The SOE Debt Crisis: What is to Be Done?

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When we talk about state owned enterprise (SOE) debt, it is really a conversation about Eskom. Other SOEs have debt, but it is either manageable based on current financial performance (e.g. Transnet) or part of deep operational problems (Post Office, SABC, etc.). Eskom's balance sheet is enormous, with debt expected to reach R475 billion in 2020. It is in a classic debt trap in that it cannot pay the interest on this debt. In the current financial year, it needs to pay R86 billion to service its debt, including capital repayments due (R48 billion) and interest (R38 billion), but will have only R25 billion of surplus operating cashflows, which must also meet its capital expenditure requirements of R34 billion. That means it needs to raise R95 billion out of a combination of new debt issuance or other forms of funding support from government.

Naturally, this is unsustainable. To rectify this situation, ideally Eskom needs to reduce its debt load by about half. This means removing R250 billion of debt from its balance sheet in order to reduce its debt service costs to within its potential operating cash flows. This must be part of a broad operational fix of Eskom, which should include, in our view, an unbundling of Eskom's generation, transmission and distribution units. The financial solution must be conditional on these operational outcomes being achieved.

The debate on Eskom's finances has been distorted. The point must be to expunge R250 billion of debt. It is not a question of who holds Eskom debt, whether the existing stock or new debt that must be issued, but a question of how we remove R250 billion from Eskom's balance sheet.

Given this objective, there are only four possibilities which I can see:

1. Contributing equity into Eskom such that it has the cash to settle a portion of the debt directly (this is broadly the status quo);
2. Engaging with Eskom debt holders to swap their interest from Eskom debt into debt in which some other entity is the obligor, such as the SA sovereign or a special purpose vehicle;
3. Forcing a renegotiating of terms. Under threat of default, Eskom could engage debt holders with a view to renegotiating terms (tenure, pricing) of the debt or some other form of restructuring such as a debt-to-equity swap;
4. Disposing of assets. Eskom could, for example, sell some of its plants and use the proceeds to settle debt.

I do not think options three and four are realistic. Of the R450 billion of existing debt, about R297 billion is guaranteed by government, so any default would immediately role into the sovereign. There could be some form of partial default on the balance, but the consequences for overall national funding would be dire in a loss of faith in South Africa (SA) to stand behind its obligations. But the possibility of engaging with non-guaranteed debt holders should still be taken off the table.

Disposals might not actually help matters, quite aside from the politics of privatisation. The carrying value of Eskom's plant on its balance sheet might well be higher than the prices it could raise in the market. Sales, therefore, could reduce its solvency instead of improving it.

Option 1 is broadly the status quo. Government is currently committed to putting R49 billion this year and R56 billion next year into Eskom to enable it to meet its commitments, and will be set to put in R33 billion per year thereafter. This basically covers Eskom's interest bill and ensures it is able to keep operating. The alternatives also come at a cost to government that is not appreciably different to the status quo. But continuing as-is means Eskom would not be able to regain its creditworthiness and be able to enter the debt market again. The only way to make Eskom a sustainable financially independent entity is to expunge a portion of the debt so that its balance sheet is restored to appropriate credit metrics.

There are two different sets of considerations that should weigh on which approach is best in dealing with Eskom's debt. The first are **technical considerations** - which options are lowest cost and most feasible in line with debt market requirements. The second are **policy considerations** - which option best fits broader policy reform objectives such as the stabilisation of overall energy supply and reduction in carbon emissions.

I will consider each of those groups of considerations in turn.

Technical considerations

Debt restructurings are nothing new. Any company, or indeed any individual, will face debt distress if their cashflows fall short of what is required to comfortably service their debt obligations. Companies, both in SA and abroad, have had to make arrangements with debt holders because of such considerations. Locally, Edcon, African Bank Investments Limited and Cell C are just some recent examples. Eskom differs to these, though, in being far larger in scale and therefore of systemic consequence. There have, though, been some 30 different proposals on what to do on Eskom. Below we sketch out a plan that draws on several of these.

In such debt rearrangements, the following are important issues that have to be considered:

1. Shareholders (i.e. the government) should not be diluted or otherwise prejudiced beyond what is necessary;
2. The cost of the arrangement should be low, representing value for money for all parties by minimising fees;
3. There should be minimal risk of hold-outs creating a situation where activist investors can extort a premium by being the last to agree to a scheme;
4. Minimise litigation risk - the risk that holders will go to court to defend their rights;
5. Is legally sound, recognising the *pari passu* ranking of creditors (which in turn reduces litigation risk);
6. Is simple to execute in not requiring a creditor vote, so minimising execution time;
7. Protects the stability and fiduciary responsibilities of the financial sector;
8. Is sustainable and does not amount to creating moral hazard for Eskom;
9. Is quick and straightforward to implement; and
10. Actually delivers the objective of providing for sufficient balance sheet relief for Eskom.

Some suggestions clearly violate several of these considerations. For example, the Cosatu suggestion that a special purpose vehicle (SPV) should be used to acquire R250 billion of debt from Eskom, funded by the Industrial Development Corporation of SA (IDC), the Development Bank of SA (DBSA) and the Government Employees Pension Fund (GEPF). The proposal did not show how it would achieve point 10 - the acquisition of debt does not mean Eskom would stop servicing it. If the debt were to be expunged, it would have to be by violating point 1 in that Eskom would have to issue shares to the SPV in return for cash to buy back the bonds and cancel them. While the SPV would be a government entity it would complicate the shareholder reporting lines. This would also clearly violate point 7, in that such a step would amount to writing off the value of the assets as Eskom equity would be worthless (there is no prospect of profitability foreseeable). As it is, given existing exposures, the acquisition alone would violate the prudent concentration risk considerations for the IDC, DBSA and GEPF, which already holds 20% of Eskom's debt. As these are state institutions, the state would ultimately bear the liabilities such a move would create anyway, so from a sovereign risk perspective, no net improvement would arise.

Policy considerations

1. The electricity supply sector should be restructured with an independent transmission and supply operator able to procure energy from all producers. This objective has been policy since the 1998 energy whitepaper and has been reiterated by the president in his 2019 State of the Nation Speech.
2. As a signatory to the Paris Agreement, South Africa has committed itself to reducing carbon dioxide (CO_2) emissions in the fight against climate change. Eskom is one of the largest emitters of CO_2 in the country. SA is the 14th largest CO_2 emitter despite being the 32nd largest economy.
3. The transition of the electricity supply system should be just in that individuals and communities should not be prejudiced in the move from coal-dominant production to renewable production.
4. The transition should support wider policy goals of eliminating poverty and reducing unemployment.

To my mind, the right approach, therefore, is a scheme by which the right amount of Eskom's debt can be converted into equity, subject to Eskom achieving policy objectives. At the same time, all possible mitigation tools should be used to reduce the cost of such a scheme.

Functionally, a SPV can be created which acquires R250 billion of Eskom's debt, either in the open market or through block trades from the GEPF and other holders of debt, or by issuing paper to those holders as a substitute for Eskom debt.

The SPV would be an Eskom financial restructuring vehicle that would then actively seek opportunities to lessen the financial burden. It would enter into an arrangement with Eskom through which policy milestones in the unbundling and establishment of an Independent Transmission Market Operator is set. With each milestone, a tranche of the debt is cancelled by issuing shares in Eskom to the SPV worth an amount equivalent to the debt outstanding. The premium on these shares would probably need to be quite low and the SPV could end up owning a large portion of Eskom as a result. But as the SPV would be controlled by government anyway, it would not amount to a loss in control.

Simultaneously, the SPV adds to the Eskom agreement certain CO_2 reduction targets. The SPV could then sell these tons of CO_2 reductions on the global carbon market to raise part funding and reduce the overall cost of the package. As well as selling CO_2, the SPV may be able to access global concessionary carbon funding at a lower cost than Eskom's existing borrowing costs and so reduce the cost of funding the debt acquisition. It would act as a central actor in engaging global funding from government development agencies and multilateral funders.

Inevitably, a large part of the SPV's funding needs would have to be a central government transfer. We think the least-worst source of this cash is the sovereign, and therefore it is effectively a taxpayer-funded bailout. We see this as a better option that some form of tax on savers (by somehow forcing pensions to buy valueless instruments). Fiscally it may require a special additional revenue measure, such as a short-term value-added tax (VAT) or income tax levy.

This deals only with the financial problem. Eskom's operational problems remain critical. To cover its operating costs, additional revenue will be required through tariff increases. Consumers, therefore, will bare part of the pain. Additionally, an operational fix is going to require rightsizing Eskom's workforce and reducing its substantial wage costs. This means labour will also carry some of the pain. This sharing of the burden between tax payers, labour and consumers appears fair, though some burden carried by debt holders would also be appropriate. Due to the guarantees and wider market consequences, however, I do not see a feasible way to do so.