

In financial terms, public enterprises saw a sharp decline in their performance from 2015. As a group, in 2018/19 the national public enterprises reported R15 billion in losses, with a rate of return on assets of –0.7%. Eskom alone lost R21 billion after paying R25 billion in financing costs. Sanral has also made losses, mostly because it has been unable to generate the anticipated revenue to pay for upgrading the national freeways in Gauteng. In contrast, Transnet has seen rapidly rising profits over the past four years (Figure 1).

From 2016 to 2019, 15 of the top 25 SOCs made losses in at least two years, and seven made losses in all four years. In late 2019, SAA was placed in business rescue and Alexkor and PRASA were under administration. SA Express has not published an annual report since 2017 and SA Nuclear turned out to have misreported losses for the past four years.

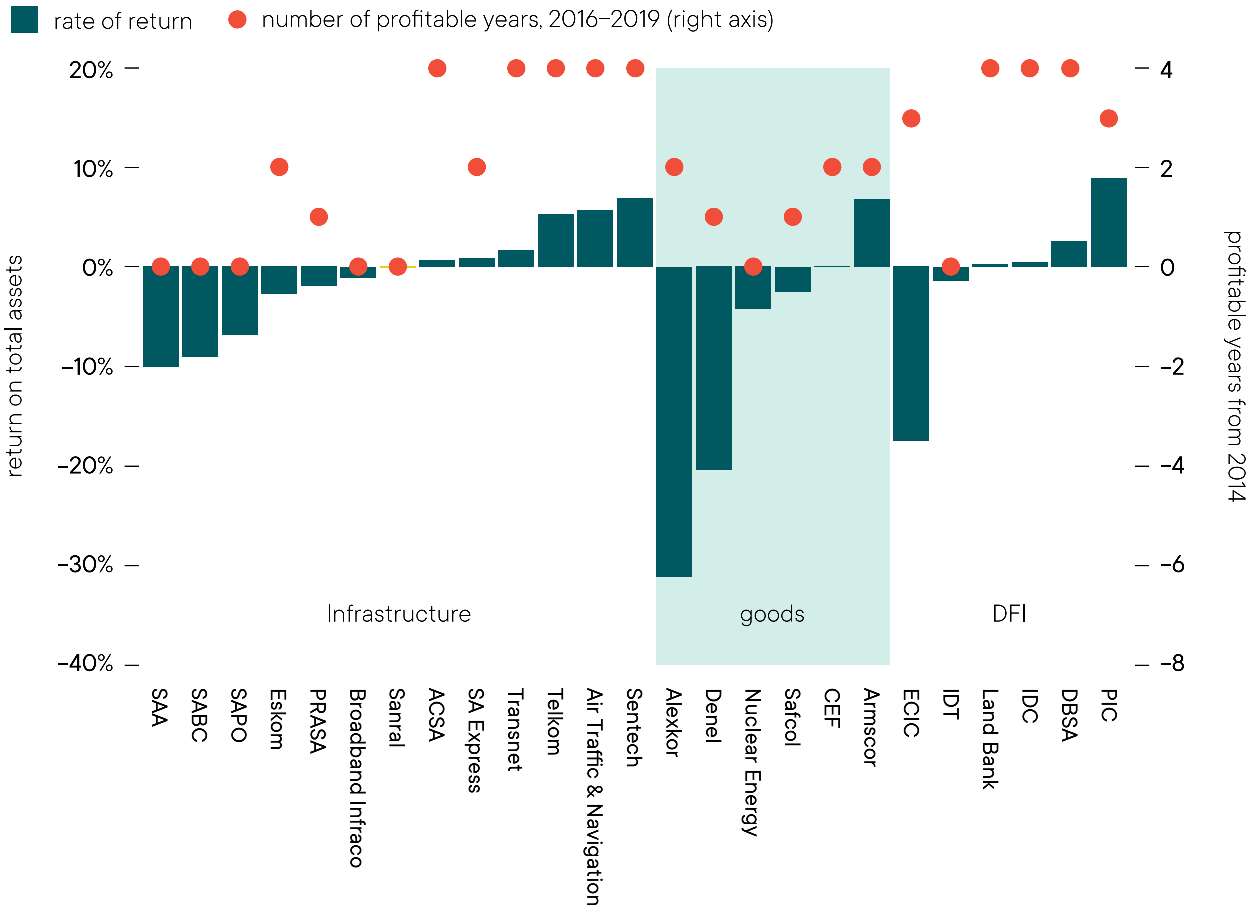
Eskom accounted for the bulk of government-guarantees on SOC borrowing in the 2019/20 budget, equal to a tenth of public debt. It also absorbed most of the money used for bailouts, followed at a distance by SAA. In contrast, Sanral and PRASA dominated planned subsidies, reflecting long-run strategies to reduce the cost of commuting and national road transport.

Figure 1: Profits and losses of the public enterprises, 2016 to 2019



Source: Most recent Annual Reports

Figure 2: SOE rates of return on total assets, and number of profitable years[61]



Source: Latest published Annual Reports for each enterprise

[61] 2016/17 reports were available for Broadband Infraco, the South African Post Office (SAPO), SAA, the South African Broadcasting Corporation (SABC), Central Energy Fund (CEF), Denel, Alexkor, the South African Nuclear Energy Corporation (NECSA), the National Empowerment Fund (NEF), Safcol, and the State Diamond Trade, and for 2017/8 reports were available or all others.

As illustrated in Figure 3 below, Eskom and other public enterprises' share in net national debt commitments and in total government expenditure, year to March, actual from 2016 to 2019, and budget or medium term expenditure framework (MTEF) projections from 2020 to 2022.

We can view the financial crisis at the SOCs through three interrelated lenses.

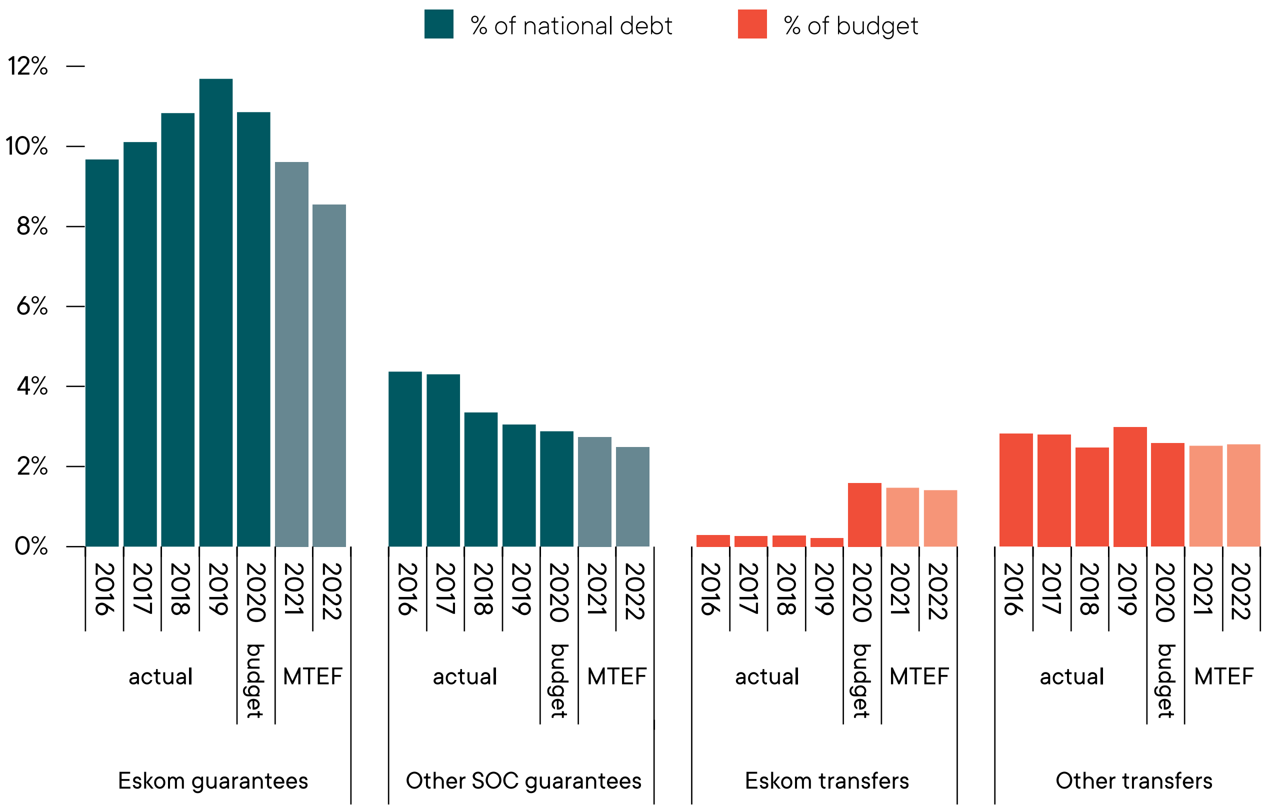
First, at the broadest level, the financial crisis resulted from the economic slowdown that followed the end of the global metals price boom from 2002 to 2011. As Figure 4 below shows, growth in the SA economy tends to parallel changes in metals prices. During the global commodity boom from 2002 to 2011, the SOCs experienced rising demand and revenues. From 2015, in contrast, as international metals prices stagnated and growth slowed, the SOCs found that demand did not meet their expectations. Eskom and Sanral, in particular, had invested heavily in anticipation of rapid economic growth, and their revenues fell far short of the resulting financing needs. In contrast, as the mines faced sharply lower returns from 2011, Transnet throttled back on its investment plans.

Second, in terms of governance, over the past decade the state was prepared to let the SOCs pile up losses over many years, even where they did not generate visible socio-economic benefits. SOCs often generate beneficial externalities that could justify subsidies. In practice, however, analysis of the 12 largest SOCs found that only four had clearly defined developmental mandates. In these circumstances, when an enterprise made persistent losses, the only reasons articulated for bailing it out became saving jobs and an ideological commitment to maintaining public ownership at any cost.

Finally, several SOCs had unsustainable and unrealistic business models. Eskom, in particular, built its business model on three deeply flawed assumptions:

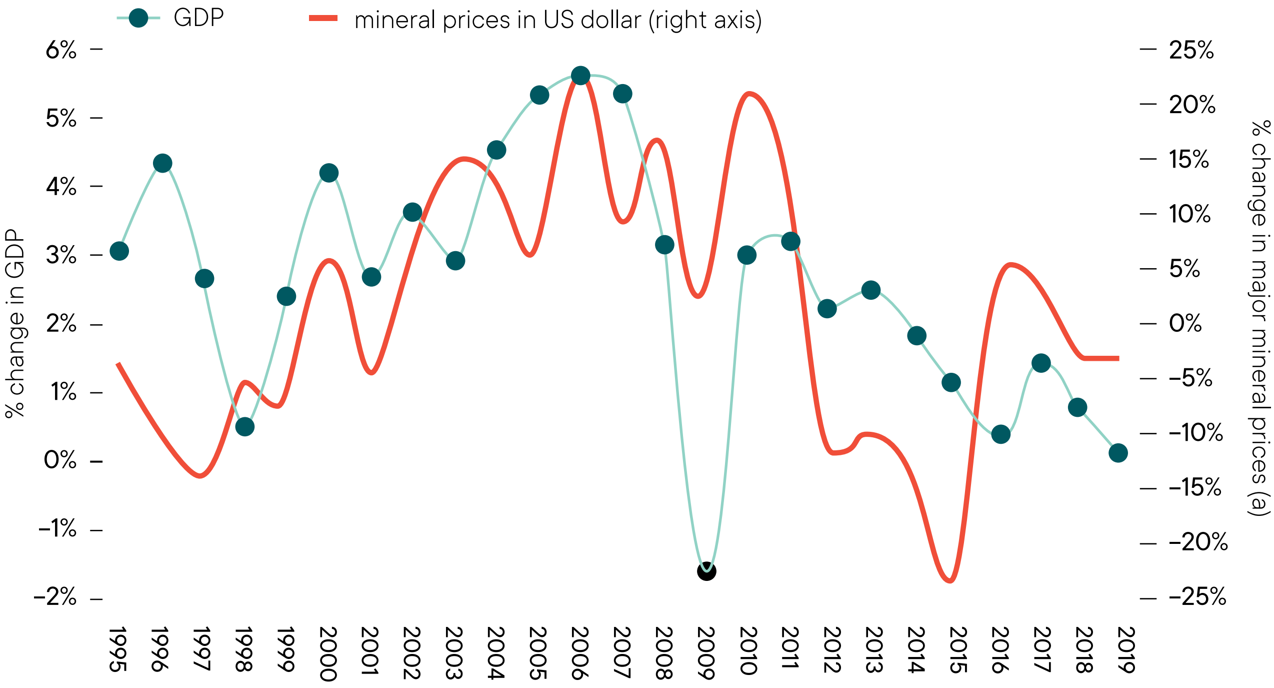
- Demand for electricity would rise continually, irrespective of the tariffs for customers;
- The best way to meet demand is very large, coal-fired plants, rather than newer and smaller technologies that could respond better to shifts in demand as well as limiting carbon emissions; and
- Faced with losses, Eskom's monopoly power would enable it to get either higher tariffs or a government subsidy, so it did not need to focus on cutting costs.

Figure 3: Eskom and other public enterprises' share in net national debt commitments and in total government expenditure year to March, actual from 2016 to 2019 and budget or MTEF projections from 2020 to 2022



Source: Calculated from National Treasury. *Estimates of National Expenditure 2019/20.* Print version and excel spreadsheets. Pretoria.

Figure 4: Growth in GDP and in trade-weighted index of international U.S. dollar prices of major mining exports (a), 1994 to 2019



Note: (a) Index of U.S. dollar prices for coal, iron ore, gold and platinum, weighted by share in exports.
Source: For GDP, Statistics South Africa. Quarterly and Regional Fourth Quarter 2019. Excel spreadsheet downloaded in March 2020; for metals price, Index Mundi and Kitco data, downloaded in March 2019; and for trade weights, Quantec EasyData, international trade data at 6–digit HST level in current rand.

In practice, none of these assumptions held in the late 2010s, leading to a pair of vicious cycles.

On the one hand, Eskom faced falling demand as tariffs increased and the international price for mining products stagnated. From 2009, Eskom's sales dropped 10% in volume terms. It argued that it could not cut costs as demand fell, however, so its main response was to escalate tariffs, further depressing demand over time. From 2017, as Nersa increasingly resisted above-inflation tariff hikes, Eskom started demanding government bailouts as well as higher tariffs.

On the other hand, Eskom delayed reconditioning its older plants as it anticipated a capacity boost from Medupi and Kusile. But the new plants were both delayed and technically deficient. As a result, Eskom faced rising breakdowns, which in turn meant that for years it undertook only rushed repairs. At the same time, it resisted any effort to licence other generators in order to protect its monopoly position. Ultimately, in 2019 it imposed rationing on customers in order to provide time for planned repairs and maintenance. That, in turn, further aggravated the slowdown in the economy and in demand for electricity.

The bailouts at Eskom and SAA dwarf the rest of the SOCs. By early 2020, three basic options had emerged: to continue to finance them from the budget; to find ways to utilise financial surpluses at the unemployment insurance fund (UIF) and the Compensation Fund as well as the GEPF; or to sell their assets for whatever they would bring.

In the case of Eskom, the sale of assets is far too risky for society. In addition to the disruption to the grid, it would likely lead to even higher tariffs in order to incentivise private investors. There are no other suppliers who could scale up to supply or manage the national grid in the short to medium term, so closing Eskom down is not an option.

In contrast, private airlines already outcompete SAA on price and often on quality in terms of both domestic and international travel. The main costs of closing it down are the loss of between 5000 and 10 000 jobs and a reduction in direct flights to SA from some locations, which could damage business engagements as well as tourism.

As noted above, funding Eskom and SAA through the budget has inordinately high opportunity costs in terms of the impact on basic social services. The R10 billion bailout for SAA, for instance, would be enough to provide an inflation-level increase for both education and health.

The opportunity costs of off-budget financing would be substantially lower. The UIF alone had a surplus of R160 billion in 2020, growing by around R10 billion a year. The Compensation Fund had around half as much. Both the UIF and the Compensation Fund have proven unable to utilise their surpluses to benefit members substantially, as reflected in their growing financial holdings. In terms of the GEPF, because public servants' pensions are defined benefit, the risk of providing lower cost, longer-term funding to Eskom would be borne by the state as employer, rather than by pension fund members. The main opportunity would be the cost of withdrawing a share of their funds from the stock market, which is already fragile. The amounts involved are, however, trivial compared to overall turnover on the stock exchange.

In sum, analysis of the SOCs' financial crisis points to the importance of improving governance, especially to ensure that financial losses trigger a rigorous response. Where an entity cannot demonstrate that its mandate necessitates some losses (that is, where its losses are not offset by external benefits to stakeholders), then it should be forced either to cut costs or to face restructuring, even privatisation. If an SOC meets critical socio-economic functions, then the challenge is to identify the most efficient funding option in terms of government's overall priorities and the opportunity costs. From this standpoint, utilising the surpluses at the social-protection funds and the GEPF makes more sense than cutting core social services.