An Accelerated Agenda Towards the Restructuring of State Owned Enterprises

Policy Framework

Ministry of Public Enterprises
Republic of South Africa
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This document is the full Policy Framework for an accelerated agenda for the restructuring of State Owned Enterprises. It has the intention of providing the reader with the rationale behind the policy. As such it includes detailed discussions on the various policy issues. A summary document providing the policy more succinctly has also been published.

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Foreword by Jeff Radebe, MP

Minister of Public Enterprises

There are many challenges facing South Africa. At the top of the list is the eradication of the crushing poverty that holds back the development of our country and region. We have adopted the view that the real conditions of every day life require a strong democratic developmental state. Only by adopting this perspective will we be able to rise above the challenges of the day and establish the conditions in which all our people are able to enjoy a better life for all.

Part and parcel of the developmental state are the State Owned Enterprises, or SOEs, that are described in some detail in this *Policy Framework*. Our SOEs do not operate in a vacuum – they engage in economic activity and provide essential services that traverse even our borders. We have found that, in many instances, their traditional methods of operation and business management, human resource development, and even their targeted constituency base were inappropriate in a democracy. Furthermore, they command large procurement budgets, social and human resources and some of them dominate the economic sectors in which they operate. Since the emergence of democracy, South Africa has begun to integrate itself into the global environment as a worthy member of the international community. In particular, our country has become an important agent towards the realisation of the African Renaissance. In this context, the accelerated restructuring of SOEs to meet these combined challenges has become a matter of urgency.

Recognising this need, Government, at a Lekgotla[1] on the 29th November 1999, directed that a detailed and coherent policy framework be prepared to guide the restructuring process into the 21st Century. The *Policy Framework* will enable Government to co-ordinate thinking on the restructuring of State Owned Enterprises. As such, it goes beyond being merely the integration and consolidation of policy arising from the experiences of Government since 1995 when the initial framework for restructuring was agreed by Cabinet.

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[1] Lekgotla is a South African word for a type of workshop where decisions are taken

In summary, Government's policy with regard to State Owned Enterprises is more properly referred to as a *restructuring* programme, and not in the more simplistic terms of privatisation. The programme was and remains designed around a multiple array of strategies, or mixes of options, that are designed to ensure the maximisation of shareholder interests defined in economic, social and development terms. Thus restructuring refers to the matrix of options that include the redesign of business management principles within enterprises, the attraction of strategic equity partnerships, the divestment of equity either in whole or in part where appropriate, and the employment of various immediate, turnaround initiatives.

At the enterprise and sector level, restructuring involves improving the efficiency and effectiveness of the entity, accessing globally competitive technologies where appropriate, mobilising private sector capital and expertise, and assisting the creation of effective market structures in sectors currently dominated by the SOEs. At the broader, macroeconomic level, restructuring initiatives aim to attract foreign direct investment, to contribute to the reduction in the public borrowing requirement, and to assist the development of an economic context that promotes industrial competitiveness and finances growth. Social imperatives include the need to ensure growth in employment, particularly in new areas of endeavour, and to rationalise or develop new skills within the labour force and their deployment throughout the economy.

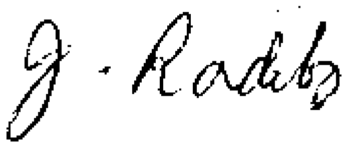
Obviously, the time lapse between initiating an economic or social programme and the realisation of objectives cannot be defined with any accuracy in terms of months or even in many instances, years. However, initial results indicate that substantial sums of money have already accrued to the state since 1996. Furthermore, the recent financial results of the major SOEs, in particular Transnet, including SAA and Spoornet, Denel, Eskom, and Telkom have revealed that internal reorganisation has resulted in very promising turnaround successes since the restructuring programme was initiated.

The past five years have represented a steep learning curve for the Government, and, although not all initiatives have been trouble-free, we can justly claim that we have established a solid foundation for the accelerated restructuring agenda that is reflected in this document.

The *Policy Framework* describes a dynamic process that will require careful monitoring and constant evaluation. As implementation unfolds, I am sure that there will be areas that may require revisiting. We do not wish to cast in stone timetables and procedures that are proved inappropriate later through the experience of action on the ground. At the same time we believe that this framework provides satisfaction, security, and will form the basis for further confidence for employees, managers, boards and investors alike. Government, as the primary shareholder in many instances, will ensure that the restructured SOEs will continue to play a responsible, proactive role in the development agenda. This document has been presented in a format that by providing the discussion around issues ensures that the readers understand the rationale behind the policy.

I am confident that the *Policy Framework* provides sufficient consensus for all stakeholders to remain part of the team who will ultimately be responsible for the success of the restructuring initiative. Indeed, it remains our intention to seek the views of all stakeholders affected by the restructuring process it unfolds to deal with any unforeseen problems that may arise. To this end we will use the institutional mechanisms afforded to us by the Constitution, Parliament and Nedlac, as well as other less formal channels to ensure that the views of all affected stakeholders are heard.

I wish to thank all those, both inside and outside of Government, who have contributed to the development of this *Policy Framework*.



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Introduction

At a Lekgotla on 29 November 1999, the Interministerial Cabinet Committee on the Restructuring of State Assets (IMCC[2]) directed that a policy framework be prepared to guide the restructuring process into the 21st century. This policy framework would provide a more comprehensive framework than has existed to date, in order to ensure a consistent approach to restructuring across Government and to address perceived market uncertainties about Government's restructuring priorities. To this end, the policy framework that follows will address these requirements by focusing on:

- Government's vision for restructuring
- The economic and social effects of restructuring
- Promoting appropriate regulatory and competitive frameworks
- Promoting empowerment and broadening participation in restructuring
- Improving corporate governance and ensuring improved ethics and probity
- Improving the restructuring process
- The four key enterprises

[2] The IMCC has since been replaced by a Ministerial Sub-Committee

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Vision for restructuring

Government confirmed its vision for the restructuring of state-owned enterprises (SOEs) at the Lekgotla in November 1999. This vision sets out the continued role of the state in the economy, in the light of recent international experience with SOE restructuring and the developmental needs of the country. It is generally accepted that South Africa employs a mixed economy to address the legacies of apartheid. The state's role is dynamic, shifting emphases to meet the changing developmental needs of society. The key policy statements of Government also have both an explicit and implicit bearing on the state's relationship with SOEs. The Constitution requires that the state should take proactive action to ensure that the injustices of the past are overcome in a manner that ensures fairness and equity. SOEs clearly have a role to play in this process.

The *Reconstruction and Development Programme (RDP)*[3] sets out an approach to the restructuring of state enterprises, arguing that Government should decide, on "the balance of evidence", whether the public sector should be expanded in strategic areas through "nationalisation, purchasing a shareholding in companies, establishing new public corporations or joint ventures with the private sector", or whether it should be reduced in a manner that will "enhance efficiency, advance affirmative action and empower the historically disadvantaged, while ensuring the protection of both consumers and the rights and employment of workers" (clause 4.2.5).

The *Growth, Employment and Redistribution (GEAR)* strategy[4] provides a similar view on restructuring, noting that it "may involve the total sale of the asset, a partial sale to strategic equity partners or the sale of the asset with Government retaining a strategic interest". It also proposes a phased process of restructuring in order to maximise value and to ensure that adequate regulatory frameworks are put in

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[3] ANC/Alliance. 1994. *Reconstruction and Development Programme*, Johannesburg: Umanyano.

[4] Department of Finance. 1996. *Growth, Employment and Redistribution: A Macroeconomic Strategy.* Pretoria: Government Printers.

place. GEAR argues for “decisive leadership by Government”. This entails a protocol on corporate governance indicating the objectives and performance appraisal norms for all SOEs, a programme of asset restructuring, and fair pricing policies that would ensure full cost recovery while “also promoting competition or protecting consumers against monopolistic practices” (s.7.2).

Meeting in November 1999, the key Ministries involved in SOE restructuring discussed the objectives of this process. It was evident that Government has benefited from its experience of restructuring over the past five years. Progress with the restructuring of some major SOEs has been considerable, but negative experiences with some smaller SOEs indicated that Government’s approach to restructuring needed to be refined. This is particularly important now that the South African economy is reorientating itself towards the regional and international markets, and the major public corporations (energy, telecommunications, transport and defence-related industries) must increasingly support this global positioning.

Despite their difficulties, the major SOEs represent massive financial, investment, labour, technology and infrastructure resources in the South African economy. They also dominate sub-Saharan Africa’s transport, communication, power and defence-related technology sectors. Government’s restructuring strategy aims at maximising the contribution that its assets can make to development both in South Africa and on the continent. The restructured South African SOEs can lead the way in promoting the African renaissance in their respective sectors, providing world-class expertise, resources, services and infrastructure to a developing continent, often in partnership with enterprises in other African countries.

Development cannot be measured only by financial criteria, and restructuring is not a means of improving government finances and enterprise efficiency at the expense of the poor. Rather, the success of restructuring will be measured by its contribution to improving the standard of living of the majority of the population. The goal of restructuring should therefore be sustainable economic and social benefits. Government’s strategy focuses on restructuring that benefits all South Africans by expanding infrastructure services that are competitively priced and accessible, and that provide an opportunity for economic participation. Private capital and expertise, within an appropriate framework to encourage delivery, will expand the potential for providing services and infrastructure beyond that which the state alone can deliver. The state will actively manage the economy through both direct and indirect mechanisms to ensure that this expanded potential translates into widespread improvements in service delivery. Restructuring should be accompanied by regulatory reforms to ensure that consumer interests are protected, that services and public participation in service delivery are extended, and that environmental and other public policy concerns are appropriately addressed.

The establishment of SOEs in apartheid South Africa created the conditions for skewed development aims, irregular infrastructure and service delivery, and a host of structural problems. Since 1994, these have limited the ability of SOEs to adjust to new requirements and new policies. Some corporations are struggling to overcome their legacy of unsustainable debt burdens, underinvestment in key infrastructure and technology, and unmanageable corporate structures. The state, therefore, currently risks not only failure to achieve its broader policy objectives, but also a severe depreciation in the value of these assets as the market discounts them owing to their present difficulties. The total effect would be continued failure to ensure rigorous and directed interventions for ensuring that socio-economic development takes root both in those areas most sorely affected by the past and in the areas of the new economy.

Frequently, restructuring or privatisation programmes are interpreted as meaning a withdrawal of state power, authority and responsibility from the provision of services, employment and investment. In the South African context, however, public ownership of some SOEs is – due to their enormous debt – all but nominal, with control and power resting firmly within the purview of international financiers. Until recently, some SOEs operated in a manner that is not aligned with the broader objectives of Government, their policies containing only vague references to social responsibility. The restructuring programme aims at returning SOEs to the ambit of citizens' concerns.

Hence, performance contracts, shareholder compacts and other regulation instruments have been designed to ensure that restructured SOEs understand fully their responsibilities while undertaking business in an economically efficient manner. Likewise, equity partners, management contractors and other participants from the private sector will be guided by a common commitment to the broader aims of the RDP. In short, a situation is envisaged in which the role of non-state institutions is incorporated into the organisation, financing and management of SOEs. Thus, rather than alienating state assets in the main, the role of private, national and international capital, and community-based capital resources such as trade union investment funds, employee share plans, public offerings and other forms of participation, is increased.

Rethinking the role of the state in a mixed economy

The role of the state in the development of the economy has been a major theme of 20th century development literature. It may be useful to refer to a recent paper by Rodrik on "Developmental strategies for the next century".[5] This paper shows that, for the second half of the 20th century, most economies in both the developed and developing world depended on the state's continued role in a mixed economy for their development. It also identifies some of the institutional prerequisites for continued development. These arguments will tie in with the discussion of various elements of the restructuring strategy described in the ensuing sections. Rodrik argued that:

> … the idea of a mixed economy is possibly the most valuable heritage that the twentieth century bequeaths to the twenty-first in the realm of economic policy …The simple idea that markets and the state are complements – recognised in practice if not always in principle – enabled the unprecedented prosperity the United States, Western Europe, and parts of East Asia experienced during the second half of the century … the state and the market can be combined in different ways. There are many different models of a mixed economy. The major challenge facing developing nations in the first decades of the next century is to fashion their own particular brands of the mixed economy.[6]

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[5] Rodrik, D. 2000a. Developmental strategies for the next century. Paper prepared for the conference on "Developing Economies in the 21st Century", Institute for Developing Economies, Japan External Trade Organisation, 26–27 January, 2000. This paper has been used extensively because it moves beyond the ideological debates about the developmental state that characterise many discussions of the role of the state and the market in South Africa and elsewhere.

[6] Rodrik (2000a: 1–3).

By shifting the focus from conventional arguments on trade strategy and industrial policies (notwithstanding their importance),[7] to concerns about social conflict and the institutions required to manage them, Rodrik provides a fresh insight into the "developmental state" and the role of a mixed economy in a globalising world economy. He reviews the critical institutions required to sustain economic development in such an economy, emphasising the importance of institutional diversity. In an assessment of the history of economic development in the second half of the last century, Rodrik argues that successful economies have been those that have adapted "pre-existing institutions", even where this has resulted in a more gradual integration into the world economy because they "economised on institution building".

An interesting example of a mixed economy that is adapting to the global economy while the state still plays a strong developmental role is that of the People's Republic of China. Although many industries are being privatised, the state intends keeping control of infrastructure used for providing public services. It does, however, concede that control does not imply full ownership. At the same time, the state has shifted from a centralised planning approach to one that encourages market incentives. This, combined with the establishment of markets and the clarifying of rights and obligations of SOEs, has brought about a significant improvement in the quantity and quality of services provided by such enterprises. The private sector in China has also grown extremely rapidly.

A recent review by the Economic Commission of Africa traversed the whole range of development strategies that had been implemented in one way or another in Africa. These included structural adjustment programmes that followed the so-called Washington Consensus of the 1980s. One conclusion was that strategies have often been too narrowly focused and exclude critical issues such as the immediate political and social problems of structural poverty in Africa. In essence, the review argues that a range of issues previously excluded from the ambit of the Washington Consensus and its successors need to be included, such as:

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[7] Rodrik, D. 2000b. Can integration into the world economy substitute for a developmental strategy. Paper prepared for the World Bank ABCDE-European Conference, Paris, 26–28 June 2000.

> … good governance, organized and supervised financial systems, poverty alleviation, investment in education and knowledge institutions, health and environment concerns and comprehensive strategies to address the issue of food production and transform agriculture.[8]

This is, in effect, a call for a broadened development agenda for Africa. Government believes that the state, inclusive of its business entities, has a role to play in developing strategies for South Africa in the new debate.

In conclusion, this discussion of the role of state, it should be noted that recent thinking on development provides important qualifications on the role of the state in the development of the economy. *The range of ideological shifts in developmental economics in the second half of the 20th century include import substitution in the 1970s, to macroeconomic stabilisation in the 1980s, to overcoming financial instability in the late 1990s. The economies that have grown and have best weathered the storm of global economic integration, are those with institutional frameworks well suited to managing the balance of external shocks and internal development.* Development is more likely to occur where appropriate, often pre-existing, institutions have adapted to the social and economic pressures arising from changes in the international economy. *In these cases, having a mixed economy – i.e. an economy that is responsive to market incentives within a framework of socially integrative institutional mechanisms – has ensured more sustainable development.*

In the ensuing discussion, an attempt is made to identify the institutional mechanisms required for ensuring the development of the South African economy in the face of globalisation.

It will be argued that the restructuring of SOEs has a better chance of success when it can exploit the potential of a mixed economy. This policy framework is, however, primarily about restructuring SOEs, and although it occurs within the overall restructuring of the economy as it is further integrated into the world economy, this document cannot cover all the social, political and economic issues arising from these developments. It instead aligns itself with the primary

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[8] Economic Commission for Africa (United Nations). 2000. *Report of the Ad-Hoc Expert Group Meeting on African Development Strategies*. Addis Adaba, Ethiopia, 20–24 March 2000.

developmental thinking in Government and outside, while focusing primarily on issues related to the restructuring of SOEs.

Government policy on restructuring and development

Since 1994, the goals with restructuring have been broadly defined to address the economic, social and political objectives of Government, and have been refined from time to time. A discussion document by the Ministry of Public Enterprises,[9] which records the decisions arising from a Cabinet Bosberaad in January 1995, lists the objectives of restructuring as follows:

- To facilitate economic growth ("restructuring should be used to increase competition and guard against monopolistic behaviour")
- To fund the RDP ("through carefully targeted expenditure on infrastructure … [however] a situation of funding short-term current expenditure out of the liquidation of assets … must be avoided")
- To create wider ownership in the South African economy ("restructuring provides an opportunity for widely dispersed ownership … restructuring must redistribute wealth, boost the small and medium enterprise sector, have sustainable affirmative action implications and facilitate genuine black economic empowerment")
- To mobilise private sector capital ("international firms operating in association with local companies … bring to bear not only the management expertise and technology but also the credit standing and ability to finance investment")'
- To reduce state debt ("restructuring and privatisation proceeds may be used to reduce state debt")
- To enhance the competitiveness of state enterprises ("individual state enterprises should be … positioned to access global resources and markets, particularly in Southern Africa")
- To promote fair competition ("fair competition at factor and product markets will promote new entrepreneurial activities and better economic performance in the country")
- To finance growth and requirements for competitiveness ("there is an inescapable demand for new financing through different forms of domestic and

[9] Ministry of Public Enterprises. 1995. *Discussion document by Government of National Unity on the consultative and implementation framework for the restructuring of the state assets.* Pretoria: Government Printer.

foreign partnerships to promote the infusion of new equity capital and especially technology … it should be emphasised that growing enterprises are essential to ensure job security for the employed and to generate new employment opportunities for the unemployed")

Since the publication of the document cited above, there have been a number of further elaborations of these objectives, including the GEAR strategy and the 1996 National Framework Agreement. Some objectives may have been prioritised differently in the various documents, but there is little difference in the overall statement of objectives, as shown in Table 1. Although it has been suggested that the objectives need further prioritisation if the restructuring process is to be improved,[10] it is not considered possible to provide a single set of priorities since different proposals may be best suited for achieving specific priorities. While such a prioritisation may assist managers in the public sector and in the SOEs in focusing their restructuring efforts, it is unlikely to change the outcomes of the process significantly.

Table 1: Key objectives from various policy documents

RDP (1994)	**GEAR (1996)**	**NFA (1996)**	**IMCC (1999)**
Meeting basic needs	Introducing budget reform to strengthen the redistribution of expenditure	Increasing economic growth and employment	Mobilising private sector capital and expertise
Developing human resources	Effecting a faster reduction in the fiscal deficit	Meeting basic needs	Ensuring wider participation in the South African economy
Building the economy	Encouraging a competitive and stable currency	Redeploying assets for growth	Creating effective market structures in the sectors currently dominated by SOEs

[10] Separate suggestions from HSBC, *Handover Report, October 1999*, and Cosatu, *Initial response to policy framework, April 2000*.

Democratising state and society	Ensuring monetary consistency to limit inflation	Facilitating infrastructural development by mobilising and redirecting private sector capital	Attracting foreign direct investment
Implementing the RDP	Reducing tariffs to complement industrial restructuring	Reducing state debt	Reducing the public sector borrowing requirement
	Introducing tax incentives for new competitive investment and labour absorption	Enhancing competitiveness and efficiency of state enterprises	Enhancing the efficiency and effectiveness of SOEs
	Accelerating the restructuring of state assets to optimise investment resources	Financing growth and requirements for competitiveness	Financing growth and requirements for competitiveness
	Expanding infrastructure investment to address service deficiencies and backlogs	Developing human resources	Accessing globally competitive technology
	Ensuring appropriate flexibility in labour markets		
	Funding skills training commensurate with needs		
	Expanding trade and investment in Southern Africa		
	Implementing stable and co-ordinated policies		

The table shows a remarkable consistency among the main objectives of restructuring and other state industrial and economic policies.[11] As regards the objectives as stated at the IMCC Lekgotla[12] in 1999, some of the more specific earlier objectives (e.g. "developing human resources" and "increasing employment") have been subsumed under the broader statement of "ensuring wider participation in the South African economy". The more recent objectives have also become more specific about the manner in which the competitiveness and growth of the South African economy can be promoted, in particular the references to "attracting foreign direct investment", "creating effective market structures" and "accessing globally competitive technology". While these latter concerns reflect the changing perceptions of Government's overall strategic needs, it is not believed that Government has abandoned or in any way de-emphasised its earlier objectives.

This policy framework aims at providing Government, SOEs and stakeholders with a common frame of reference, integrating and reconciling the various objectives for restructuring as championed by the different stakeholders concerned with SOEs. In general, the objectives of restructuring enhance the business efficiency and effectiveness of the enterprises, address macroeconomic needs to promote investment and/or reduce public sector debt, and involve social concerns such as employment losses and/or improving service delivery.

Although the policy framework seeks to reconcile the different objectives, it remains true that different stakeholders will seek to emphasise different objectives at the expense of others. For example, management and boards are usually more concerned with improving business efficiency and effectiveness, which will undoubtedly ensure better service delivery and better investment values, thus also meeting macro-economic and social objectives. Nevertheless, other stakeholders who value the latter objectives more highly, may be less enthusiastic about realising improved business performance, especially if they believe that this will occur at the expense of realising their priorities.

Those who champion the macro-economic objectives of reducing public debt and/or promoting investment may seek to emphasise these objectives and

[11] Some of the GEAR objectives do not relate directly to restructuring, but support the economic environment in which the restructuring objectives are met.

[12] A Lekgotla is a South African word describing a workshop.

discount the extent to which current management can improve the performance of or turn around poorly performing SOEs. Indeed, it is often the strategy of investors to acquire failing firms at bargain basement prices rather than wait for a turnaround that would enhance the value and, hence, the cost of these firms. Some may harbour doubts as to whether the turnaround strategies will be effective or whether they will merely further extend the public sector borrowing requirement.

Those, such as the trade union movement, concerned about job losses, increased service costs or reduced service delivery to the poor, may be sceptical about any restructuring initiatives that do not prioritise these objectives over others. It has been argued that the objectives of reducing public sector debt and improving investment and/or business efficiency and effectiveness are, in fact, subordinate to those of improving service delivery for the poor, creating additional jobs or overcoming the socio-economic legacy of Apartheid.

Finally, the shareholder – in this instance, Government – is concerned with broader economic and social objectives, while still requiring business efficiency and effectiveness. Given the developmental role of the state and the part that SOEs need to play in achieving developmental objectives, Government will be seeking to ensure that infrastructure and services are provided at the lowest cost and highest quality, and that access is extended to those who were previously disadvantaged. Government will ensure that this occurs through shareholder compacts with the enterprises and through direct interventions (e.g. subsidies) to pay for social requirements.

The policy framework therefore addresses these different emphases by attempting to establish a means of reconciling them in a manner that enhances overall social and economic welfare. Many of the objectives may be achieved in a specific restructuring initiative, but the extent to which trade-offs between different objectives occur will ultimately be determined in each individual case. Therefore, although it is unlikely that every initiative will adequately address all the objectives, Government is committed to ensuring that the entire restructuring programme will improve overall public welfare.

3

The economic and social effects of restructuring

The consequences of restructuring can be explained in terms of their impact on the firm, industry or sector, and broader economic impacts and social impacts. This makes it possible to assess the impacts and to distinguish the relationships between them. It also becomes easier to ascertain whether these differing impacts arise from different forms of restructuring strategies. To aid the discussion that follows, the various government approaches are classified in terms of their impacts:

Internal to the firm, industry or sector	Broader economic impacts	Social impacts
Enhancing efficiency and effectiveness of state enterprises	Reducing the public sector borrowing requirement	Ensuring wider participation in the South African economy
Accessing globally competitive technology	Attracting foreign direct investment	Mitigating possible negative social impacts arising from restructuring
Creating effective market structures in the sectors currently dominated by state owned enterprises	Financing growth and the requirements for industrial competitiveness	Promote sustainable employment, either directly or indirectly, through improvements in the economy
Mobilising private sector capital and expertise		

Restructuring has been practised internationally for more than twenty years, but there is still no consensus about its consequences. Although restructuring has yielded generally positive outcomes for individual nations, most analysts concede that there have been significant failures. These have resulted from institutional arrangements within former SOEs, as well as structural problems associated with the market environment in which they operate. Good restructuring policy must therefore take both kinds of challenges into account.

There is a growing body of literature that describes the main benefits of restructuring, indicating how both institutional and market failures can be mitigated. Potential mechanisms for overcoming the problems are identified, whereas specific concerns remain unanswered.

In this policy framework, therefore, it will be possible to identify issues on which there is general consensus, that can be used as guiding principles for the restructuring process, and also to note areas where there is not enough consensus to suggest an unequivocal position on restructuring. In the latter instances, it will be suggested that the state adopt a strategy that is sensitive to the specific circumstances of individual SOEs and the industrial sector of which they are part. Although some policy analysts would rather want unambiguous policy prescriptions, this approach will enable Government to proceed with restructuring within a more clearly defined set of parameters.

International experience with restructuring

The impact of restructuring SOEs can be understood when reflecting on the international experience. In a far-ranging assessment, former World Bank Chief Economist Joseph Stiglitz,[13] acknowledges that

> … Not only were the state enterprises inefficient, but their losses contributed to the government's budget deficit, contributing to macro-

[13] Stiglitz, J. 1998: 20–22. *More instruments and broader goals: moving toward the post-Washington consensus*. WIDER Annual Lecture, Helsinki, Finland, 7 January. Stiglitz is a renowned author on questions of privatisation. The arguments reported here are also supported by other recent survey articles on privatisation, including Nestor, S & Mahboobi, L. 1999. *Privatisation of public utilities: the OECD Experience.* Paper presented at an international seminar on "Privatisation in Brazil: the case of public utilities". 29–30 March 1999, and Megginson, W & Netter, J. 1998.*From state to market: a survey of empirical studies on privatisation,* presented at a joint conference on " Global equity markets" held by SBF Bourse de Paris and the New York Stock Exchange, Paris, 10–11 December.

> instability. Privatization would kill two birds with one stone: it would simultaneously improve economic efficiency and reduce fiscal deficits.

In the same paper, he observes that:

> … In retrospect, the advocates of privatization overestimated the benefits of privatization and underestimated the costs, particularly the political costs of the process itself and the impediments to further reform ... The conditions under which privatisation can achieve the public objectives of efficiency and equity are very limited.

He notes, in particular, that privatisation has been less successful where private ownership has not been accompanied by greater market competition:

> … If, for instance, competition is lacking then creating a private, unregulated monopoly will likely result in even higher prices for consumers. And there is some evidence that, insulated from competition, private monopolies may suffer from several forms of inefficiency and may not be highly innovative... There are strong incentives not only for private rent seeking on the part of management, but also for taking actions which increase the scope for such rent seeking.

Stiglitz concludes that there is still a case for privatisation, but that much more must be learned about the manner in and extent to which governments manage the process:

> … The Washington Consensus is right, privatization is important. The government needs to devote its scarce resources to areas that the private sector does not and is not likely to enter … Government needs to focus its attention on those areas that represent its distinct advantages, which distinguish it from private organisations. But that having been said, there are critical issues both about the sequencing and scope of privatization: even when privatization increases productive efficiency, there may be problems in ensuring that broader

> public objectives, not well reflected in market prices, are attained, and regulation may be an imperfect substitute.[14]

Stiglitz states that many of the gains attributed to privatisation actually occur prior to privatisation: “They arise from the process of corporatisation, from putting into place effective individual and organisational incentives.” Noting that there is a “continuum of arrangements” between public and private enterprises, he argues that both corporatism, “which maintains government ownership but shifts towards hard budget constraints and self-financing”, and other performance-based government organisations that “use output-oriented performance measures” are equally valid alternatives to privatisation. Key to his argument are the dual themes of increasing competition and managing the process of restructuring to ensure that rent seeking is not promoted.

Other authors support the views of Stiglitz (and Rodrik) described above. Fisher & Sahay’s[15] review the impact of privatisation and restructuring in transition economies after ten years. In particular they emphasise that hard budget constraints are more important than ownership, and that the scale and pacing of privatisation are significant. While it is possible to privatise smaller-scaled enterprises relatively quickly, larger enterprises may need more time so that the appropriate institutional frameworks can be in place.[16] This point is also made by Tornell,[17] who having reviewed the experience of privatisation internationally, notes:

> … During the last decade, … we have learned that simply transferring the ownership of state owned enterprises to private hands, and breaking up state monopolies does not automatically lead to higher efficiency … privatisation without the implementation of the three reforms [discussed below] … will simply replace government bureaucrats with private mafias (i.e. private groups with the power to extract fiscal transfers). These

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[14] Stiglitz (1998: 21–22).

[15] Fisher, S & Sahay, R. 2000. *The transition economies after ten years.* NBER Working Paper 7664. Paper presented at the AEA Meeting in Boston, January.

[16] Fisher & Sahay (2000: 19, 30).

[17] Tornell, A. 1999. *Privatising the privatised*. NBER Working Paper 7206. Paper presented at the conference on “Economic policy reform: what we know and what we need to know”, Stanford University , September 1998.

> private mafias might behave more voraciously than the bureaucrats they are replacing, reducing aggregate efficiency and further hindering the growth of the competitive private sector.[18]

Tornell argues that it may be necessary to "privatise the privatised":

> … First, re-establishing property rights *within* each firm, so that the new owners enjoy full residual rights of control in their firm. Second, *outside* the firm, facing new owners with "hard budget constraints" so that they do not have the power to either extract fiscal transfers, or obtain bailouts. Third, establishing a non-corruptible judicial system, and transparent bankruptcy procedures that are free from political pressures.[19]

The aspects around ownership, social impact and corporate governance are returned to below. The literature thus far therefore quite explicitly states that *restructuring needs to take place in a context where the institutional preconditions have been established so that market incentives can operate effectively. This does not necessarily mean that other social and political objectives should be thrown out but as will be argued below, these should be dealt with separately from the need to ensure that the enterprises are operated as businesses that respond effectively to market incentives.*[20] It is also clear from the international views that if the institutional preconditions are not established, then privatisation may not only fail to lead to restructuring, but could also result in even worse economic outcomes, with privatised firms holding the economies at ransom. Monopoly power, political influence and/or fiscal resources (extracted directly or indirectly) and imperfect legal structures provide many opportunities for rent seeking and other forms of corruption that could undermine any developmental agenda.

The literature also provides a useful indication of the appropriate conditions under which privatisation and/or corporatisation may be successful. A recent study of private participation in infrastructure provision by sector and region shows that Latin America and the Caribbean accounted for 48 per cent of all such initiatives between 1990 and 1998, East Asia and the Pacific for about 30

[18] Tornell, (1999: 2–3).

[19] Tornell (1999: 2). Support for these arguments is also provided Rodrik (2000a: 14–21).

[20] See the discussion of these issues in Rodrik and Tornell.

per cent, Europe and Central Asia for about 10 per cent, South Asia for 8 per cent, the Middle East and North Africa for about 3 per cent and Sub-Saharan Africa for only about 2 per cent.[21] These statistics confirm the suggestion by other studies that restructuring is more likely to succeed in medium- to high-income countries that have better developed economic institutions than lower-income countries.[22] *South Africa, like many countries in Latin America and East Asia at a similar level of economic development, is therefore likely to have better institutional preconditions for successful restructuring than many of its African counterparts.*[23] However, the economic crises experienced by these more developed economies in recent years have shown that even they suffer from institutional shortcomings that have undermined international confidence in developing economies as a whole.

The literature also indicates that the telecommunications and energy sectors have led private sector involvement in infrastructure provision between 1990 and 1998. Telecommunications, which accounts for 43 per cent of the initiatives, and energy, accounting for 36 per cent, have been driven largely by technological changes that have reduced sunk costs, allowed for the reform of market structures and facilitated competition. By contrast, the transport and water sectors, accounting for 17 per cent and 5 per cent of initiatives respectively, have seen fewer technological changes and have experienced greater political

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[21] Roger. 1999. Recent trends in private participation in infrastructure. *Private Sector Note 196,* September. Please note that there is a rounding error in the above percentages. Also note that these statistics refer to the value of projects and not their number, which means that in some of the poorer regions there may have been a greater number of projects of low value (relative to other regions). In such circumstances the impact of restructuring would have been much greater on that specific economy than in the more wealthy economies, even though these initiatives are relatively insignificant on a global scale. Note further that many of these schemes would refer to what are regarded as public-private partnerships, although some (approximately 40 per cent) refer to the divestiture of public assets.

[22] Boubaki & Cosset. 1998. Privatisation in developing countries, *Private Sector Note 156,* November.

[23] There seem to have been very few reviews of the African experience per se. One recent article, which presents mainly anecdotal evidence, largely confirms the above observations. Samual, S.B. 2000. *A new look at African privatisation.* IFC Corporate Finance Service Department. Washington, D.C: World Bank.

opposition and/or subnational government involvement.[24] These trends reflect the South African reality to some extent, although they suggest that more progress could possibly have been made in the energy sector.

Impacts internal to the firm, industry or sector

In terms of the impacts of restructuring internal to the firm, industry or sector, it is generally agreed that there has been an improvement in the efficiency and effectiveness of SOEs, and this has been reflected in improved productivity, profitability, innovation and levels of investment.[25] There remains some measure of disagreement as to whether these improvements occur before or after the transfer of ownership, i.e. whether they are due to restructuring prior to privatisation, or to the privatisation itself.

The relatively recent experience of privatisation and incorporation in developing countries makes it difficult to assess the long-term impact of microeconomic performance. Nevertheless, a study of the post-restructuring performance of 79 companies in 21 developing countries indicates that average profitability increased by 124 per cent, efficiency by 25 per cent, investment by 126 per cent, output by 25 per cent, employment by 1,3 per cent, debt leverage by -5 per cent and dividends by 44 per cent.[26] In most cases, therefore, increasing market incentives in the operation of public enterprises have had a positive impact. Some indicators (e.g. profitability and dividends) have increased more than others (e.g. efficiency and output), possibly indicating that the benefits of restructuring have been more skewed towards the shareholders than towards customers. It is also worth noting that, in line with Stiglitz's arguments above, competition also seems to impact on performance, especially in terms of investment that increased significantly in such environments, but was "insignificant for firms in non-competitive markets".

International experience is not conclusive about whether or not privatisation is the primary impetus for the improvement of performance of firms and industries,

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[24] Roger (1999). Please note the rounding error.

[25] See Stiglitz (1998), Megginson & Netter (1998), Nestor & Mahboobi (1999) and Sheshinski, & Lopez-Calva, L (1999). *Privatisation and its benefits: theory and evidence.* CAER II Discussion Paper No. 35.

[26] Boubaki & Cosset (1998).

since it is not easy to distinguish between pre- and post- privatisation impact in the studies reviewed. The theoretical argument for ownership transfer has, however, been made in a less ambiguous manner. It is argued that owing to information asymmetries (that is, differential access to information) and contract incompleteness (i.e. all contingencies cannot be specified contractually), full privatisation (i.e. complete transfer of ownership) should be more efficient and effective than partial privatisation or other forms of restructuring that do not involve equity sales.[27] This is based on the assumption that restructured SOEs that are not fully privatised may continue to be subject to political interference (i.e. management will be guided more by political rather than economic or financial considerations), and that they will continue to operate with "soft" as opposed to "hard" budget constraints (i.e. the state will assist them if they encounter financial difficulties). It is argued that without full privatisation, the markets will remain doubtful of Government's intentions, which could lead investors to discount such restructuring initiatives on the basis that they could be reversed.

Notwithstanding the number of existing studies, such arguments are not supported by hard empirical evidence and, even in the cases cited, a large number of competing interpretations remain. What these arguments do suggest, however, is that these perceptions may not be valid to the extent that Government is unclear about its restructuring programme, its relationship to the enterprises and its commitment to introducing market incentives into the operations of the SOEs. If, as envisaged by this policy framework, *Government can address these concerns by providing a clear signal of its intentions and the parameters within which restructuring should take place (especially as defined in the protocol of corporate governance and shareholder compact, as discussed below), then the argument that full privatisation will have the greatest impact on microeconomic efficiency is much less persuasive.[28] Other restructuring approaches such as incorporation, outsourcing, joint ventures and public-private partnerships may yield equal, if not*

[27] These arguments were first raised in this context by David Sappington and Joseph Stiglitz, who formulated the "fundamental privatisation theorem" in 1987, "*Privatisation, information and incentives*" NBER Working Paper No. 2196. Many proponents of privatisation have referred to this article without fully acknowledging the qualification that the authors make regarding their model.

[28] This view has however been questioned by Shirley, M. 1998. Why performance contracts haven't worked. *Private Sector Note 150,* August.

better, performance while also realising Government's more developmental objectives.

The arguments for privatisation (either partial or full) are more persuasive where the issues of investment and the introduction of new technologies are concerned. It is evident from most studies consulted that partial and/or full privatisation often contributes both investment finance and technology which can make SOEs more competitive. In the context of highly indebted SOEs with a history of underinvestment (like those in South Africa), there is generally a valid argument for equity sales. This can either be to a strategic equity partner where technology and expertise are required, or through a public offering if investment funds are needed. The case for some degree of ownership transfer may, therefore, still be valid, even when the information and contractual concerns can be addressed through other means.

The final point to note is that *there is virtually unanimous support for the argument that establishing competitive markets is the most important policy component of any restructuring initiative. The failure to establish such competitive conditions will, at best, lessen the full microeconomic improvements and, at worst, lead to serious economic abuses of monopoly power.* Early attempts at restructuring in some countries sought to preserve the monopoly status of some SOEs in the belief that this would make them more globally competitive and/or increase their sale value. There has been little evidence, however, that any positive impact resulting from such a strategy has outweighed the consequences of failing to establish competitive markets. All commentators reviewed agree that, coupled with the change in technology in the main telecommunications and energy sectors, the establishment of competitive markets should be a priority goal of any restructuring initiative.

Broader economic impacts[29]

The broader economic impacts of restructuring are those impacts that affect the broader economy. These impacts are generally less controversial, largely

[29] This section was based in part on *The macroeconomic impact of privatisation* prepared by the Chief Directorate: Macroeconomic Policy in the Department of Finance. This document made use of Megginson & Netter (1998), Nestor & Mahboobi (1999) and Sheshinski, & Lopez-Calva, L (1999).

because they reflect some self-evident realities. In most instances, any injection of financial resources (such as tax, dividends, or proceeds from equity sales) will result in a reduction of the public sector borrowing requirement which, in turn, will enable the state to prioritise other expenditure or reduce its demands for borrowing. A lower borrowing requirement should result in lower interest rates, which would stimulate investment and contribute to economic growth.

Most proponents of privatisation argue that the greatest economic impacts result from full privatisation. This is because the latter will provide a larger injection of resources to the fiscus than a partial privatisation or other form of restructuring (unless these approaches yield other returns to the state in the form of greater tax returns or dividends, or increased deferred payments). This argument can be demonstrated by means of a simple model, based primarily on the assumption that a larger (rather than smaller) quantum of resources will undoubtedly have a greater effect on the other variables described above. However, such a model will not necessarily reflect the microeconomic impact and the manner and timing in which other returns are made available to the state. These concerns will be discussed below.

While many forms of restructuring can improve the efficiency with which SOEs use resources, a process that involves a transfer of ownership can have important additional macroeconomic benefits. These include:

- Fiscal impact (including lower costs of state debt and increased fiscal resources for targeted expenditure)
- Financial market impact (including lower domestic interest rates and an improved credit rating)
- Balance of payments impact (including increased foreign capital inflows and a reduced forward book or increased foreign reserves)

An increased scale of privatisation allows for an accelerated reduction in the level of state debt which, in turn, has a significant impact on the interest costs of Government in subsequent years. With given deficit targets, a reduction in debt service costs translates into greater resources for spending on social services or infrastructure investment. Alternatively, it results in lower revenue targets and greater discretionary spending by the private sector. It is assumed that there is a net improvement in the fiscus as the sum of the privatisation proceeds plus the net present value of the increase in future taxation receipts (or decrease in subsidies) and reduction in state debt costs exceeds the net present value of the sum of future dividend flows and tax receipts.[30] The assumptions associated with returns from equity sales proceeds, increased taxation and reduction in subsidies are discussed further below.

The consequence of using privatisation proceeds to fund Government's borrowing requirements is a reduction in the amount of new government debt that needs to be issued in any given year. Reducing public sector borrowing should, all other things being equal, translate into lower interest rates. However, should there be a simultaneous fall in the demand for government bonds, then the effect on interest rates may be neutral. The ultimate impact on interest rates depends on the nature of the financial flows that take place. In a closed economy, privatisation would result in a transfer of investment funds out of bonds and into equity as investors take up holdings in the newly privatised entities. In an open economy, however, much of the investment in privatised firms is likely to be in the form of foreign investment. This constitutes additional investment in the economy, which mitigates the domestic switching effect. Institutional factors will also limit the extent of demand switching. Certain institutions (such as pension funds) require a relatively constant proportion of bonds in their portfolios for prudential reasons. Lastly, lower interest rates can paradoxically result in an increase in the demand for bonds if the decline in rates is interpreted as a sign of economic stability and lower risk.

Another reason for expecting lower interest rates arises from a reduction in the risk premium demanded on domestic debt. Higher capital inflows, increased foreign reserves, perceptions of accelerated economic reform and potential credit-rating upgrades can all contribute to significant reductions in a country's risk premium.

The current structure of SOEs is the outcome of a long period of isolated development in which narrow "strategic" interests had preference over broader economic and social development. Investment decisions that were not always efficient or in line with development needs have left a legacy of poor SOE performance and infrastructure backlogs. In addition, some SOEs do not have access to global technology and skills, which makes them uncompetitive in a rapidly changing world economy. Given the key role they play in providing

[30] Mackenzie (1998).

economic infrastructure for other sectors of the South African economy, this situation is making our integration into the global markets all the more difficult. Many SOEs also have high levels of borrowings, which raises the overall level of the South African public sector borrowing requirement. High borrowings translate into high interest payments that affect profitability and, hence, an inability to expand development opportunities.

Unfortunately, the state lacks the immediate resources to address these investment and infrastructure backlogs. There is thus an inescapable demand for new financing through different forms of domestic and foreign partnerships to promote the infusion of new equity capital and technology. Although Government is seeking a range of restructuring methods from corporatisation to management contracts, strategic equity partnerships and public offerings, the South African context of infrastructure backlogs and limited government resources indicates that, in many cases, there will be some level of equity sales to provide capital, technology and/or access to markets for infrastructure expansion. Given the limited fiscal resources, further infrastructure investment can only be achieved through an accelerated programme of the restructuring the SOEs and more extensive use of public-private partnerships. Both types of programme should see an increase in local and foreign direct investment.

Restructuring is expected to lead to increased capital inflows in the form of both portfolio flows and foreign direct investment (FDI). FDI increases directly as a consequence of ownership transfer. The prospects of higher FDI and foreign exchange reserves alleviate balance of payments fears. Privatisation also acts as a catalyst for subsequent FDI. Portfolio flows in the equity market may respond to the prospect of falling interest rates, higher growth and the growth of a utilities sector on the stock exchange. Higher capital inflows allow for an increase in foreign exchange reserves (or, in South Africa’s case, a reduction in the forward book). This improves investor confidence and reduces risk premiums. The higher credit rating can thus translate into lower costs of borrowing. Significant capital inflows and increased foreign reserves reduce the possible constraint of the balance of payments on the pace of economic growth. The capital account of the balance of payments is bolstered by capital inflows associated with asset sales. Pressures on the current account may increase following privatisation, owing to higher import demand during infrastructure expansion and a rise in dividend and interest payments to foreign institutions, but these are generally outweighed by the scale of capital inflows.

Interest rates can therefore be expected to decline if the increased demand for capital resulting from new infrastructure expansion under private ownership is met by increased foreign capital inflows and limited investment switching from debt to equities. The sustainability of lower interest rates, however, depends on the degree to which the added stimulus to the economy is non-inflationary, since inflationary pressures would require a tightening of monetary policy and a consequent reversal of the interest rate gains. It is here that the establishment of competitive markets is likely to contribute to sustainable non-inflationary growth because of the assumed efficiency improvements that arise from the microeconomic impact discussed above.

No discussion of the broader economic impacts of restructuring would be complete without some mention of the proceeds from restructuring and their impact on the country's macroeconomic situation. The Macroeconomic Policy Unit of the Department of Finance has modelled some of these impacts. International comparisons indicate that, as a benchmark, gross privatisation proceeds in developing countries during periods of active privatisation have averaged 1,5 per cent of GDP per year.[31] In South Africa's case, this would translate into approximately R12 bn per year in 1999 prices. It should be noted that there can be no certainty about the proceeds from restructuring, as they depend on the form of restructuring, market sentiment, timing and on what is happening in the global and local markets generally and the sectors specifically.

While it cannot be disputed that increasing the financial resources of the state through privatisation will have positive macroeconomic effects, it is still not clear whether the best way in which this can be done is through the divestiture of equity in SOEs. Proponents of such a course of action would have to prove that there are no instances where continued state ownership can be more beneficial than private ownership. As shown in the section on microeconomic impact, considerable debate remains as to whether the competitiveness benefits of restructuring arise prior to or after the sale of equity. If information asymmetries and contractual incompleteness can be addressed, there is sufficient support for the proposition that the state can benefit from restructuring without necessarily following through with full privatisation.

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[31] Based on World Bank data, quoted in International Monetary Fund. 1999. *Fiscal and macroeconomic impact of privatisation*. Working Paper, New York: IMF, December.

In particular, it may be argued that in instances where the SOE value is heavily discounted owing to poor performance, underinvestment and/or high debt leverage, it may be reasonably suggested that the state should turn around the SOE before it proceeds further with privatisation. Where such turnarounds are feasible, the returns to the state from increased dividends, taxation and/or deferred equity sales outweigh the returns from immediate privatisation. Since there is no unequivocal evidence to support either option, it would be prudent to argue that decisions to restructure and/or privatise will need to be dealt with in each individual case. In some instances, especially those involving small enterprises and non-core assets, there may be little value in adopting this approach, but the restructuring and/or privatisation of major state enterprises will need to be justified by a thorough investigation of the options. On the basis of preliminary work done by Government, there is sufficient evidence to suggest that a range of restructuring options beyond full privatisation will yield the greatest economic value for the state.

Social impact

It is important not to conclude the discussion of the impact of restructuring without considering the social impact. In this section, it will be argued that the potential exists to generate higher "public good" outcomes with respect to both micro- and macroeconomic processes through continued state ownership of SOEs, even if the immediate financial rate of return on SOE assets is lower. It is suggested that the benefits of positive externalities realised under state, worker or community ownership (and potentially forgone under private ownership) may justify an ongoing public investment role.[32] In these instances, the state may pursue such developmental objectives without necessarily yielding to the past shortcomings of public ownership.[33]

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[32] To some extent such public good effects can also be generated through regulation, as discussed further below.

[33] It is important to reiterate that the well-known criticisms of public ownership largely derive from the belief that such ownership necessarily leads to inefficiencies and ineffectiveness because of undue political influence. As argued in the section on microeconomic impacts, these problems are less likely to arise when the state's developmental objectives are accounted for in a transparent manner. The problem is therefore not whether public ownership itself is a problem, but whether

Most of the issues discussed in this section arise from the changed economic conditions under which the restructured SOEs would operate. Because of sensitivities associated not only with potentially conflicting labour-management relations, but also with maximising social welfare by accounting for public goods and promoting black economic empowerment, the realisation of social impact generally requires some political guidance. The two major social impacts referred to in the international literature are employment (including wage or salary level) implications and the effect of restructuring on the quality and pricing of services. A third impact is the incorporation of public goods within SOEs, so as to continue to utilise state assets for broader social objectives, if transparency and rigorous cost-benefit analysis justify this. Finally, issues of "economic empowerment" (as they are defined here) arise. Although in some respects these issues are unique to South Africa, there are also important international experiences concerning diverse forms of restructuring in post-socialist societies. In general, the theory of public goods, as discussed below, covers these objectives. It should, however, be stressed at the outset that the social and empowerment objectives should not be seen as distinct from, but as complementary to, the micro- and macroeconomic objectives.

Dealing with the most controversial impact first, it is universally agreed that the immediate impact of restructuring involves employment losses. What is not always evident is whether the longer-term benefits of restructuring in the form of more efficient firms and a more competitive economy create more employment than was initially lost through restructuring. Even in cases where restructured firms shed labour in the short term, this does not necessarily make labour worse off as a group.[34] Other medium- and longer-term benefits for labour may include the appreciation in the value of shares acquired in the restructured enterprises and, more importantly, improved economic conditions that permit re-absorption into the job market. In the long run, restructuring can produce new employment opportunities owing to the probable expansion in output.

Nevertheless, some declining sectors will experience an irrevocable loss of jobs. However, where restructuring brings about significant efficiency improvements and new technology, the result is often the development of new niche industries

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the influence of that ownership can be properly accounted for in the business decision-making of the enterprise.

[34] Nestor & Mahboobi (1999).

able to absorb retrenchments in other areas. The lags involved in structural adjustment are such that, even though restructuring may not have an adverse effect on sectoral or total employment in the long run, there may be workers who suffer temporary unemployment. The state has a role to play in these circumstances by ensuring that measures are put in place to mitigate the social impact of privatisation, such as retrenchment packages, unemployment insurance and job reskilling. This will be discussed in more detail in the section on social plans.

Estimates from the model discussed above indicate that, for the three restructuring options, combined employment effects can vary from overall job losses, despite indirect job gains, to significant overall employment gains arising from efficiency gains in other sectors.[35] The restructuring process should not only attempt to limit the number of job losses, but also to develop new employment opportunities. It is likely that the expansion of some key sectors – especially telecommunications and perhaps defence – would lead to additional employment opportunities being created as the economy seeks new technological niche markets to exploit.

The second social impact to be considered is the effect of restructuring on consumers. It is here that the question of increased competition becomes particularly relevant. International experience indicates that in cases where a public monopoly has been converted into a private monopoly and/or insufficient conditions exist for creating a competitive market, the full benefits of restructuring have not been realised.[36] Either the full benefits of improved microeconomic performance have not been achieved, or, where they have, these have been largely retained as monopoly rents by management and/or the shareholders. It is important therefore to acknowledge that privatisation, especially when it occurs in a non-competitive environment – such as exists in most sectors in which South African SOEs operate – can lead to monopoly

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[35] These estimates probably understate longer-term employment impacts as they do not consider the counter-factual consequences of not restructuring railway and port enterprises. Without the restructuring of these SOEs, the competitiveness of the economy is likely to decline. The longer-term impact of such a decline has not been calculated but could easily amount to several hundred thousand rands (estimated on the basis of jobs lost since the opening up of the economy since the 1990s).

[36] Megginson 7 Netter (1998).

pricing, underinvestment (and/or disinvestment) and other forms of rent-seeking behaviour.[37] Although regulation has been proposed as a means to address the problem of monopolies, international and local experience with such forms of regulation would suggest that regulation is not very effective in curbing monopolistic behaviour in an environment in which alternative pricing cannot be established.[38]

One of the major aims of restructuring should be to meet the needs of consumers by providing them with improved access to higher-quality, reliable services and/or lower prices. It is assumed that where customers have a choice between competing service providers, service levels are more likely to increase and prices are more likely to fall than under monopoly conditions. Local and international experience suggests that consumers derive a range of benefits from competition. Where consumers have a choice, they may elect not to use a supplier or producer who does not offer good service or charges higher prices. It is also assumed that competition in the market will encourage innovation, as different suppliers or producers that offer similar products will be forced innovate to ensure that their product is distinguishable from others. Competition also enables consumers to make their own trade-offs between price and quality of service. Price-sensitive consumers may be prepared to accept a lower quality of service in exchange for a reduced price. Other consumers may be prepared to pay a premium for a high level of service.

While regulators are often charged with regulating prices and regulating access to the market, they are rarely charged with ensuring quality of service to consumers. If Government therefore intends to ensure that consumers benefit from the restructuring of state assets, then it will need to make certain that service costs and quality are covered by regulation in non-competitive environments. Price regulation will usually ensure that excess profits are not being charged. Comparisons should therefore be made between the economic performance of the monopoly and comparable industries locally and abroad. Even where there is a natural monopoly, there may still be areas where competition can be introduced in the vertical chain of production. Competition in supply or in the retailing of the product may be possible. Consumer protection

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[37] This is not to say that the new shareholders and management are not pursuing their rational self-interest, but their interests will not necessarily coincide with those of the nation of a whole.

[38] Anbarci & Karaaslan. 1994. *An efficient privatisation mechanism*.

can also be encouraged through the truthful and adequate disclosure of information by state enterprises. Disclosure of information ensures greater transparency and accountability.[39]

The third social impact of restructuring is the issue of public goods and services. The theory of public goods posits that, in a market system, certain goods and services are not produced or consumed with sufficient quantity and quality to maximise social welfare. The result is a form of market failure. Usually Government, or its agent (often an SOE), is required to produce such goods or services. Although public goods can be observed and measured, they have two theoretical characteristics: “non-rival consumption” and “non-exclusion” from consumption. Non-rival consumption means that the consumption of a public good or service by one person need not diminish the quantity consumed by anyone else.[40] The principle of non-exclusion means that it is impossible to prevent other citizens from enjoying the benefits of public goods, regardless of whether they are paid for. This is important, as Government gradually determines the nature of social policy, and distinguishes between necessities guaranteed by the state, versus luxuries for which people must pay.[41] (For instance, a new national water pricing policy, for instance, assures a supply of 25 litres of water to everyone for free.)

These aspects of public goods are crucial to an SOE’s view of a cost-benefit analysis of the goods and services it delivers to the public. The more the characteristics of public goods of, for example, telephone, electricity or transport, the more it makes sense for Government to assess to what degree these SOE

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[39] Hilke, J. C. 2000. *Federal Trade Commission*, Presentation at a Conference on “Competition and Regulation”. Gallagher Estate, 17–18 April.

[40] A typical example is South Africa's national defence system, which is “consumed” by all citizens in a quantity that is not affected by the consumption of defence benefits by fellow citizens. Likewise, the benefits of a clean environment and hygienic public water system (reflecting a strong municipal water system and a lifeline access to all those who have constitutional rights to water) are enjoyed by all municipal consumers, regardless of how much water is consumed by a particular individual.

[41] Television broadcasting, for example, has benefits that relate to “non-rivalry” in that once someone has a television set, he or she can enjoy broadcasts without regard to whatever fellow citizens are enjoying. But because television entertainment is a luxury good, even a state supplier has the right to exclude people, for instance those who do not pay their licence fees or those who simply cannot afford a set of their own. In turn, this raises another issue that Government will take up in future, namely “free riders” who consume public goods but do not pay their fair share.

goods or services can be considered socially "necessary", as opposed to being "luxury" goods or services that can be left to the market to provide. If SOEs produce necessary goods or services or if they have a substantial "externality" effect, i.e. the consumption of the goods or services has a positive (or negative) impact (e.g. pollution), upon those who do not consume them, then Government will need to take a more active role in defining and regulating their production and consumption in the public interest.[42] How Government chooses to ensure their production will be determined by social policy, as distinct from the economic operations of the SOE.

For many public goods, consumption becomes as important as production. For example, simply establishing an SOE to generate electricity, invest in new telephone exchanges or provide transport options is not sufficient. It is crucial to tap into the vast "social capital" that exists among South African consumers of these services, namely trust, horizontal community information and democratic development processes. The objective here is for any new SOE investment in infrastructure associated with a public good or service to become a much more integral part of the South African social fabric.[43] Government must therefore help establish and sustain such relationships, as they cut across all SOEs. Economists have only lately begun to recognise the value of "human capital" (particularly through long-term state investments in health care and education); likewise, a new interest in maximising social capital is increasingly seen as an extremely cost-effective way in which to increase the returns on development investments.

On the other hand, many goods or services produced by SOEs should rather be considered necessities or, more accurately, "rival" and "excludable" goods that have such small externalities that the private sector could have a greater role in their production. For historical reasons, many such goods or services, (e.g. air travel for elite consumers or businesspeople), have been produced by South African SOEs

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[42] The difference between a public good and an externality is simply that the latter is an *unintended* consequence of an activity undertaken for a different purpose. The challenge, therefore, is to increasingly recognise the existence of externalities in a more proactive, *intentional* manner, especially insofar as they help achieve South Africa's broader goals. They should be considered as public goods and hence be treated *transparently* by the SOEs that produce them.

[43] This in turn assures that a relationship between the particular SOE and consumers may help provide solutions to problems such as theft (e.g. in the case of copper telephone lines) or inability to access a service owing to affordability constraints (as has happened with the rural electrification programme).

instead of private firms. It is now the time to remedy this situation more coherently, where possible, by assuring that decisive asset restructuring occurs more rapidly where the goods are of a non-strategic character.

In short, Government will need to define more carefully the pricing, distribution, consumption and even the very nature of goods or services that SOEs produce, by means of an overarching framework defining the nature of public goods. For it is the very "public" character of SOEs that distinguishes them from private suppliers. Since the usual means by which Governments intervene to enhance public goods and positive externalities (or to limit external costs like pollution) include direct production, regulation, subsidisation and taxation, such a framework will ensure that the best combination of these techniques is more effectively deployed in future. Government will need to take a firmer stance than it has to date in ensuring that public interest is met through the production and consumption of public goods and services. Aspects of regulation, to this end, are discussed in a subsequent section.

Lastly, there is the issue of empowerment, defined in its most general sense to involve greater participation of those historically disadvantaged in the economy by race, gender or disability (whether as shareholders, workers or consumers). These issues are discussed in more detail below. At this stage, it is important to recognise that the form in which restructuring takes place will determine the effectiveness of empowerment. The international experience also offers a mixed picture of empowerment. For example, the situation in Eastern Europe generated similar patterns of disadvantage as in South Africa by excluding a large proportion of the population from effective economic participation. Attempts to promote popular shareholding ("voucher capitalism") and worker participation have had limited success. They may also have contributed to the failure of these countries to realise significant micro- and macroeconomic benefits from restructuring.[44]

An important lesson from the international experience, however, is not to disregard these critical issues of social impact, but to account for them in a more transparent manner. This would mean that Government's intention of making SOEs more responsive to market incentives (i.e. promoting microeconomic efficiency and effectiveness) should not be undermined by other social or political obligations to preserve employment and/or deliver services uneconomically.

[44] Megginson & Netter (1998).

Such social responsibilities could rather be dealt with directly through subsidies and/or social programmes that are fully accounted for in the budget. Or, if a regulatory approach is adopted that explicitly sets prices on an SOE's product so as to achieve other social goals, this should be made clear within published price or tariff schedules.[45]

Social objectives should also be made transparent through their explicit inclusions in the "shareholder compact" discussed below. The management and boards of the restructured SOEs would then be less susceptible to external influence, budget constraints would remain hard, and the state could demand performance improvements (reflected in tax receipts or dividends) sufficient to cover the additional subsidy burden of explicitly addressing the social impact. As far as broadening access to ownership in the economy is concerned, Government will need to examine the international experience further. Evidently, broader opportunities for meaningful participation will have to be created by increasing the range of restructuring options implemented.

Conclusion – factoring the impact into restructuring approaches

The discussion in the three previous sections described the main impacts of restructuring internationally and showed how this experience could help shape the approach to restructuring in South Africa. While there is a growing understanding of restructuring, there are still many areas that remain unresolved. Nevertheless, *the growing consensus on the issue allows Government to pursue an accelerated programme of restructuring that should incorporate the following principles:*

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[45] Consider an example *not* covered by any particular SOE at present, namely the provision to consumers of water with a free "lifeline" supply so as to meet minimal health/hygiene standards, and using a rising block tariff to cover this subsidy. For this measure to be effective, politically acceptable and also a contributing strategy in a broader water conservation programme, it is vital that every consumer of water knows when he or she is moving from one block of consumption up a price curve to the next, and what these benefits mean to society as a whole. This technique targets provision of vital state services to very low-income recipients more successfully than a general welfare subsidy, as suggested in a survey of infrastructure pricing by the World Bank. 1994. *World Development Report: Infrastructure for Development*, Washington, DC: World Bank, 80.

- *The promotion of competition and competitive markets should be an integral element of any restructuring strategy* to ensure that the benefits of restructuring (such as efficiency gains) translate into lower prices, higher quality goods and services, and wider coverage. This should be undertaken within an appropriate regulatory framework where necessary. In addition, where there are social needs that will not be dealt with by a competitive market, government intervention will be necessary.

- Although the scope for promoting competition has increased with globalisation and technological change*, in those business areas where competition is not feasible, a regulatory framework needs to accompany any restructuring initiatives.* Residual natural monopolies are those businesses for which, owing to their nature, it is not feasible to have more than one firm within the industry. Examples of these are usually network industries, like power transmission, where it would not make sense to have two networks serving the same market. The establishment of such regulatory regimes should help ensure that these residual monopolies do not distort the development of competitive markets in the non-regulated sectors of the industry. The regulatory framework must be consistent, manageable, appropriate and without red tape.

- *Government should clearly spell out its intentions and envisaged relationship with the restructured SOEs* in individual shareholder compacts with enterprises, in the corporate governance framework for all SOEs, and in a clear policy framework and programme for restructuring. If Government's intentions are clear, the performance of individual SOEs will be easier to assess, enabling the state (as shareholder) and investors alike to make more appropriate investment decisions.

- *Government should explore options to enhance productivity, profitability, investment and innovation.* This will often entail equity sales (full or partial privatisation) in order to access additional funding, technology or markets. Where this is not required, other approaches such as corporatisation, joint ventures, employee participation schemes and community partnerships may be more beneficial. In instances of partial privatisation, other partnership arrangements may also be adopted.

- *Government should maximise the optimal return to the shareholder (fiscus), whether through the proceeds from equity sales, dividends and/or tax returns.* By adopting this optimal approach, Government can maximise its long-term returns on its shareholding by trading off short-term gains from equity sales in depreciated assets for medium- to longer-term gains (dividends, taxes, deferred equity sales) from successfully restructured SOEs.

- To ensure that the elements of public goods and services delivered by SOEs are still accounted for, *restructuring proposals should assess their impact on overall social welfare.* Such an analysis should address the costs and benefits to society, both direct (e.g. immediate impact on pricing or employment) and indirect (e.g., social costs from non-delivery of certain essential services or the impact of unemployment on specific communities). Apartheid concentrated people, as opposed to infrastructure and services, in the geographical areas of the former Bantustans. Consequently, the Northern Province, KwaZulu-Natal and the Eastern Cape are the most affected by structural poverty. The analysis should therefore consider such regional variations, as well as the impact that the restructuring process will have, for example, on the rail and road transport networks, and electricity and communications roll-out.

- Government should be transparent in addressing its social objectives (social plans, employment creation, price subsidies, optimisation of public goods, empowerment, etc.), allowing stakeholders to reach agreement on the logic and methods of the restructuring process. Such transparency will enable both Government and the restructured SOEs to better account for their individual actions towards meeting their objectives, and to ensure that poor performance can be both identified and remedied. Government will continue to monitor and evaluate the implementation of applicable laws, in particular on transparency and on the management of public finances.

There are various approaches that Government could use to achieve these objectives. These approaches can be classified into three interrelated categories: those internal to the industry or sector to which the enterprise belongs, those that relate more broadly to the economy, and those that relate to the achievement of social goals. The approaches Government adopts are related to its overwhelming electoral mandate and are defined by the dynamic relationship between its responsibilities to all South Africans and to the region as a whole.

Within each industry or sector, Government aims at enhancing the efficiency and effectiveness of SOEs to secure services and infrastructure delivery at an optimal cost and level of service. This requires access to globally competitive technology to ensure that they are able to provide the best available and affordable services. Appropriate market structures should be created within the sectors currently dominated by SOEs to ensure encouraged effectiveness and efficiency. Private sector capital and expertise should be mobilised and structured in such a way that the aims of Government are achieved.

SOE borrowing represents a significant portion of debt in the broader economy. Government wishes to lower the public sector borrowing requirement, which includes SOE borrowing, primarily to release interest commitments for greater public benefit. Currently many SOEs are highly geared – their level of borrowing is very high relative to various other financial measures, including their earnings before interest and taxation. Foreign direct investment needs to be attracted into the country to provide access to markets and technology, and to finance growth and the requirements for industrial competitiveness. If Government is to promote development, then it also needs to restructure the economy.

In terms of approaches to addressing social issues, Government needs to ensure wider ownership and participation in the South African economy. Government needs to improve service delivery in terms of cost, quality and access, and to promote human resource development, including the development of management skills for SOEs. Comparative assessments of restructuring and privatisation initiatives indicate short-term job losses in some sectors, resulting from over-employment, or from the enterprises responding to new challenges. South Africa is currently undergoing rapid changes, particularly in the secondary or the manufacturing sectors. The emergence of small, medium- and micro-enterprises as an important component of the sector reflects a shift in the industry's organisation and also impacts on the nature of the labour market. The new economy has also had an impact on the nature of work and on the job opportunities linked to its emergence. Tourism, as a new industry linked to the recreation and environmental sector, has also emerged as a new role-player in job creation. Government has noted these new contexts, and aims at mitigating the short-term negative impacts through a conscious and viable social plan programme. Thus, Government recognises the need for promoting the creation of sustainable employment either directly or indirectly through improvements in the economy, as well as through immediate alleviation programmes to ensure that the short-term losses do not become a longer-term reality. Expanding the scope for employment in general and in new areas, in particular, remains a key objective of government policy.

The discussion of the impacts of restructuring has also highlighted a number of important methodological considerations that will be dealt with in more detail in the chapter on improving the restructuring process. Of importance here is that restructuring proposals should clearly identify and describe the micro- and macroeconomic and social impacts so that stakeholders can weigh up the various restructuring options.

4

Promoting appropriate regulatory and competitive frameworks

As discussed previously, the optimal benefits from restructuring are only realised when the markets in which the SOEs function are reorganised to promote competition. The expansion of markets internationally and technological advances create increasing opportunities for promoting competition, even in industries that were traditionally regarded as natural monopolies. For instance, in the energy sector, new technology has enabled competitive generation and distribution industries to develop, even where the network remains a public monopoly. Similarly, in telecommunications, new technologies are challenging the predominance of a single national network and are opening up the market to competition. Nevertheless, some areas in the economy will remain susceptible to non-competitive behaviour or to other market failures (such as negative externalities or the failure to incorporate public goods), and these will need to be addressed through some form of regulatory regime.

The establishment of a regulatory regime prior to the restructuring of a public monopoly has become standard practice in South Africa, and many such regulators now exist. Ministers at the IMCC Lekgotla expressed some concerns about the current practice. They believe that the proliferation of independent regulators is likely to grow as the restructuring programme is accelerated. They are particularly concerned that certain regulators have adopted a policy-making role independent of Government. Both the rapid increase of regulators and the lack of clarity about roles and responsibilities are seen to contribute to market uncertainty that could eventually undermine the achievement of the restructuring objectives.

The Ministers stated the need for establishing a common framework governing the functions, responsibilities and operations of regulatory authorities, and possibly for consolidating regulators in certain sectors. The question was raised whether the newly established Competitions Commission could not (as in the case of Australia) take over some, if not all, of the functions of individual sector-specific regulators. The Department of Trade and Industry and the Competitions Commission then undertook to provide some guidance on this issue.[46]

Competitions Commission and the Regulators

The new Competition Act, which came into force on 1 September 1999, creates an institutional framework for the regulation of mergers and the proscription of anticompetitive behaviour. These two areas are also, to varying degrees, the subject of the jurisdiction of various industry-specific or multisector regulators. Jurisdictional conflict over which authority should regulate which area often, leads to tedious and expensive litigation over purely procedural matters, thus preventing regulators from engaging in substantive issues. Generally speaking, economic regulation is undertaken to control specific industries, markets and business practices, thus focusing on price, markets and the obligation of the industry has to provide the public with adequate service. The distinction between technical regulation and competition regulation is, however, often blurred. For example, technical decisions regarding spectrum use in the telecommunications sector and the accompanying decisions about licences profoundly affect the intensity of competition in the sector.

Competition authorities and regulatory agencies (be they industry--specific or multisectoral) can co-exist under various conditions, depending on their jurisdiction and mandate. Competition issues in a regulated sector may pose certain dilemmas, the outcome of which depends on how the allocation of jurisdiction in these matters is understood and the effectiveness of the agencies involved. Moreover, friction may exist regarding the prioritisation of objectives and the methods used by regulatory authorities and competition authorities.

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[46] The discussion that follows is drawn primarily from the document *Competition and regulation: who has jurisdiction* prepared by the Policy and Research Division of the Competitions Commission (1/2/2000). Mr Anton Eberhard of the National Energy Regulator also provided input.

[47] As distinct from social regulation, which aims at addressing social issues that relate to the production of goods and services, such as pollution, product safety and product reliability.

[48] For our purposes, competition legislation is considered an economy-wide regulation, whereas regulation refers to industry-specific regulation, as is currently administered by separate authorities such as ICASA and the NER.

Regulation is implemented as a substitute for competitive forces (by enforcing a price cap, for instance), whereas competition law is aimed at protecting and enhancing the competitive process (which will drive prices down) and to set boundaries for acceptable business conduct. Unlike regulation, competition law is not suited to protecting individual firms or sectors from competitive forces; rather, it is aimed at providing firms the opportunity to enter markets and at providing choices for consumers. The rationale for economic regulation is found in market failures that prevent socially optimum levels of production from being realised.

The objective of sector-specific regulation of certain industries is, therefore, to counteract market failures, such as externalities, monopoly power, the need to incorporate public goods, and information asymmetries. It is generally accepted that economic regulation is warranted in an industry where the competitive forces do not lead to optimal outcomes, be it for consumers, the environment or related domestic industries. However, due to the global trend towards the liberalisation of markets, as well as technological advances, the notion of what constitutes a natural monopoly, is constantly being eroded.

Regulation is often thought of only in terms of the establishment of preventative mechanisms for restraining unscrupulous business activity when competition is being introduced. However, it also incorporates measures for ensuring that restructured SOEs function in a manner that does not divorce them from the interests and well-being of the public, who are both the consumers of services and the “shareholders”.

Differences in method

An important distinction between the methods used by regulatory agencies and those used by competition authorities is that of the timing of the intervention. Regulation is usually prospective and consists of legislation, regulations, rules, directives, and the terms and conditions of licences, all of which are aimed at preventing harmful business practices. These rules are determined in advance and will pertain to situations that may arise in the future. By contrast, competition law, with the exception of merger control, is applied retrospectively by the competition authorities only once a concern in this respect is raised or identified. The law is applied as the need arises in each individual case.

The emphasis on technical expertise in sector-specific regulatory agencies can lead to an underestimation of economic or competition principles, and of the need to meet Government's broader socio-economic, developmental and environmental objectives. Regulatory interventions can have the undesirable effect of limiting innovation and investment or even of reducing competition by creating distortions in the marketplace. "Captive regulation", in which regulators are under obligation to industry groups, norms and practices, is also a common problem. Conflict between the optimal technical solution and the optimal competitive solution to a certain problem is therefore a distinct possibility. The prospective characteristic of sector-specific regulation is further challenged by technological innovation, which is difficult, if not impossible, to predict.[50]

Notwithstanding the above, it is important to note that despite the potential contradictions in the objectives and methods of the different regulators, there should be no difference between the broad objectives of the respective authorities, which will invariably include affordable prices, quality improvements and choice for the consumer. (More specific issues such as universal access form part of the overarching policy framework and should normally be taken into consideration by both regulatory and competition authorities.) Moreover, regulation is often seen as a means to mimic competitive conditions in the market, and is therefore likely to be established in markets with competition concerns. Hence, it is possible to find examples of close co-operation between institutions or of concurrent jurisdiction.

International experience

The interaction of competition authorities and regulators in promoting competition varies from country to country, and sometimes even within a particular country. Four approaches can be adopted:[51]

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[49] As an example of how regulation can hamper the introduction of new products and limit innovation, consider the case of regulation of cellular telephony in the United States. Although the technology was available in the early 1970s, the first licences were only issued in the 1980s. (Guasch, L. *Competition policy advocacy and regulatory reform*).

[50] Refer to Section 3.1 for a discussion on the merits of sector-specific regulation vs generally applicable antitrust.

[51] OECD. 1999. *Relationship between regulators and competition authorities*, *background note to Competition Policy Roundtable.* OECD. 1999. *Roundtable discussion on relationship between regulation and competition authorities: submissions by Australia, Korea, Mexico, United Kingdom, and the United States.*

1. Competition authorities can be granted all sectoral regulatory functions for a particular sector or sectors.
2. Competition law enforcement can be separated from sector-specific regulation, so that the competition authorities adjudicate all competition issues while the regulator deals with all other regulatory matters.
3. The competition authorities can have concurrent jurisdiction with the sector regulator on competition issues.
4. The sector regulator can retain exclusive jurisdiction over competition issues in its sector.

The Australian Competition and Consumer Commission was recently mandated with some technical regulatory functions (option 1), such as regulating access to telecommunications networks, but this was an exceptional case. This approach was adopted to accommodate factors considered unique to Australia, such as the failure of courts to adjudicate effectively on issues regarding access and other complex regulatory matters.[52]

In international practice, there are few examples of either option 1 (competition authorities as regulator) or option 3 (concurrent jurisdiction), suggesting a demarcation of authority that places full jurisdiction regarding competition issues either with the competition authorities or with the sector regulator. Most OECD countries follow the mandate-driven division of labour approach (option 2). Concurrent jurisdiction (option 3) appears to be rare. There are some examples of option 4 (jurisdiction with sector regulator), particularly in developed countries with established regulators and experience of antitrust. The United Kingdom has taken this approach and the United States has established this tradition in specific sectors (e.g. banking and telecommunications).

In practice, the demarcation of authority may vary within a country, and therefore the options mentioned above should not be taken as mutually exclusive. The ideal approach may vary across industries and will be determined by the characteristics of the industry involved, the current regulatory and adjudicative regime and the possibility of introducing or strengthening competitive forces. The suggested approach for the South African regulatory regime is therefore a sector-specific approach that specifically addresses all of these issues.

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[52] OECD. 1999. *Aide-Memoire of the discussion.* Secretariat report on Competition Policy Roundtable.

Distinctions between industries

Before any conclusions concerning the interaction between regulatory authorities and the Competition Commission can be made, it is imperative to make a few distinctions.

First, one should separate network industries (e.g. electricity, water, gas and telecommunications) from other regulated industries (such as the sugar industry, agriculture, liquor). Network industries as defined earlier may, by virtue of their functionality and social impact, require regulation under all circumstances to ensure universal access and affordability of essential services. However, as noted above, the scope of network industries is being reduced through the application of new technologies.

Second, a distinction should be made between industries according to their envisaged trajectory or phase of development. In other words, is it a “transition” industry aiming at competitive conditions, or is it an industry that is judged to be most efficiently operated by a single provider with strict regulation (either partially or in its entirety)? Both trajectories are plausible, although the notion of “natural monopolies” is being progressively eroded, thereby diminishing the case for publicly owned regulated monopolies – more likely, the network part of the supply chain will require regulation. Transition industries require more careful scrutiny by competition authorities than industries in which competitive forces are unlikely and stringent regulation is opted for.

Third, one should distinguish between the industries in terms of their history of regulation, as well as their social significance. If the industry in question provides a public good, or a good or service that is deemed essential to the public interest, this is likely to affect the assessment of the agency that is most suited to enforcing competition in the industry.

Prospective sector-specific regulation dealing with competition concerns is becoming increasingly problematic in the global economy. Regulators cannot predict accurately how technology will change or which innovation consumers will favour. Overzealous regulation, or simply an inability to keep track of the rapid technological changes, may lead to undesired outcomes. This argument is often cited when explaining a global trend in changes in the balance of power between regulators and competition authorities.

There is a shift away from prospective sector-specific regulation to generally applicable competition law. This trend is seen to have additional benefits in terms of the consistency with which the application of competition principles are applied across industries. Regulation may be inflexible when confronted with a dynamic market. Globalisation and the liberalisation of the telecommunications market, for example, pose specific challenges to regulators as technological innovations spread rapidly across country borders, continuously changing the relevant geographical and product markets (via greater substitutability). Thus, except for those industries in which competition is unlikely or deemed socially undesirable and regulated monopolies are preferred, generally applicable competition law is preferable to sector-specific competition regulation.

As a rule, competition authorities should limit themselves to competition issues within the given framework (i.e. the strategy developed for the sector and social objectives imposed by policy-makers) and should not become involved in regulatory decisions outside their core competency. For instance, it would be impracticable for competition authorities to develop the expertise required to make decisions on “efficient use of frequency spectra” in the telecommunications industry. Therefore, coexistence of competition authorities and regulatory bodies is inevitable.

If the industry in question is a network industry in which competitive forces will be introduced, the technical decisions regarding licences, connectivity and rules should be made in consultation with the competition authorities. The competition authorities should consider other matters, such as mergers and acquisitions, with advice from the regulator on technical matters. For this decision-making process to have any success, an unambiguous demarcation of duties and a set mandate for co-operation should be embedded in the legislation governing the bodies in question. The demarcation of authority should be clear and procedures should be established for those cases in which the two bodies hold opposing views.

On the other hand, if the industry is a network industry in which no competition is foreseen, concurrent jurisdiction by the competition authority would be illogical. In this case, the regulator should deal with all matters relating to the industry. The competition authorities should review the options for the introduction of competitive forces into that industry and reassess the situation as technological advances are made. The advocacy function of the competition authorities is its sole means of operation in such a case.

In many industries it is foreseen that the level of regulation will be progressively reduced as the market becomes more competitive. Dispensing with a sector-specific regulator during the transition or even afterwards is not necessarily the most sensible approach. The judicial system alone may not be able to cope with technical and commercial complexities of sector-specific issues. Moreover, even when competition has been introduced, regulation of entry and exit, prices, quality and accessibility is often deemed essential. In short, distinct industries require distinct approaches.

Pricing for maximal social welfare

As argued above, while Government recognises that the restructuring of SOEs through market incentives should lead to improved business and macroeconomic performance, the broader social, political, environmental and economic objectives summarised in the phrase "social welfare" still need to be addressed if Government's overall objectives are to be realised. These concerns force public policy to reconsider the rationale for regulation.

Historically, implicit contracts between SOEs and society (or at least the most powerful groups) were mediated through the state. With that role came many distortions, including interference by politicians, operational inefficiencies protected from market discipline by state power, and "soft budget constraints" arising from, for example, tax exclusions or implicit state guarantees that allowed SOEs to borrow capital at below-market rates. To deal with such welfare-reducing measures, SOEs have been restructured in many different ways, and the resultant welfare effects have been equally diverse.

For instance, in a rigorous study of the "welfare consequences of selling public enterprises", the World Bank conducted an analysis of 12 firms from four countries, decomposing the welfare gains and losses from various divestiture processes.[53] Stakeholders included the government, workers, foreign buyers, domestic buyers,

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[53] Galal, A., Jones, L., Tandon , P. and & Vogelsang, I. 1994. *Welfare consequences of selling public enterprises: an empirical analysis*. Washington, DC: World Bank.

competitors and consumers. The diversity of experiences was striking, and it was found that SOE shareholders, management and workers were generally better off in most cases of divestiture. Because competition was often absent, consumers had the most unsatisfactory experiences. Much of this analysis has been “first-cut”; relating to the stakeholders most directly affected. Next-generation analysis of the welfare effects of privatisation will increasingly incorporate the public good issues described above. The study concludes: “Competition cannot do it all. It will remain necessary to regulate the prices of some large divested enterprises for two quite different purposes: to set prices low enough to preclude exploitation of consumers yet high enough to allow a fair return on capital; and to motivate producers to keep costs as low as possible.”

This problem of price -setting to achieve social welfare benefits has been studied in great depth in industries (e.g. electricity provision) in advanced, relatively competitive economies, and the market has been found wanting.[54] Pricing is, therefore, emerging as a key dilemma for welfare maximisation in SOE divestiture. This occurs not only where natural monopolies have simply been transferred from state control to the private sector, but also in the failure of competitive market theory in cases of undifferentiated commodities based on large fixed-capital overhead investments. In such cases, bargaining power is extremely diverse between customers. Bulk customers usually can and do demand discounts, either because they can purchase and store goods at off-peak hours and in large quantities, or because they have sufficient economic and political power to insist on price breaks. Lower-income, less powerful customers are usually disadvantaged in such an unregulated market.

It is worth highlighting that the American electricity sector has demonstrated, that once divested and even broken into smaller competing units, power utilities often become oligopolies, engaging in collusive or outright anti-competitive practices to achieve fuller use of the large capacity that typically resides in these industries. The literature ranging across a variety of SOE divestiture and deregulatory processes suggests that the welfare effects of deregulating prices are often extremely badly distributed, so that low-income consumers and small firms will typically be disadvantaged.[55]

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[54] Coyle, E. 2000. *Price discrimination, electronic redlining, and price fixing in deregulated electric power.* Report prepared for the American Public Power Association, January.

[55] Galal, A., et al. (1994).

As will be discussed below, SOE restructuring can be quite difficult when the state plays diverging roles (e.g. producer, regulator and consumer). Nevertheless, it should be obvious that the maximisation of social welfare entails incorporating many of these problems within Government's overall responsibilities. Therefore, in establishing a framework for restructuring SOEs, Government will need to address these issues through a broader framework defining its social welfare responsibilities.[56] The regulatory provisions that accompany such restructuring will need to be designed to incorporate these diverse responsibilities.[57] Although the values and objectives of regulation will vary in each case, social welfare will be an equally important objective along with the price- and performance-orientated objectives.

Conclusion: recommendations on competition and regulation

In the light of the above discussion, *there is clearly a need for a sector-specific regulatory regime within the broader framework of current competition policy based on the type of industry and the potential for competition*. Nevertheless, general principles that reconcile the different emphases of competition and more general regulation should also be established. Given the prevalence of residual natural monopolies in SOE sectors and the size of SOEs in relation to potential local competitors, Government should assure all stakeholders that restructuring will lead not only to competition, but also to an appropriate degree of regulation.

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[56] The definition of Government's overall social policy objectives is considered to be beyond the scope of this policy paper. At best, it can highlight the areas where the restructuring of SOEs is likely to have an impact on social welfare, and within the scope of the restructuring brief,, address the immediate consequences. It will be the task of the regulator to establish the appropriate social welfare implications for pricing and services within such an overall framework.

[57] Such a regulatory framework will also need to incorporate principles and safeguards including a distinct legal mandate for the regulator (free of ministerial control); professional criteria for the appointment of regulators; involvement of both executive and legislative branches in the appointment of regulators; fixed terms and protection from arbitrary removal; staggered terms of regulatory commission members, including appointment cycles that do not coincide with electoral cycles,; and a reliable source of funding. In addition to independence, regulators should have high standards of transparency, prohibitions on conflicts of interest, effective appeal procedures, external audits, public watchdog capacity,, and the power to terminate the services of possibilities for firing regulators in cases of misconduct or incompetence.

While competition policy remains the responsibility of the Department of Trade and Industry, the Department of Public Enterprises seeks to play an advisory role in relation to policies associated with each of the relevant sectors in which SOEs will be active.

The policy recommendations by the Competition Commission and Department of Trade and Industry indicate that, in the interim, Section 3(1)(d) of the Competition Act should be removed and concurrent jurisdiction should prevail in all regulated industries. Mergers should be approved by both authorities – abuses of dominance require a sector-specific approach. Unless this is specifically mandated by the relevant legislation, abuses of dominance and other restrictive practices should be investigated by the competition authorities in conjunction with the regulator.

In the longer term, regulators could concede jurisdiction on competition matters to competition authorities and seek their advice and opinion on other regulatory decisions. This reform requires amendments to the legislation establishing the individual regulatory authorities. All mergers should be within the jurisdiction of the competition authorities, albeit with the understanding that the competition authorities will seek advice from the regulatory agencies and that the dual notification process remains in place.

Mergers that involve regulatory decisions, such as the transfer of a licence, will remain under concurrent jurisdiction. This does not give the regulators a mandate to adjudicate on competition matters; rather, it provides for the consideration of divergent factors. The Securities Regulations Panel, for instance, evaluates takeovers as these impact on the shareholders, and related issues. No overlaps occur when the Competition Commission and the Securities Regulations Panel evaluate a proposed transaction based on their individual mandate.

Restrictive practices and abuses of dominance will require a sector-specific approach, depending on the nature of the industry. The regulatory reform should take issues such as network industries and the history of regulation and public good or public interest concerns into account. Regulation and specific rules for matters not concerning the Competition Commission will be maintained:

- In transition industries the concurrent jurisdiction should be formalised and clarified. The competition authorities should play a leading role in assessing industry structures and desirable changes. The Competition Commission, in consultation with the regulator, should deal with competition issues. The final decision-making powers should preferably rest with the competition authorities.
- In regulated industries with little potential for competition, the regulator should remain the sole actor, although the Competition Commission should be able to investigate mergers, as well as abuses of dominance by the incumbent, where applicable.
- In regulated industries with a high degree of competition, the Competition Commission should have jurisdiction on all competition matters and be required to consult with the relevant regulator. Final authority should be clarified and ideally rest with the competition authorities.

In all cases, the competition authority should monitor regulatory decisions on technical issues by the regulator, but it is not its responsibility to replace the sector-specific regulator. Inconsistencies between national and industry-specific competition rules should be addressed; industry rules should be amended to conform to the Competition Act of 1998. Co-operation between the agencies should be institutionalised and embedded in the respective procedures.

All should benefit from improvement in the regulatory environment in the key sectors (such as energy, telecommunications and transport) that are dominated by SOEs. South Africa's globalising economy will benefit from lower prices and/or improved service outputs, which will enable it to become more competitive, thus creating more employment and investment opportunities. The unemployed and poor, in particular, will benefit from increased job opportunities and more affordable and available services. More certainty in the sectors involving SOEs will stimulate investment and enhance customer satisfaction, thereby ensuring that the quality of life for all is improved.

5

Promoting empowerment

Problems with empowerment to date

This policy framework is concerned with addressing market distortions that prevailed in SOEs and in the economy as a whole during the apartheid period. One of the most obvious of these distortions was the prohibition of substantial property ownership by black people. In general, Government views transformation as a process aimed at raising the level of basic living conditions enjoyed by the vast majority. Correcting past wrongs requires a systematic, genuine empowerment strategy to bring black people and others who faced discrimination into the mainstream of the economy, including into ownership, procurement and training relationships with SOEs and into more harmonious, productive relations with each other.

Government's policy on restructuring SOEs should entail new, creative, diverse strategies for genuine empowerment so that SOEs more effectively spread the benefits of restructuring. These *strategies of alternative service delivery*[58] *may include broadened ownership, training, procurement and self-management opportunities for black people, women and the disabled, both directly through involvement in SOE management and indirectly through widespread ownership opportunities. There are many ways to achieve this objective, and it would be a mistake to seek a single, unidimensional approach, particularly given the unsatisfactory record of SOE-related empowerment strategies.*

Correcting past wrongs and in the process rectifying market failures requires different techniques for empowerment and different institutional configurations than endured, generally through artificial protection, during the apartheid era. Since the early 1990s, black economic empowerment has been built on existing pyramid-type ownership frameworks (with stakes in conglomerates purchased at high share prices via high debt levels), or on special deals crafted for those with privileged access, there have been severe disappointments and even some failures. Indeed, the overall operating environment for black enterprise has been badly impaired as a

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[58] Langford, J. 1996. Power sharing in the alternative service delivery world. In Ford & Zussman. *Alternative service delivery: transcending boundaries.*

result. Systems of ownership, control and access that may have worked to empower earlier generations of white entrepreneurs, strategic shareholdings for the sake of company control and artificial conglomeration, or blatant state patronage based purely on ethnicity, currently face enormous resistance and operational difficulties.

Partly because of factors beyond the control of practitioners, black economic empowerment (as well as some investment schemes aimed at women's and disabled people's interests) did not fare well in a turbulent period of dramatic currency volatility, interest rate increases, share price fluctuations, declining per capita GDP growth and the exogenous shocks of 1996–1998. Even into 1999 and 2000, when financial markets recovered, interest rates fell and growth improved, some important "black chip" holding companies and other special purpose investment vehicles suffered enormous losses. Beside the efficacy of the empowerment model utilised to date, there is also a growing concern that black economic empowerment has enriched a few fortunate players but left most constituents behind. Some of the problems considered below are structural (flowing from conditions not of the empowerment practitioners' own choosing), while some reflect naive strategies and questionable assumptions behind empowerment-orientated financial engineering.

The need for a more appropriate strategy is widely recognised. The Black Economic Empowerment Commission (BeeCom) suggests in a draft report that "the state's privatisation and restructuring programme has failed in so far as empowerment objectives are concerned".[59] The BeeCom argues that "effective black participation has been hindered until now by a multitude of factors. Assets are privatised or restructured with the assumption that empowerment will flow from new black ownership, instead new owners have been confronted with debt burdened enterprises, a tough financing environment, and in some cases confused privatisation objectives and conflicting interests".

Criticisms of the state's commitment to black empowerment initially emerged over the specific neglect of black involvement when Telkom's two main international

[59] There are many different points of view about why empowerment strategies have faltered, but this document refers mainly to arguments presented by the Ramaphosa Commission on Black Economic Empowerment (BeeCom). Black Economic Empowerment Commission. 2000. *BEE revisited: an opportunity for transformation*. Pretoria: BeeCom.

Strategic equity partners were chosen in 1997 (although 10 per cent of Telkom's shares were set aside for empowerment purposes, as described below).[60] The Airports Company empowerment stake was set at 10 per cent, but due to the high prices that the foreign bidders offered and a shortage of finance, only 4,2 per cent of the Airports Company shares were transferred to black owners.[61] In all these cases, empowerment strategies via equity stakes in SOEs have, understandably, been hampered by the fact that even small share options require expensive borrowed funds, given the lack of past opportunities for black bidders to accumulate capital.

Other frustrations emerged in SOE divestiture to black owners. The Sun Air privatisation included a substantial empowerment ownership/management component, but its liquidation highlights some of the arguments noted above about competition and pricing issues.[62] The attempted sale of Aventura resorts to a union investment company also collapsed due to difficulties in raising finance and, on two occasions, to the black bidder's partners pulling out unexpectedly (a management contract with a major hotel company was negotiated instead).[63] The Alexkor diamond mine management contract included a strong empowerment component, but ran into serious difficulties when this was translated to prospective ownership owing to difficulties in raising finance.[64]

Other investment strategies launched from 1994–1999, including special purpose vehicles established by the Industrial Development Corporation to promote black firms,[65] and loan guarantee and credit enhancement schemes established by the Department of Trade and Industry (Khula and Ntsika),[66] have been disappointing.

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[60] BeeCom (2000: 47).

[61] Ibid.

[62] Ibid., p. 48.

[63] Ibid., p. 49.

[64] Ibid., p. 50.

[65] Five support programmes launched in 1998 include a wholesale finance scheme, a low-interest-rate empowerment scheme, a take-overs and acquisitions scheme, group consortium finance, and a fish harvesting scheme. (Ibid., p. 38).

[66] The "intense criticisms" of Khula recorded by the Beecom (p. 36) include:

- First, Khula's loan application assessment is too conservative, no different from those used by banks.

While some smaller credit initiatives (e.g. NGO microcredit projects and the Land Bank Step-Up programme) have had impressive results,[67] many in the black business community consider these to be nowhere near the size, scale and sectoral relevance required to assure meaningful participation in SOE restructuring.

In sum, *a more genuine empowerment strategy is required for black people, women, disabled people and other groups who have faced systematic discrimination in past years,* via one or more of several options discussed below. To avoid the problems discussed above, a variety of strategies and tactics described by the term "alternative service delivery" will be employed. *Some of the alternative service delivery approaches will entail some degree of equity transfer or sale while other will focus primarily on changing operational responsibilities to ensure greater participation by employees and client communities.*

A more multi-faceted approach to empowerment

Widely different conditions have prevailed in the existing SOE empowerment deals. None have been unequivocally successful, and some have been disastrous. A new approach is required, based on the strengths of the National Empowerment Fund vehicle (with its goals of broadened ownership), but adding further instruments as required, including procurement and subcontracting, training, managerial skills development and transfer, and a more imaginative role for worker and community investment and/or self-management.

With regard to ownership, there are many international examples of voucher systems, collective investment programmes and public offerings, as well as employee share ownership plans (ESOPs) and community-controlled trusts. Beyond simply a change of ownership, several other appropriate strategies arise which, through operational reform, can also generate more genuine forms of empowerment. According to the BeeCom, "the current approach by government prescribes the acquisition of assets. A phased approach where empowerment is initially loaded at the operational level and then extended into the equity ambit

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- Second, the credit guarantee scheme has not changed the criteria used by financial institutions when they assess small business loans.
- Third, Khula has paid little attention to institution building.

[67] Ibid., p. 38.

once the asset is on a productive footing, could prove more effective".[68] The inclusion of employees and communities in SOE restructuring plans is vital, not least because creating and enhancing "social capital" (roughly defined as the fabric of trust and mutual support that is recognised as vital to successful development)[69] is one of the South African government's overarching socio-economic objectives. This is particularly true in areas that have been subject to systematic violence and social tension. The role of each approach (broadening SOE ownership, SOE operational empowerment strategies, and SOE-employee/community "alternative service delivery" in strengthening social capital) is considered, in turn, below.

As described below, there are many reasons why restructuring SOEs for empowerment objectives via new forms of employee and community ownership and self-management make sense. From a pro-privatisation standpoint, David Binns of the US Foundation for Enterprise Development argues that:

> … The strategic and political appeal of employee ownership in privatisation transactions is based on several key factors. Ownership can provide the work force with a direct financial incentive, mitigating employee opposition to the concept of privatisation. For employees and their unions, ownership offers a means to minimise job loss and adverse impacts of the transition from the public sector. It also provides opportunities for significant capital ownership and potential career enhancement through an immediate transition to private-sector employment. From the perspective of the government, employee ownership may offer improved employee relations, more efficiencies and greater cost reductions. The creation of an employee group as a viable bidder also can expand the competition base to acquire government assets or to out-source contracts. It potentially offers a seamless transition for the conversion from public to private ownership.[70]

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[68] Ibid., p. 49.

[69] Stiglitz and Ellerman define social capital as habits of teamwork, Cupertino, and reciprocal trust (see reference below).

[70] Binns, D. 1999. *Using employee ownership to facilitate federal privatization initiatives: a potential win-win scenario.* Foundation for Enterprise Development, p. 1.

A growing literature promotes the social and community benefits of worker ownership and self-management as being as important as a transformed site of production. According to a Ford Foundation and Kent State University group, broadening capital ownership:

- Empowers individuals and families
- Anchors capital and jobs in communities
- Fosters enlightened workplace practices and enhanced education for workers
- Develops a long-term view on capital investment
- Creates an investment for environmental responsibility[71]

Such social goals overlap closely with the South African Government's aim of promoting genuine empowerment for those denied access to the benefits of ownership and management during apartheid. In the discussion that follows, alternative models of service delivery will be described in some detail. Given that these approaches have only been implemented in a few places and/or have only been recently adopted in others, it should, therefore, be accepted that the further development of such strategies would need to involve all stakeholders to provide models suitable for the South African context.

Broadening ownership

The National Empowerment Fund (NEF) Trust was established by the 1998 National Empowerment Fund Act to "facilitate the redressing of economic inequality which resulted from the past unfair discrimination against historically disadvantaged persons".[72] It is the intention that the NEF Trust be capitalised primarily through receiving shares of SOEs undergoing restructuring. It has received shares with a nominal value of about R2 billion, and may receive up to 10 per cent of the shares of other SOEs, with a nominal value of between R10–20 billion, making it potentially one of the most significant investment entities in the South African financial markets.[73]

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[71] Ford Foundation, Capital Ownership Group and Ohio Employee Ownership Project. 1999. *Broadening capital ownership in the global economy: creating an international network to develop policy options.* Ohio: Kent State University, 3.

[72] National Empowerment Fund. 1999. *Business plan 1999–2004*, June.

[73] Given that most SOEs have not reached the market, it is both difficult and irresponsible to indicate a clear value of the shareholding, since the value will largely be determined by the market when (and if)

The NEF Trust will promote its objectives through three different investment vehicles. First, it will have an investment trust that will market investment units to historically disadvantaged investors. The portfolio of this investment trust will include SOE shares and other investments to provide a competitively marketable and balanced portfolio. Currently, the unit trust approach is being explored, among other collective investment mechanisms, to develop an instrument that can provide small investors with affordable and accessible investment products. Second, a portfolio trust will warehouse the shares of SOEs, which will thereafter be sold on to historically disadvantaged individuals and firms that seek a direct shareholding in these SOEs. Third, an equity management fund is envisaged to provide venture capital to encourage entrepreneurship among the historically disadvantaged groups through joint ventures, management buy-outs, outsourcing and other forms of spin-offs. The NEF is therefore likely to play a significant role in promoting many of the empowerment options discussed below, providing a range of investment vehicles from those accessible to small investors, to those available to SMMEs and larger firms originating from historically disadvantaged communities.

It is useful to consider how the broader goals and objectives of promoting the public good might coincide with the use of collective investment programmes and public offerings geared to empowerment. Funds considered under the category of "collective investment programmes" can be endowed through government-owned equity, pension schemes and even unit trusts. Such programmes may not have as great a scope for ease of entry and exit as did the controversial Eastern European voucher schemes,[74] but these programmes have been criticised because of the rapid recentralisation of ownership through voucher buy-backs.[75] Although the Eastern European evidence indicates that Government should proceed cautiously with such approaches, some voucher experts argue that the lack of familiarity with capitalist investing was the crux of the problem. They argue

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the equity is made available to investors. The nominal estimates provided here are based largely on readily available sources; the information in Table 2 is based on data from the *Financial Mail*.

[74] Johnson, S. & Loveman, G. 1995. *Starting over in Eastern Europe: entrepreneurship and economic renewal*. Boston: Harvard University Press; Shleifer, A. & Vishny, R. 1998. *The grabbing hand: government pathologies and their cures.* Cambridge: Harvard University Press.

[75] Ellerman, D. 1998. *Voucher privatization with investment funds: an institutional analysis*. Policy Research Report No. 1924. Washington, DC: World Bank.

that "privatisation is more likely to succeed when people spend time thinking about what to invest in, learning about companies, picking mutual funds, or even deciding whether to sell their vouchers, than when they simply get pieces of paper to store under the pillow or in a bank".[76]

Collective investment programmes with provisions protecting investments from easy liquidation may therefore be more advisable. As one World Bank official argues, under prevailing conditions such as:

> … little or no understanding of share ownership, cultural barriers to individual accumulation of wealth, low degrees of literacy, and logistical constraints such as a highly disbursed and difficult to reach population. These factors produce prohibitively high transactions costs of secondary share trading, in which case a collective scheme which limits entry and exit (an investment trust, for example) might be preferable to a voucher-based approach.[77]

Malaysia's (1971) New Economic Policy (NEP) "*bumiputera* unit trust scheme"[78] and Korea's (1987) "People's Share Program" public offerings of SOEs at deeply discounted prices for low-income groups[79] are probably the most successful precedents for spreading ownership through collective investment vehicles. However, in both cases, because there are large numbers of small-scale owners, beneficiaries have not exercised any real control either over an SOE in transition

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[76] Boycko, M., Shleifer, A. & Vishny, R. 1994. Voucher privatization. *Journal of Financial Economics*, 35: 255.

[77] Bell, S. 1997. *Sharing the wealth: privatization through broad-based ownership strategies*. World Bank Discussion Paper 285. Washington, DC: World Bank.

[78] Jomo, K.S. 1991. Whither Malaysia's new economic policy? *Pacific Affairs*, 63: 4; Sieh Lee, M.L. & Lyn, C.K. 1986. Redistribution of Malaysia's corporate ownership in the new economic policy. *South East Asian Affairs*. Singapore: Institute of South East Asian Studies.

[79] There were two share offerings worth $8 billion, by priority (95 per cent, of which 20 per cent was to employees and 75 per cent to low-income people) and by general (5 per cent) allocations. The shares were undervalued, and in one case (steel) they tripled in price the day the general allocations became available on the local stock market. The mechanism entailed a means test for priority buyers who opened a savings account with the programme. There was a three-year time requirement on holding the shares prior to sale. For details, see Song, Dae-Hee. 1989. *Three essays on Korean privatization policy.* Seoul: Korea Development Institute.

or even over the investment trust (which typically take the form of closed-end mutual funds and, hence, lack flexibility). Moreover, as the World Bank reported, in Malaysia,

> … the program had the effect of severely dampening foreign direct investment in the economy, which declined throughout the early 1980s... [as a result] the government began to downplay the NEP guidelines in 1986 by relaxing foreign equity restrictions on companies established with foreign capital prior to 1986 and exempting all those established after 1986 from the NEP equity requirements entirely.[80]

Even if these issues are addressed through the appropriate design of such investment trusts, a major concern remains around the sustainability of the collective investment. If the real values of either privatised SOE shares (e.g. Iscor) or collective investments, marketed only to a particular group (e.g. Ikageng black empowerment shares initially issued in 1996), do not hold their value over time, a good-faith empowerment scheme runs the risk of becoming a vehicle for financial disempowerment. Even in South Korea, before the 1998 stock market crash, the global recession of the early 1990s caused extreme financial volatility. This meant that many low-income investors who sold their shares in the two largest privatised enterprises in the People's Share Program[81] were forced to sell shares at 65 per cent of their offer price. This, in turn, led the Korean government to cancel the programme.[82] At present, when overvalued share prices are the norm, it is worth considering whether the risks of collective empowerment schemes dependent upon buoyant stock market prices are worth the benefit.[83]

The use of Initial Public Offerings (IPOs) to promote empowerment in South Africa in the private sector has, however, been reasonably successful to date. In the case of five private sector offerings assessed by Deutsche Bank,[84] four of the five have seen significant gains for the shareholders, with only one being "out of the money". The schemes were also judged to have been properly marketed,

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[80] Bell (1997: 25)

[81] Responsible for 22 per cent of the Korean stock market's capitalisation.

[82] Bell (1997: 30).

[83], For example, from April–September 1998, the Johannesburg Stock Exchange's main share index suffered its worst-ever crash of nearly 50 per cent.

[84] Deutsche Bank. 2000. *Schemes to encourage retail participation*, April.

providing adequate information and education to the potential investors. Each of these schemes used an option payment model that allowed shareholders to access shares for a modest upfront payment, with the balance due later. In three cases, the upfront subscriptions were considered accessible and, in the other two, an upfront subscription of only between R300–R600 was required, still making them accessible to many from historically disadvantaged communities. The main problems identified with the schemes to date are that they provided little downside protection to shareholders, that they had no incentives to encourage long-term shareholding, that options were not tradable, and that options were redeemable on a single date (increasing the risk that shares would be sold off at that date to cover costs).

It would seem possible to design similar schemes for SOEs, in which the above problem areas could be addressed without much difficulty. It is proposed that similar option models be used with a variable redemption date and a redemption price decreasing with time, thus providing investors with incentives to hold onto their options. In order to limit the downside risk, options could be tradable. Government would also need to consider whether to discount the shares, or to provide bonus shares to reward longer-term shareholding. The existing Post Office network may serve as a marketing facility, alternatively nationwide banks and/or shops could process applications and trading orders (via a link to a brokerage house).

Despite the hazards, increasing the ownership of SOEs should remain one crucial component of empowerment. The approaches discussed above should provide Government with a starting point in expanding the range of black shareholding. There must also be alternative means of addressing the other features of socio-economic transformation discussed previously, since this policy framework seeks an alignment of private, state and social interests. In addition to broadened ownership, operational empowerment and procurement also offer an alternative form of empowerment, as do a combination of ownership alternatives and self-management strategies. The next two sections deal with these options.

Operational empowerment

"Operational empowerment" describes the variety of processes related to active, hands-on participation in industries affected by SOE restructuring. These range from more meaningful access to state-regulated activities, training and skills development, affirmative action in management, to entrepreneurial opportunities through outsourcing, partnerships, procurement and easier access to financing. By broadening the range of service delivery models to include greater worker, SMME and community participation, Government can help ensure that a broader grouping of the historically disadvantaged is empowered.

The recent Preferential Procurement Policy Framework (Act No. 5 of 2000), the 1997 Green Paper on Procurement, and the Affirmative Procurement Policy set out a comprehensive scheme for increasing the participation of historically disadvantaged people and enterprises in the activities of the public sector.[85] In particular, since the policy and legislation provide adequate guidelines on how the services of such enterprises can be procured, they need not be repeated in this document. However, one policy issue that needs to be addressed here is whether the provisions of the policy and legislation should also apply to SOEs. It can be argued that making the provisions of the Act applicable to SOEs will hinder their ability to compete with other private sector firms in the same sectors. However, given that they should continue to dominate their sectors, they might be able to define the terms under which that market segment may function. Therefore, the provisions required by the policy and the Act are unlikely to make SOEs significantly less competitive.

It is estimated that the procurement budgets of state owned enterprises amount to between R40 and R60 billion.[86] It is, therefore, argued that unless the provisions of the policy and legislation are extended to the SOE sector, it is unlikely that Government's objectives in drafting the policy will be fully realised. Government believes that the procurement policies of all SOEs should comply

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[85] Preferential Procurement Policy Framework Act, Act No. 5 of 2000; Departments of Finance and Public Works. 1997. *Green Paper on Public Sector Procurement Reform in South Africa*. Pretoria: Government Printer.

[86] The gross domestic fixed investment figures (Reserve Bank Quarterly Bulletin, March 2000) reflect amounts of R18 billion for the public sector and R20 billion for SOEs for procurement for 1999. These figures do not, however, account for all procurement, as they are limited to residential, non-residential, construction works, machinery, transport and other equipment, but they at least indicate the relative significance of each of these sectors. The 1997 Green Paper on Public Sector Procurement Reform in South Africa quoted a 1995 figure of R56 billion for public sector procurement. If one uses this as a basis for estimating total procurement and assume that the proportions remain approximately the same, one can estimate the total procurement budget of SOEs to be between R40–R60 billion.

with all the principles of the Green Paper and Preferential Procurement Act. To ensure such compliance, the Department of Public Enterprises will lead an initiative to ensure that SOE procurement policies and procedures are aligned with Government policy on procurement, using the proposed shareholder compacts to initiate the process. The Department will also include the monitoring of procurement polices in its overall performance monitoring activities. To this end, it will require SOEs to include their preferential procurement status in their quarterly reports on performance. Finally, the Department will interact with the Department of Finance to ensure that appropriate regulations are put in place.

For the policy of preferential procurement to lead to genuine operational empowerment, the principles of the 1997 Green Paper have to be operationalised. In general, there should be provisions for direct preferencing for small-scale contracts, and the use of contract participation goals for medium- and larger-sized contracts (which may be satisfied through joint ventures or subcontracting).[87] Of course, depending on the sector, the thresholds that will apply for these two approaches will differ, requiring that Government's procurement policies take into account their differential impact in the various sectors in which SOEs function. Critically, however, historically disadvantaged individuals are in each case given the opportunity to participate directly in productive and management activities and are not restricted to passive involvement as investors or "fronts". Through the judicious use of targeting, using these two approaches, Government can ensure that the full spectrum of historically disadvantaged people (blacks, women or disabled persons) are included. In particular, it can use these two approaches to ensure that those who are retrenched in the restructuring process are favoured through the preferential procurement policies of SOEs, thus mitigating the short-term effects of such restructuring.

A critical operational constraint that prevents SMMEs from effective participation in SOE restructuring is inadequate collateral for financing. Even if procurement contracts become available, commercial banks in South Africa have been unwilling to consider financing the particular project because a contract does not offer sufficient repayment security. Indeed, a common concern in the small business sector is a lack of access to debt or equity financing. According to the

[87] Departments of Finance and Public Works (1997).

Department of Trade and Industry's 1998 policy paper, *Financial access for SMMEs*, insufficient competition is again a part of the problem:

> … A key factor mitigating against increased investment in the SMME sector is the structure of the financial sector. The sector is composed of a concentrated formal banking sector targeting corporate accounts and competing with smaller niche banks and investment banks. Few second tier banking institutions exist that can absorb savings and extend credit to SMMEs. Furthermore, there is a dearth of strong alternative financial institutions providing credit to the self-employed for productive purposes.
>
> A further concern is the risk aversion of institutional investors (particularly pension and insurance funds), who tend to focus on "safer" and larger investments which yield relatively few social and economic benefits. These investors have few social responsibility vehicles that effectively cross-subsidise from their wealthy clients to those requiring start-up support.
>
> As a result, a large portion of the SMME sector does not have access to adequate and appropriate forms of credit and equity, or indeed to financial services more generally. In competing for the corporate market, formal financial institutions have structured their products to serve the needs of large corporates [sic]. Alternative financial institutions such as Non-Governmental Organisations (NGOs) offer a limited range of products and do not have the infrastructure to reach a significant number of SMMEs.[88]

Banks should, of course, be sufficiently confident of firms owned and managed by black, women and disabled South Africans to review and revise collateral requirements. However, given ongoing resistance, what other kinds of financing are available to help SMMEs gain more operational opportunities in SOE restructuring? One answer may come from the NEF, which is setting aside some venture capital to finance such initiatives. Another possibility may be through the enhanced use of social capital.

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[88] Department of Trade and Industry. 1998. *Financial access for SMMEs*. Pretoria: Government Printer, p. 3.

As Stiglitz and Ellerman argue:

> … There is considerable experience in providing finance to micro- and small businesses in developing countries ... One approach is to emphasize methods of “capitalizing social capital” to minimize the need for financial capital ... If workers were involved as co-venturers with an equity stake in the enterprise, then a substantial amount of the upfront finance would be replaced by their “sweat equity”. Their social capital (teamwork, cooperation and trust) would have been obtained by other means. Family-based startups, as seen with the overseas and mainland Chinese, provide other examples where social capital is obtained (based on familial relations) outside of expending financial capital in market relationships.[89]

Such a synthesis between alternative equity and empowerment vehicles is embodied in models such as ESOPs, as described next.

Employee ownership

Questions that have yet to be answered in the South African context are whether there is a harmonious combination of broadened ownership options for SOEs and operational empowerment through skills transfer and procurement and whether the broader (low-income, black, women, disabled) constituencies can be better served by SOE restructuring than they have to date. As the BeeCom complained of most empowerment exercises:

> … There remain few examples of community or employee spin-offs to speak of (for instance, share schemes, community trusts and effective social responsibility programmes). Owners, who have been licensed on the basis of representivity or broadness of dividends, need to be tested against this. The question must be asked and should have been asked at the time of tender

[89] Stiglitz, J. & Ellerman, D. 2000. *New bridges across the chasm: macro- and micro-strategies for Russia and other transitional economies.* World Bank Discussion Document. Washington, DC: World Bank, p. 16.

> adjudications, what in particular are they doing for the members they represent?[90]

A major vehicle for alternative service delivery, which is worth considering as an option for future SOE restructuring, is ESOPs. This possibility should be considered alongside the broader social responsibility of SOEs (and society as a whole) to enhance social capital, as a critical component of overall empowerment. The idea of an ESOP is straightforward. The most important details are those associated with share prices, profit sharing, a requirement on length of shareholding, and taxation issues. At a more general level, however, what is most crucial is that the needed components of restructuring are recognised from the outset by worker-owners, who increasingly take on board self-management responsibilities.

Although worker ownership has been experimented with for centuries, the ESOP movement in its modern form began with US entrepreneur Louis Kelso's post-war vision, which combined ownership and management with the innovation that large-scale debt (backed in some cases by pension funds) could leverage workers into positions of meaningful control.[91] Earlier share ownership participation offered by corporations to workers were considered unsuccessful when, during the Great Depression, employee shareholdings[92] collapsed by 75 per cent in value from 1929 to 1932, and indeed fell to just 15 per cent of their 1926 value at a time when, facing mass unemployment, many workers were desperate to liquidate their shares simply to survive.[93] By the mid-1930s, 90 per cent of the employee share plans had closed.[94] However, in addition to the overall financial crisis of the 1930s, the early plans faltered because they were mainly "beneficial ownership" without employee control.

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[90] BeeCom (2000: 102).

[91] The first Kelso-originated ESOP was the purchase in 1954of a small Californian newspaper by employees, originated in order to block a takeover by a larger chain. Many ESOPs emerged in the United States because of similar threats and, hence, were defensive in character prior to more facilitative pension-related legislation in 1974.

[92] At peak, these were responsible for only 1 per cent of all outstanding stock ownership.

[93] The dangers associated with overpriced shares in the contemporary setting are discussed below.

[94] D'Art, D. 1992. *Economic democracy and financial participation: a comparative study*. London: Routledge, p. 87.

The need to merge management with ownership is evident from more recent United States experience. According to the National Center for Employee Ownership:

> … Studies consistently show that when broad employee ownership is combined with a highly participative management style, companies perform much better than they otherwise would be expected to do. Neither ownership nor participation accomplishes these significant gains on its own.[95]

This insight becomes a critical challenge for South African SOE restructuring, and there are many precedents to draw on from settings other than the United States. An important version of worker ownership and self-management exists in the Mondragon region of Spain, and has been initiated at scale in Quebec. Sweden's Meidner Plan aimed at building a large trust that would not only ensure worker self-management at the shop floor level, but also elevate key union representatives to the boards of companies.

In contemporary times, worker ownership and self-management is most common in the United States, where major firms like United Airlines, Starbucks, Crest, Ramada, Wal-Mart and others have majority or dominant worker ownership. Indeed, more than 10 million American workers are part-owners of substantial stakes in their companies, and more than one-third of stock market investors made their first share purchase through their company plan. By the early 1990s, 15 per cent of Wall Street's 7 000 listed companies had substantial worker ownership, averaging 12,2 per cent of shares. In half of these firms, employees were the dominant shareholders. By 1998, an estimated 9 per cent of all shares in United States' stock markets were owned by workers. The United States' legislative facilitation of such plans dating to the mid-1970s included 15 per cent discounts on share purchases by employees and the use of a tax provision (s.401k of the Internal Revenue Code) to promote joint employee/employer pension investments in ESOPs. Before the favourable tax and pension

[95] Rosen, C. 1998. *An overview of ESOPs, stock options and employee ownership.* Oakland: National Center for Employee Ownership, p. 1.

legislation, American ESOPs numbered less than 1 000, but within a decade there were nearly 6 000.[96]

The debate continues over how successful ESOPs are in relation to firms not owned by employees. In the United States, the main studies of motivational effectiveness do register impressive results for ESOPs[97]. This is particularly the case when other preconditions are in place: implementation of the ESOP with worker motivation as a primary objective, the existence of voting rights for employee share-owners, and employee motivation[98]. Privatisation has also been accomplished through ESOPs in recent years. The first major experience was in the United States in 1974, when 15 per cent of Conrail railroad shares were sold to employees. In Britain, the 1983 sale of 90 per cent of National Freight to workers represented the first major SOE sale. These were successful examples, at least initially, until the original employees retired and cashed out their shares to ordinary members of the public in stock market transactions, at which point the nexus between ownership and self-management began to wane.

In an extreme way, the disjuncture between ownership and management was the tragic outcome of Russia's stock voucher ownership experience of the early 1990s. An analyst of Russian privatisation ESOPs, Joseph Blasi, concluded after a study of 150 firms:

> … The trends in corporate governance were so uniform that they do not require a detailed statistical analysis. The top managers have negated in a series of actions which essentially turn the firms into closed corporations, take them out of the market of corporate control, emasculate employees as shareholders, restrict outside access to information, and tightly control boards and shareholder meetings and registries.[99]

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[96] Blasi, J. 1993. *Employee buyouts and employee ownership in the west: development and implications for transitional economies and privatization*. Institute of Management and Labour Relations. New Brunswick: Rutgers University, 4; Rosen. (1988: 2); D'Art. *Economic democracy and financial participation,* p. 94.

[97] The seminal study was Conte, M. & Tannenbaum, A. 1978. Employee-owned companies: is the difference measurable? *Monthly Labor Review*, July.

[98] D'Art, p. 127.

[99] Blasi, J. 1995. *Privatized enterprises in Russia: some initial observations.* Foundation for Enterprise Development, p. 11.

Additional problems associated with SOE-related ESOPs not grounded in self-management, even in less corrupt western settings, were acknowledged by the Ford Foundation and Capital Ownership Group:

> Most of the privatization [ESOP] systems have used employee ownership as a quick pass-through from state ownership to private corporate ownership, without creating lasting, capital-anchoring solutions. The European profit sharing systems are virtually voiceless and co-determination is statutorily a minority voice.[100]

However, experiences with privatisation-related ESOPs from other countries include success stories, even in Third World settings. In Canada, Chile, China, the Czech Republic, Egypt, France, El Salvador, Germany, Holland, Hungary, India, Jamaica, Poland, Russia, Slovakia, Slovenia, Venezuela and Zimbabwe ESOP movements have begun to show success at employee ownership and self-management. Chile allowed workers to borrow 50 per cent of severance pay to buy 10–5 per cent of shares in 15 SOEs at a discount. Chinese village enterprises are increasingly worker and community-owned, instead of being controlled by the central state. More than 150 employee shareholder associations have formed in Egypt to buy SOE shares. El Salvador's state-owned electricity company sold 20 per cent of its shares to workers at a 20 per cent discount and with a 50 per cent discount on interest rates for workers who borrowed to buy shares. France's privatisation programme occurred in part through financial participation (profit sharing) schemes, in which 17 000 private companies also participate. In ex-East Germany, 10 per cent of management buy-outs of privatised companies entailed major employee ownership.

In Hungary, ESOPs have played a substantial role in 150 privatisations, based on a 15-year period for acquiring ownership, and loans available for up to 85 per cent of share values per worker. Jamaica's privatisation programme includes tax deferral on shares for 25 per cent of the principal and 100 per cent of any interest charges associated with borrowing to buy. Poland's discount of 50 per cent on privatised companies for ESOPs is enhanced by tax-free status on the shares once they are held for six years. In Slovakia, terms for employee purchase of privatised companies include a 10–15 per cent cash deposit but a 10–15 year

[100] Ford Foundation, Capital Ownership Group and Ohio Employee Ownership Project (1999: 3).

repayment period on highly subsidised loans. Slovenia's arrangements include a 20 per cent grant of shares to employees at no charge, 20 per cent to broad citizens' funds, 10 per cent to the national pension fund, and 10 per cent to a national compensation fund, with the remaining 40 per cent sold to employee groups or to the general public.[101]

There are obviously many models, with differing technical details. If ESOPs and related community trusts are to succeed in meeting South Africa's combined efficiency and social empowerment objectives, tapping the organic knowledge of workers and communities will be crucial in order to ensure that once a sale to an ESOP is made, the restructured SOE does not stagnate (as happened in many Eastern European cases during the 1990s).[102] As Binns puts it:

> … employees are more likely to invest their own money in the one company they know something about and where their own efforts can have the greatest impact ... Employees may be in the best position to determine the viability of the enterprise as an independent entity. Because they represent a readily identifiable buyer, sales to employees can be conducted more expeditiously.[103]

To illustrate the application of ESOPs to SOE restructuring, the most recent major example, that of the Irish SOE Telecom Eireann (TE), can be considered in detail as one of a series of potential models.[104] The TE trade unions agreed to

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[101] Employee Share Ownership Worldwide.

[102] In addition, the confidence of having a local consumer market behind an ESOP can be very important. In general, community and consumer trusts are potentially useful, especially where utility SOE restructuring is concerned. In the United States, the National Rural Electrification system emerged during the 1930s New Deal era to help spread the benefits of the Tennessee Valley Authority hydropower schemes into low-income rural areas that were not otherwise commercially viable. A more recent innovation, Consumer Utility Boards, gives consumers a strong role in local tariff setting and environmental management in public and public-private utilities, with potential for ultimate ownership in the event of institutional restructuring.

[103] Binns, D. 1998. *Privatization through employee ownership: lessons learned from the international experience*. Foundation for Enterprise Development, 1.

[104] Information taken from Oakeshott, R. 2000. *From lipservice stakeholders to real shareholders: why, how and to what extent its staff became significant shareholders in Telecom Eireann.* Unpublished paper. London.

staff reductions and changes in working practices in exchange for a standard 5 per cent of TE's share capital through an ESOP, as well as the option to purchase (through ESOP trustees) an additional 9,9 per cent of the TE share capital at a "fair market value". The additional employee purchase was financed through employee pension contributions and a loan. TE was floated in an initial public offering in July 1999, and currently trades substantially above the ESOP purchase price. The total 14,9 per cent stake cost the 12 000 TE employees IR£1 billion, and is allotted to individuals through personal stakes over a five year period.

The seven ESOP trustees comprise four members nominated by the trade unions, two by TE and one independent. To assure overall co-operation, the Irish government also invoked a "lock-in" arrangement that allows TE, if necessary, to prevent sale of shares within five years of their transfer. In addition, the 9,9 per cent of shares purchased through pension fund and loan financing cannot be liquidated until the ESOP has paid the fund liabilities and loan interest. Those workers who voluntarily quit TE qualify for an allotment only for the period they are employed, while incoming workers only qualify for allotments after one year. There are no other qualifications or differentials between the workers, however (based on pay, status or length of service). Assuming current share prices, each of the workers remaining with TE from 1999-2003 will be worth an additional IR£80 000. The ESOP is enhanced by an Approved Profit Sharing Scheme.

The merits of the TE model are described by the former general secretary of the Irish Communication Workers' Union, David Begg:

> … workers are stakeholders and have a vital interest in the fortunes of the Corporations in which they work. It is not unusual for people in authority to recognise workers as stakeholders but too often this is mere lip-service. In reality, to mean anything, workers' influence must be backed up with economic power. This is where owning part of the equity of the corporation comes in because it gives workers financial clout which must be listened to.

Financial markets also favour the TE model. According to a key observer, Robert Oakeshott:

> Although the initial reaction of the "financial community" was sceptical or even hostile, that later changed. The initial argument had been that a substantial employee shareholding would be a downward drag on the share price. After discussion and reflection, that view was apparently changed, and the "up to 14.9 per cent ESOP" came to be seen as a potential source of buoyancy in the share price rather than the opposite.

Binns argues that any state interested in SOE restructuring with a component of employee ownership should follow nine core lessons:

- Ensure fairness of opportunity so that all employees have an equal opportunity to acquire stock
- Maintain transparency of the process so as to spread information on employee ownership options
- Be prepared for differing expectations, given that employee ownership is seen as a means either to enhance corporate performance, or to make ownership available to a broad cross-section of employees, or to ensure job preservation
- Allow for flexibility, given the difficulty of imposing a standardised approach
- Involve employee groups from the beginning of the process so that employees feel they have an opportunity to affect the outcome and will not have their fate determined by dynamics entirely beyond their control
- Empower employees to participate in restructuring transactions so that unions or groups act in a consultative capacity to the trustee to determine a feasible approach
- Facilitate the use of credit to help finance employee ownership transactions, so that employees are not bidding directly without assistance in the form of financing
- Do not dictate the permissible level of employee ownership – allow employee groups to determine the best feasible deal (not necessarily the largest ownership percentage)
- Policy reforms should facilitate a good legal environment, for example clarifying the role of independent trustees in negotiations on behalf of employee groups
- Emphasise privatisation, not revenue enhancement, so that government underwrites the transaction costs of structuring effective employee buyouts (the costs of legal and financial representation that employee groups will

need) in order to achieve long-term reductions in the cost of government operations
- Education and training are important, given the difficulty of the transaction and the lack of employee experience.[105]

These policies and programmatic interventions will assure a more feasible environment for ESOPs projects when SOE restructuring occurs. However, beyond establishing a level playing field, there are numerous creative approaches that should also be adopted by Government, once the benefits they have demonstrated elsewhere are clearly translated to local SOEs. Once established, the following policy options will allow each SOE facing restructuring to tap into particular state support systems to assure successful worker and social ownership and management:

- Tax benefits can be provided to companies on a sliding scale, depending upon quality and quantity of employee ownership and control.
- Existing SOE restructuring formulae for empowerment components can be amended to include a bonus for meaningful employee ownership.
- Inexpensive credit to worker-owned restructured SOEs can be provided through various government programmes and agencies.
- At any point when government offers "largesse"[106] to SOEs (or any large corporations), a *quid pro quo* can be granted to a broader ownership-broadening fund (as exists in Canada and Sweden).
- A public trust can be generated to receive payments in cash or stock for pollution by energy companies, to be ploughed back into ameliorative and preventative worker and/or community-owned environmental institutions and strategies.
- A labour and community venture capital pool can be specifically established to promote investment and related start-ups when SOEs are restructured.
- A hybrid of employee ownership can be established to handle SOE restructuring related to public utilities.

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[105] Binns (1998: 4–5).

[106] This term will increasingly be defined, not least because the World Trade Organisation and more transparent public management systems will force Government to more clearly specify subsidies and cross-subsidies, and to justify these as being in the public interest. Largesse is also considered to include major "bail-out" operations where a corporate or bank bankruptcy would have excessively destabilising effects.

- The new capital gains tax and related taxes can be adjusted to ensure progressivity and incentives for employee and social ownership in SOE restructuring.[107]

The introduction of ESOPs in South Africa may, however, be complicated by the social structure of most enterprises that are segmented by racial and class divisions. Introducing ESOPs in such an environment, where the majority of skills and resources lie with minority ethnic groupings, will not ensure that participation is broadened sufficiently to address historical inequalities. The design of ESOPs will therefore need to pay much greater attention to overcoming these historical inequities without undermining the overall benefits associated with greater employee involvement across the range of employment categories in the firm. Such ESOPs may need to provide further resources to empower and train underresourced and less skilled employees to participate more equally in the operations of the business.

Community trusts

A final area where participation can be enhanced in the restructuring of state enterprises is with community trusts. Such trusts seek to obtain the benefits of small economies of scale, resolve micromanagement challenges and incorporate the benefits of "social capital" and non-pecuniary gain within the production-distribution-consumption process. Community trusts include producer co-operatives, consumer co-operatives, mutual companies, not-for-profit firms and other avenues of collective activity that allow an enterprise to extend beyond the reach of the market.

Most community trusts are purchasing arrangements. The greater economies of scale associated with collective purchasing provide an incentive to establish co-operatives so as to enhance bargaining power in the market or to share overhead costs more efficiently. Community trusts may also take the form of, for example, pooling savings so that members of the trust can afford to borrow a much larger amount than would otherwise be available from a commercial financier. Pooled savings may also be used to ensure the provision of a service, for example electrification of rural areas, which would not be available to the individual consumer.

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[107] Documentation for each of these techniques is provided in Ford Foundation, Capital Ownership Group and Ohio Employee Ownership Project (1999: 5–6).

The best-known exercise in co-operative utility enterprise is probably rural electricity in the United States, dating to the New Deal era, but continuing today through the National Rural Electrification Co-operative Association. Currently, two thirds of the US land mass is electrified by consumer-owned rural co-operatives. These are not limited only to retail end-users. Electricity generation and transmission co-operatives emerged to supply local distribution co-operatives, and increased their share of the latter's inputs from less than 20 per cent in 1960 to more than 50 per cent today. The core barriers to co-operative ownership (including high capital intensity, the need for state subsidies, risk, and a biased responsibility for enterprise capitalisation falling on older generations) were all provided for in supporting state programmes, legislation and funding sources.

There are important precedents for introducing community trusts to SOEs undergoing restructuring. These are mainly in areas associated with utility functions involved in the supply of electricity, telecommunications and transport. Non-profit co-operatives may be the only kinds of enterprises willing to reach out to sectors of the population for which markets are uneconomic. Given the geographic and social inequalities in the South African space economy, Government support for community trusts is vital. This may include provision of venture capital, technical expertise (business planning), and marketing information/linkages. Ultimately, however, the broader transformation of South African society should also entail a state commitment to investment in social capital, which is where the combination of employee-managed firms and community trusts may have its greatest potential.

Conclusion: encouraging empowerment

In the process of restructuring SOEs, the interests of society can be realised through aligning the objectives and processes discussed above, and through assuring that all restructuring processes account for the full set of public good issues associated with their operation. In previous sections of this policy framework, it was argued that SOE restructuring should seek, in part, to use state assets to correct market failures, particularly in cases where some goods or services are not produced or consumed with sufficient quantity and quality to maximise social welfare, hence requiring the state to act as provider or regulator of public goods. It was also proposed that SOE restructuring should seek to ensure that consumer welfare is not threatened by price discrimination associated with the privatisation, incorporation or deregulation of some SOE goods whose characteristics lend themselves to market failure. Hence active, creative regulation of SOEs that become subject to market discipline will be essential.

In addition, this policy framework proposes a multi-faceted approach to broader social empowerment through three kinds of intervention, informed by strategies of alternative service delivery in SOE restructuring processes:

- First, SOE ownership can be broadened through the National Empowerment Fund and other kinds of unit trust structure, in ways that do not reproduce or amplify the problems in existing empowerment-related financial engineering. These new approaches can take the best lessons (and avoid the most serious drawbacks) associated with international experiences of collective investment vehicles to provide a range of equity schemes for those previously excluded from mainstream economic participation.
- Second, operational empowerment strategies should be improved, to ensure that beneficiaries are not merely absentee owners, but gain meaningful access to state-regulated activities, through training and skills development, through affirmative action in management, through entrepreneurship opportunities arising from new opportunities for outsourcing, expanding partnerships, affirmative procurement and easier access to financing.
- Third, combining the first two strategies, alternative vehicles for empowerment such as ESOPs and community trusts should be piloted, so as to improve enterprise self-management and community involvement, and in the process to raise investment in and take advantage of social capital. In these latter cases, the full range of alternative service delivery models needs to be extended to develop new methods of involving those previously marginalised.

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Improving corporate governance and ensuring improved ethics and probity

In the preceding discussion, the issues of corporate governance surfaced in a number of areas generally related to the ownership, management and performance of SOEs. In the discussion of microeconomic impact, the argument against all forms of state ownership was challenged on the grounds that if appropriate forms of corporate governance were established, the traditional criticisms of state ownership (contractual incompleteness, information asymmetries and undue political influence) could be addressed. Therefore, the improved corporate governance is most needed to address these microeconomic concerns. There are, however, both practical and political reasons why the state may seek to improve corporate governance.

In practice, Government's relationship with the SOE sector was less than optimal over the past five years. Government's previous advisers, HSBC, noted in their handover report that a number of overlapping problems arose with the restructuring process between 1994 and 1999. Two of the key problems they raised concerned relationships between various departments responsible for achieving different objectives of Government, and the problematic relationships between Government and the management and/or boards of these enterprises.[108]

The different roles of Government

As noted from the first section, the state has a large number of strategic objectives for the restructuring process arising from the differing roles that it is called on to play. These differing objectives, all legitimate and equally important, are often difficult to reconcile, especially when they are represented by different line function departments:

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[108] HSBC's Handover Report, October 1999.

- First, the state sets the overall policy context for Government as a whole. The policy objectives of restructuring then need to be contextualised in the light of overall government policy. While it can be hoped that these more general policy objectives can be reconciled with the state's restructuring objectives, Government may have to make some hard choices between different objectives. For instance, its objective to expand service delivery and to ensure that the quality of life of poor is improved needs to be balanced against objectives such as ensuring that the SOEs provide these services in an economically sustainable manner.
- Second, the state has a responsibility as shareholder to maintain, if not improve, the value of the assets under its custodianship. This shareholder role need not conflict with its policy-making role, but the trade-offs need to be spelt out more clearly to those managing the restructuring process. For instance, the SOE may need to retain earnings in order to generate sufficient income to reinvest in maintaining and perhaps improving its capital stock. Although such capital reinvestment may improve the longer-term efficiency and effectiveness of the SOE, it may also conflict with more pressing requirements such as reducing the public sector borrowing requirement.
- Third, given the existence of both natural and/or legal monopolies, the state has to ensure an appropriate level of regulation. Again, this regulatory role need not be in conflict with the state's other roles, but the specific choices to be made need to be spelt out. A key trade-off is between the SOE's need to re-invest and/or improve its competitiveness in a globally defined market, and the regulator's responsibility for ensuring affordable prices and/or expanded service delivery to the poor.

International experience seems to suggest that restructuring has been less successful when the differing roles of the state overlap significantly.[109] This indicates that the separation of the roles of those tasked with formulating overall state policy, with regulation and with the restructuring process needs to be more clearly defined in South Africa. These issues were resolved at the IMCC Lekgotla in November 1999, where the Ministers agreed that while policy departments would continue to perform these functions in the sectors they oversee (for example, transport, communications, energy, defence etc.), the Department of Public Enterprises would take overall responsibility for the restructuring of

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[109] Shirley. 1995. *Getting bureaucrats out of business: obstacles to state enterprise reform*. Megginson, Nash & Van Randenburgh. 1996. *The privatisation dividend*.

enterprises. Similarly, the potential conflict between Government and regulators was clarified by restating that regulators need to operate within the framework of government policy rather than seeking to influence policy themselves. While these pronouncements will clarify the different roles of government agencies, these relationships will need to be spelt out more clearly in a formal document such as a refined Protocol on Corporate Governance or in the shareholder compacts.

A similar ambiguity in the roles of management and the boards versus that of the shareholder in the restructuring process has complicated this matter. These players may, in some cases, have taken actions during or before the restructuring process which were not necessarily fully aligned to Government's overall objectives. While both management and the boards have certain operational and fiduciary responsibilities or interests that are distinct from those of the state, in the absence of an accepted framework for corporate governance, it remains difficult to address these questions.[110] The experience with restructuring so far, particularly some of the problems with the Sun Air, Aventura and Alexkor deals, also suggests that the state, as the major shareholder, needs to play a more active role in the process.

Underlying the difficulties associated with these differing roles is the lack of agreement on a framework for corporate governance. Unfortunately, as long as the role of the state remains ambiguous, different stakeholders will exploit this for their particular ends. A framework for corporate governance[111] was finalised in 1997, and most major SOEs have indicated that they support this framework, but Government has only recently taken action to ensure compliance. More recently, the Public Finance Management Act, No. 1 of 1999 (PFMA) provided a clearer statement of fiduciary responsibility and accountability, which, if complemented by a revised protocol on corporate governance, should address these concerns. In the ensuing sections, this chapter will highlight the main areas where the 1997 Protocol can be revised to bring it into line with the PFMA and international best practice. The shareholder compacts discussed below, coupled with a refined protocol on corporate governance should assure Government that its continuing interests in SOEs are better managed. It will also reassure investors, boards, management and the workforce because Government's intentions regarding the

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[110] HSBC's Handover Report, October 1999.

[111] Protocol on Corporate Governance, HSBC, 14/10/1997.

SOE will be spelt out in detail. The proposed shareholder compacts and a refined protocol should also assist the management and boards of SOEs in performing their duties with the confidence that their roles and responsibilities, and those of the state, are more clearly defined.

Refining the protocol on corporate governance

The importance of corporate governance lies in its contribution to both business prosperity and accountability. The latter has been the subject of much public debate over the past few years in many countries, including South Africa.[112] This emphasis on accountability has tended to obscure the board's responsibility for enhancing the prosperity of the business. People, teamwork, leadership, enterprise, experience and skills are what really produce prosperity and there is no single formula to weld these together. Rules and regulations about structure will not necessarily deliver success. Accountability, by contrast, does require appropriate rules and regulations, of which disclosure is the most important element.[113]

In the discussion below, various elements of the 1997 Protocol on Corporate Governance are discussed and compared with international best practice. It shows where the 1997 Protocol conforms to international best practice, and where it may need refinement. Since the 1997 Protocol has received Cabinet endorsement, there is no intention to update it at this stage. The policy framework will, however, identify areas where the 1997 Protocol can be improved to meet international best practice, to facilitate a future revision. Where possible, the suggested revisions will be carried through into the shareholder compacts

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[112] The comparative analysis of corporate governance related to the Protocol on Corporate Governance in the Public Sector (hereafter referred to as "the Protocol") was based on the following sources:

- CACG guidelines: Principles of Corporate Governance in the Commonwealth (CACG)
- OECD Principles of Corporate Governance (OECD)
- Committee on Corporate Governance – Final Report (CCG – UK)
- Performance Audit report: Corporate Governance (Audit Office of New South Wales) (NSW)
- Perspective on Directors' Duties – Deloitte & Touche (D&T)
- HSBC handover report (HSBC)
- Views from various Deloitte & Touche Specialists (Views)

[113] CCG-UK, CACG.

(discussed below) and then used by the Department of Public Enterprises in their day-to-day management of specific SOEs.

Appointment of the Board

The selection or appointment of the board follows a well-planned, formal and transparent procedure. This managed and effective process should ensure board appointments that provide a mix of proficiency, with people who are able to add value and bring independent judgement to the decision-making process. Only people of integrity who can bring a blend of knowledge, skills, objectivity, experience and commitment to the board, must be appointed. The board should be led by a capable Chairman who brings out the best in each member. It is crucial to have a proper and credible director selection process for executive and non-executive directors at both holding and subsidiary company level, to avoid the propensity for "cronyism" and "tokenism". Consequently, the composition of the board, its size and the succession programme should be planned with strategic considerations and objectives of the corporation in mind. This also applies to the appointment of the Chairman and the Chief Executive or Managing Director. The term served by all directors must be determined in advance and form part of a comprehensive letter of appointment. Where appropriate, performance contracts should be entered into.[114]

Board Structure

The Protocol suggests a unitary structure, in line with international best practice; this suggests that a unitary board with sufficient and credible non-executive directors would be the preferred option.[115] Although most international sources cite the need for a balance between executive and non-executive directors, private companies seems to have more non-executive than executive directors.[116] The Protocol suggests a balance between executive and non-executive directors, but this may need to be revisited as more non-executive directors would ensure better review of the performance of the board and the organisation.

[114] CCG-UK.

[115] CACG, King Report, CCG-UK, Views.

[116] NSW, CCG-UK.

Independence

The Protocol refers to the independence of the non-executive directors from management, but does not address the issue of undue political influence affecting the independence of such directors. It is important to distinguish between the state's influence as a shareholder and "undue political influence". In line with the above discussion of the impact of restructuring, it is argued that the state can use SOEs to meet some of its objectives, as long as this is accounted for in a transparent manner. This means that the state's ability as major shareholder to appoint the board, approve key strategic and business plans, and other aspects of performance management cannot be considered inappropriate if done in terms of acceptable and recognisable procedures. Similarly, the state's objectives to use SOEs to provide basic services can also be considered legitimate if done transparently, through either direct subsidies or visible cross-subsidies. State influence may be considered excessive (or undue), if it seeks to influence the SOE without being publicly accountable, e.g. through hidden cross-subsidies or private agreements to address objectives not clearly defined in the strategic and business plans. In these circumstances, it seems advisable that the boards use their independence to bring such practices to public attention.

The independence of directors, especially in SOEs, is considered a key feature in the international literature, especially since appointment of the board by the State makes this independence even more difficult. Independence is necessary, not just to protect against undue influence (whether this comes from management or the state), but also to ensure proper oversight of enterprise performance. In this regard, best practice indicates that it is better to keep the management, the setting of strategic direction and performance monitoring as discrete processes. The independence of the board can be bolstered by the appointment of credible, objective and skilled non-executive directors. It may then also be prudent to ensure a majority of non-executive directors.[117] Non-executive directors should be independent of management; they may be directors or managers from the company's holding company, but have no executive responsibilities in the company.[118] While the current protocol addresses independence adequately, the experience of the next couple of years will indicate whether further provisions may be required, especially to deal with the issues of independence from undue

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[117] CACG, NSW.

[118] D&T, CACG-King report.

political influence. These issues will however be addressed in SOE-specific shareholder compacts.

Remuneration

International precedent indicates that the director's remuneration should at least in part be linked to the performance of the SOE and the board[119]. It also suggest that full disclosure of the total of executive and non-executive directors' earnings should be made in the annual report and that the directors' remuneration should be balanced between an amount which would lose significance for the director and a level at which the director may lose independence[120]. The Protocol deals adequately with the issues of performance-linked remuneration and disclosure, but there is little evidence that this is actually being implemented, as some annual reports do not contain this information. The issue of partial or even full liability (discussed below) may scare off some non-executive directors of SOE boards unless their remuneration is in line with their responsibilities. International precedent indicates that compensation should accurately reflect the responsibility and risk involved in being an effective director.[121]

The role and involvement of the shareholder in the final determination of the board remuneration need to be clearly defined. While it is general practice that a committee of the board may be tasked with the responsibility for investigating and recommending to the full board the remuneration structures and levels, the shareholder's involvement may be to consider the board's recommendations for approval. The shareholder's involvement is clearly to ensure that a uniform approach and common standards are applied by the enterprises in the determination of remuneration structure and, where appropriate, remuneration levels.[122]

Role of the board

The Protocol is very general as regards the function of the board and the responsibility of the directors. The specific nature of the relationship between

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119 CACG, CCG-UK.

120 CACG.

121 CACG.

122 CCG-UK.

legislation, regulation, shareholder interest and the board is not addressed adequately, although it does state that the board (directors) are individually and collectively accountable to the shareholder and must comply with and co-operate fully and at all times with government policy. The Protocol states that the board needs to maintain full and effective control over day-to-day management but does not mention the board's role in major capital decisions (acquisitions, disposals, etc.) and in appointing senior management. These functions are best performed by the shareholders, but they should be featured in the strategic and business plans of the enterprise, which requires board participation. There remains, therefore, some confusion over the roles and responsibilities of the board in the Protocol. This can be addressed in the shareholder compacts which makes explicit reference to the content of the strategic and business plans to be approved by the shareholder.

International precedent makes a number of suggestions that would help clarify these concerns. The first question that needs to be properly addressed is whether the board acts in a governing or an advisory capacity. If a unitary board structure is adopted (as in the Protocol), then it appears that the role of the board would be a governing or controlling one (sanctioned by the Minister). In fulfilling this role, the Minister would need to communicate with the boards and ensure they understand the nature and extent of authority delegated to them. The Minister should also establish measures of performance for the board. The board should also be provided with written guidance on how legislation, policies, administrative arrangements and conventions affect its decision-making ability.[123]

Notwithstanding the above, the boards would still have "total accountability for all corporate activity", with their roles and functions identified as follows in the international literature.[124]

- Responsibility for strategic planning and direction, major plans of action, risk policy, annual budgets and business plans, performance objectives, major capital decisions and monitoring good governance
- Appointing, training and monitoring senior management
- Monitoring and managing potential conflicts of interest
- Ensuring integrity of accounting and financial reporting systems

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[123] NSW.

[124] NSW, CACG,CCG-UK,D&T, OECD, Views.

- Implementing a code of ethics for the organisation
- Abstaining from day-to-day management activities
- Ensuring that technology and systems used are adequate to run the business properly and for it to remain a meaningful competitor
- Regular assessment of its own performance and effectiveness, and that of the individual directors
- Regular review and reporting on internal procedures.

It must be emphasised that the board members, individually and collectively, have a fiduciary responsibility to the corporation they serve. This responsibility dictates that the board must at all times ensure that the business enterprise is financially viable and properly managed, so as to protect and enhance the interests of the corporation and its shareholders over time.[125] However, during the restructuring phase, the shareholder will play a greater oversight role, especially in monitoring the management of the restructuring process. To this end, the shareholder will be responsible for the final approval of the senior management appointed by the board.

Performance management

Although the Protocol states the need for annual budgets against which performance can be monitored, this is probably not sufficient. International experience suggests that Government should define the elements of a performance contract and identify more criteria than just budgets for assessing performance of the board. The Protocol states what is expected from the board and the three duties of the directors,[126] but does not clearly indicate how the board's performance will be assessed. International best practice suggests that boards should have performance agreements in addition to existing legislative and regulative requirements, and it specifically indicates that the board's performance should be monitored along with that of the organisation.[127] The review of the board's performance can be conducted by the non-executive directors,[128] and a yardstick for measuring board performance is the availability of

[125] CACG.

[126] Duty of loyalty, Duty of care and skill, Duty of attention.

[127] CCG-UK, CACG, NSW.

[128] NSW.

written rules and procedures for the board.[129] These could include (but are not restricted to) information on:

- The board's constitution, purpose and charter
- Induction materials
- Roles, responsibilities and activities of key stakeholders
- Reporting procedures
- Standards
- Responsibilities of the board to key stakeholders
- Processes, methods and responsibilities of the board for the management of the organisation
- Processes, methods and responsibilities of managers for reporting to the board
- Record keeping

Decision-making by boards

The Protocol does not follow international best practice regarding decision-making guidelines and how decision-making should be addressed. The role of the shareholder in board decisions is also not clearly indicated. It is therefore suggested that the shareholder compact should include a section dealing specifically with decision-making procedures.

International precedents provide some guidelines. Best practice provides that boards should:[130]

- Vote on all material issues
- Establish formal procedures to govern the conduct of its business
- Ensure that minutes of meetings accurately record decisions taken and, where appropriate, the views of individual board members
- Avoid consensus-seeking decision-making at board level, which could entail too much compromise and eventually weaken the decision

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[129] NSW, CACG.

[130] NSW.

Disclosure and transparency

The Protocol includes some principles concerning disclosure and transparency, but these are not grouped under a particular heading or section. In future revisions of the Protocol, it would be useful to have a specific section dealing with these issues, which would also identify all stakeholders and the information they should have access to. As noted in the section on microeconomic impacts, information asymmetries have caused a significant failure in SOE corporate governance relationships.

International precedent indicates that communication with shareholder(s) should be based on openness, with substance prevailing over form. Some better practices suggest that parts of board meetings be opened to the media and other stakeholders, and that the board should undertake field visits to assess the organisation at first hand. It is also suggested that information should be timely, accurate, regular and comparable, and that disclosure should include:[131]

- Financial and operating results of the company
- Company objectives
- Major share ownership and voting rights
- Members of the board and key executives, and their remuneration
- Material foreseeable risk factors
- Material issues regarding employees and other stakeholders
- Governance structures and policies
- Compliance with legislation.

Standards of behaviour

The Protocol covers this well, adding that a separate code of conduct can be drawn up to guide the behaviour of directors. Compliance testing is a requirement in the Protocol but, as with the disclosure of remuneration, actual practice is questionable. The Protocol could be clearer on what it prescribes in terms of compliance testing, perhaps with reference to third party assessment.

International practice indicates that the board should oversee the development of a formal code of conduct defining the standards of personal behaviour to which

[131] D&T, CACG, OECD, NSW.

individual board members and all employees of the body would subscribe. The code could include the following provisions:[132]

- Directors should act in the interests of the company as a whole.
- Full disclosure of any conflict of interest or potential conflict of interest to be made and a register of interests to be kept in this regard.
- The board should ensure the establishment of a fraud control strategy.
- Board members should devote sufficient time to their responsibilities.

Liabilities

The Protocol is not clear on the issue of liabilities. Given the difficult relationship between the boards and the shareholder (especially Government), issues pertaining to liabilities should be addressed in more detail in the revised protocol and/or the shareholder compact.

As power without accountability is dangerous, some degree of director liability is considered good practice. This should be based on stated roles and undertakings of the shareholder, board and the director. Director liability needs to be regulated and assessed in terms of both internal factors (i.e. financial health, restructuring, etc.), and external factors (specifically legislation and degree of shareholder support or interference).

International best practice suggests that a limited personal liability for directors is advisable, except that directors are held liable without limitation where reckless or fraudulent actions are involved. Where such personal liabilities exist, however, organisations can be expected to take out insurance to cover the liabilities of directors.[133] However, when “directives and controls” by the Minister result in questionable outcomes, Government may be liable as a principal and the SOE would be viewed as an agent.[134]

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[132] NSW, CCG-UK, CACG, OECD, D&T, Views.

[133] CACG, D&T.

[134] NSW.

Financial reporting (including subsidiaries)

Much of the financial reporting requirements will now be governed by the PFMA and any applicable Regulations promulgated in terms thereof. The financial reporting aspects of the Protocol will serve only to supplement these reporting measures to the extent that they are not superseded. Any revised protocol would, however, need to address the relationship between the shareholder (Government), the holding company and the subsidiaries. Government will also have a final say over the appointment of board members to the subsidiary companies.

International practice supports the notion that there should be total independence of the audit process and that directors are ultimately liable for the integrity of the audit. It indicates that directors should describe in their financial statements the internal control procedures and measures that were introduced.[135] There is little mention of subsidiaries in the international literature, except for a suggestion that, in the case of subsidiary companies or divisions not reporting to the shareholder, they may "effectively be removed from political scrutiny and accountability". It would thus appear that subsidiaries should be liable for reporting to the shareholder, as is the holding company.[136]

Establishing shareholder compacts

The shareholder compact represents an agreement between Government as the major shareholder and the board of the SOE as regards performance expectations and parameters. It does not replace the strategic, business and other plans required for the effective and efficient management of the enterprise. Rather, it complements these and, recognising the need for a controlled and managed involvement of the shareholder in its investment, describes the relationship between the signatories. Most of the standard and general principles of contract will therefore govern this relationship. The shareholder compact is based on the Protocol, which is time independent, as well as on the strategic, business and other plans of the enterprise, which are time dependent.

Shareholder compacts are being developed with the major SOEs. While the Department of Public Enterprises is using the 1997 Protocol and the above

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[135] CCG-UK, OECD, CACG, NSW.

[136] NSW.

guidelines, the actual format and content will be the result of a process of negotiation and accommodation between the shareholder and the enterprise. Although the provisions of the compact do not differ in substance from international best practice in both the public and private sectors, some boards may want to incrementally implement the provisions described below. Given that Government is seeking to improve its relationships with the SOEs within a developing framework of corporate governance, it will therefore accept a compromise around the original compacts. These are likely to be updated in the light of the experience with their implementation over the next couple of years. The compacts will therefore seek to cover most of the following areas:

Introduction: The shareholder compact will state that it is based on the Protocol for Corporate Governance in the Public Sector (1997) and all its subsequent amendments, and on the strategic plan and the business plan of the SOE. It will include the critical assumptions about the operating environment, economic conditions and political relationships for the period covered by the compact. It will state who the signatories to the contract are and what their respective roles are.

Interpretation: There will be a clear definition of all terms that could be misunderstood or interpreted in different ways in the shareholder compact.

Primary relationship between the signatories: The compact will clearly indicate the role of the SOE Board and Management. This will include responsibility for key activities, e.g. appointment of senior executives, and capital decisions. It will also include requirements on nature and degree of contact between management and shareholder. The SOE's board mandate from the shareholder will be spelt out. The compact will put forward mechanisms to address violations of autonomy and independence.

Undertakings by Management of SOE: The compact will seek to cover what management undertakes to do or not to do, and the tasks for which management is responsible.

Undertakings by Shareholder: The compact will also spell out the role of the shareholder and what it undertakes to do or not to do. For example, the shareholder will undertake to issue instructions with sufficient warnings and response times. The compact will include a statement of intent by the shareholder on how it will fulfil its role as shareholder.

Governance: The statement of governance in the compact will outline the principles and protocols upon which it is based. It will spell out which legislation the SOE will have to comply with (for example, Companies Act, Eskom Act). It will specify requirements for ethical conduct and internal fraud control procedures. It will require a register of conflicts of interests. The compact will outline that directors are committed to duties of care and skill, loyalty and attention.

Corporate goals and objectives: The compact will spell out agreed weight allocations and/or priorities to goals and objectives contained in business and strategic plans (inclusive of main subsidiaries).

Key performance indicators: The compact will define agreed weighted performance indicators (e.g. financials before internal process efficiencies etc.)

Extraordinary reporting: The compact will spell out when extraordinary reporting is required and to whom, by whom, on what, and how.

Decision-making: The compact will contain clear statements on how decision-making is to take place at board level (e.g. voting or consensus seeking). It will also outline the role of the shareholder in decision-making.

Policies: The compact will define the role of policy-making departments as against the SOE and the shareholding department. It will include details on policies and legislative requirements that the SOE is obliged to implement, for example, employment equity and procurement policies. It will also outline the planned development of any other/additional policy frameworks, for example, strategic sourcing, share-option schemes, outsourcing, alternative employment models and concessioning.

Obligations to deliver service: The compact will include an undertaking by the SOE to deliver specified critical services, notwithstanding any restructuring policy/arrangements (until there is official notification that the SOE is relieved of those responsibilities). It will also state who can make changes to the service delivery obligations.

Liabilities: The compact will include agreements on the liabilities of management as against those of the shareholder, specifying when management liability falls away. It will also outline the liabilities of executive and non-executive directors. It will spell out insurance and indemnity clauses and arrangements. It will also specify areas where conduct can affect liability.

Penalties and rewards: The compact will define the penalties for non-achievement of agreed objectives (for example, redeployment). Similarly, it will define the rewards and/or bonuses for meeting or exceeding targets. It will also specify the process for confirming rewards and penalties, including reporting procedures, queries, defence submissions, third party assessments, etc.

Third party assessment: The compact will spell out the involvement of third party assessment in the assessment of performance results. It will define who will be responsible for the assessment of non-compliance with agreed roles, responsibilities and undertakings. It will outline how performance expectations can be adjusted flowing from third party assessment.

Notices: The compact will specify the format for notices and that they must be in writing. It will also specify when a notice will be deemed to have been received, depending on whether it is delivered by hand, posted, in the form of a telegram, faxed or e-mailed. It will also define when notices shall be regarded as adequate communication.

Whole agreement: The compact will specify the period it covers. It will also specify the extent of this agreement relative to others, and that the undertakings and annexures to the agreement will be declared active when signed.

Variations: The compact will specify that no variations shall be of any force unless these are in writing and signed by both parties. It will also specify the process for introducing variations (notifications, draft submissions, final).

Conflict with memorandum and/or articles of association: The compact will outline the relationship between the shareholders compact and the Memorandum or Articles of Association, and the procedures that should be followed in case of conflict.

Proposed annexures to the shareholder compact: The following documents will form annexures to the shareholder compact:

- A five-year strategic plan
- A one-year business plan (updated annually)
- A code of ethics
- Corporate governance schedules (board meetings, reports, etc.)
- Register of conflict of interest (for management and board)
- Risk control plan (fraud control strategy)
- Statement of responsibility (signed)

As should be evident from the above description of the scope of the shareholder compact (as currently being defined by the Department of Public Enterprises), it will cover all the key areas of concern mentioned in the review of the 1997 Protocol. The shareholder compact is understood to be an interim agreement designed to assist Government in managing the restructuring process. As the restructuring proceeds, a revised protocol on Corporate Governance is drawn up and is adopted by the SOEs, the compact will be revised and/or superseded by more formal corporate governance practice. Furthermore, since the compacts will largely define the relationship between specific SOEs and Government, each compact is being tailored to the distinct requirements of each enterprise. Government therefore envisages a process whereby the shareholder compacts are used as an interim measure to establish better relations of corporate governance between itself and the main SOEs, and that these compacts will fall away once such an improved relationship is in place.

Refining the corporate governance protocol and establishing shareholder compacts

The review of the 1997 Protocol indicates that, while it covers many issues commonly found in other corporate governance frameworks, it will need to be refined in future to be brought into line with international best practice. However, it is still sufficiently sound to be used to establish the foundations for corporate governance over the next few years. The above discussion details the type of revisions that will be required when it is updated. In the interim, however, the IMCC directed the Department to ensure that the largest four SOEs (Eskom, Transnet, Telkom, and Denel) sign off on the 1997 Protocol. They also requested that the relevant shareholder Ministers to conclude shareholder compacts with these SOEs. Since the shareholder compact will primarily serve to develop an enterprise-specific relationship between Government and the SOE, most (if not all) the limitations listed above are expected to be addressed in the shareholder compact.

Ethics and probity in relation to corporate governance

The Protocol endorses the King Report and adopts both the Code of Corporate Practices and Conduct, and the Code of Ethics. The PFMA also aims at disciplined management of the public resources and establishes a culture of financial probity. These documents cover codes of conduct and conflict of interests, especially pecuniary interest and fraud control. In relation to these matters, the literature on best practice specifies that organisations should:

- Develop a formal code of conduct defining the standards of personal behaviour to which individual board members and all employees of the body should be required to subscribe.
- Directors must act in the interests of the company as a whole.
- Full disclosure of a conflict or a potential conflict must be made to the board.

Imperatives of ethics and probity in business[137]

There is an argument which suggests that corporations that are properly managed and controlled by directors with long-term vision and purpose will, in their own enlightened self interest, ensure that they take proper account of these wider objectives. Corporations now rightly attach increasing importance to their corporate reputation for commercial success; this is underscored by increasing scrutiny from the regulators, the press, pressure groups, labour unions, employees and communities in which they operate.

In this regard, most contracts concluded by corporations involve mutual rights and obligations. This, in turn, involves trust and responsible management to ensure that the conduct of the corporation, internally and externally, is based on enterprise and integrity. The fiduciary duties and responsibilities of directors should, at all times, remain paramount. All stakeholders with a link to the corporation should feel confident that their dealings with the corporation are undertaken with honesty, openness and fairness. It is advocated that one of the responsibilities of directors of any business enterprise (whether private, public,

[137] CACG, the Protocol, King Report, Final Report (CCG – UK).

family-owned or state-owned) should be to determine the moral and ethical climate of the business. This can take many forms (and is normally documented and widely disseminated in the organisation), but the conduct of the directors in their dealings both within the corporation and outside will set the example for others to follow.

Bribery and corruption[138]

Ethics is an aspirational objective, and should represent the intrinsic cultural values of the society in which the corporation operates, as well as the behaviour expected of the corporation in all its dealings with shareholders and other stakeholders generally. Where a corporation codifies ethical conduct, as it should, such guidelines should be succinct but sufficiently detailed to give a clear direction. Ethical practices and issues are both complex and vexed. No single or universal model can be defined or prescribed, other than to emphasise the significant importance that international institutional investors and other significant interested parties attach to this issue. While difficult to quantify in precise economic terms, the impact of bribery and corruption on countries, communities and business enterprises has been devastating. Given the many and subtle forms that this may take, the Asian Development Bank estimated that losses due to corruption can total more than a country's foreign debt in lost revenues and additional costs for goods and services

Ultimately, corruption and fraud, in any manifestation, are theft and criminality against the people of South Africa. In the context of continuing poverty and inequality, these practices can deprive people of homes, livelihoods and sustenance, and will not be tolerated.

Business ethics[139]

This concept means various things to various people, but it generally relates to knowing what is right or wrong in the workplace and doing what is right regarding products/services and in relationships with stakeholders**.** Wallace and Pekel explain that attention to business ethics is critical during times of fundamental change, as now faced by SOEs. In such times, values that were previously taken

[138] CACG.

[139] Carter, M. 1999. *Complete guide to ethics management: an ethics toolkit for managers.*
Wallace & Pekel.

for granted are strongly questioned, and many are no longer followed. Consequently, there is no clear moral compass to guide leaders through complex dilemmas about what is wrong. Attention to ethics in the workplace, therefore, sensitises leaders and staff to how they should act, providing them with a strong moral compass in times of crises and confusion. However, attention to business ethics provides numerous other benefits; these are listed later in this document.

Management of business ethics[140]

Managing business ethics holds tremendous benefit for leaders and managers. However, the field of business ethics has traditionally been the domain of philosophers, academics and social critics. Consequently, much literature about business ethics is not geared toward the practical needs of leaders and managers, the people primarily responsible for ethics in the workplace. This lack of practical information is the outcome of insufficient involvement of leaders and managers in discussion and literature about business ethics. Lack of involvement of leaders and managers in the field of business ethics has spawned considerable confusion and misunderstanding among leaders and managers about business ethics. Consequently, many managers believe business ethics to be irrelevant as business ethics training often avoids the real-life complexities in leading organisations.

Two broad areas of business ethics[141]

There are two areas that business ethics needs to address:

Managerial mischief: this includes “illegal, unethical, or questionable practices of individual managers or organisations, as well as the causes of such behaviours and remedies to eradicate them”. A great deal has been written about managerial mischief, leading many to believe that business ethics is merely a matter of preaching the basics of what is right or wrong. More often though, business ethics is dealing with dilemmas that have no clear right or wrong answers.

Moral mazes: this includes the numerous ethical problems that corporations must deal with on a daily basis, such as corruption, bribery, dishonesty, potential

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[140] Carter, M & Thompson, T. 1991. *Managing business ethics.* Canadian Public Administration.

[141] Masden, P & Shafritz, J. 1990. *Essentials of business ethics*. New York: Penguin.

conflicts of interest, wrongful use of resources, mismanagement of contracts and agreements, insider trading or financial interest.

Benefits of managing ethics in business and the workplace[142]

Managing ethics in business and the workplace has various benefits. Ethics programmes:

- Help maintain a moral course in times of fundamental change
- Cultivate strong teamwork and productivity
- Support employee growth and meaning
- Help ensure that policies and procedures are legal and ethical
- Help avoid criminal acts "of omission" and tend to detect ethical issues and violations early on so they can be reported or addressed
- Help manage values associated with quality management, strategic planning and diversity management; this benefit needs more attention
- Promote a strong public image of the business
- Legitimises managerial actions, strengthens the coherence and balance of the organisation's culture, improves trust in relationships between individuals and groups, supports greater consistency in standards and quality of products, and cultivates greater sensitivity to the impact the enterprise's value and messages.

Managing ethics as a programme[143]

Organisations should establish ethics management programmes that can convey corporate values. These programmes often use codes and policies to guide decisions and behaviour, and can include extensive training and evaluating, depending on the organisation. They provide guidance in ethical dilemmas, as they balance competing values and reconcile them.

The following guidelines can be used to establish an ethics programme:

- Establish organisational rules to manage ethics
- Schedule ongoing assessment of ethics requirements

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[142] Genfan, H. 1987. Formalizing business ethics. *Training and Development Journal*; Kissane, D.E. 1990. Managing values: a systematic approach to business ethics. *Training and Development Journal*.

[143] Genfan, Kirrane, Thompson

- Establish required operating values and behaviours
- Align organisational behaviours with operating values
- Develop awareness and sensitivity of ethical values
- Integrate ethical guidelines into decision making
- Structure mechanisms to resolving ethical dilemmas
- Facilitate ongoing evaluation and updates to the programme
- Help convince employees that attention to ethics is not just a knee-jerk reaction done to get out of trouble or improve public image

It is necessary to develop guidelines for managing ethics as a programme in the workplace. It must be recognised that the programmes are more process-orientated than most management practices. The bottom line of an ethics programme is accomplishing preferred behaviours in the workplace and creating the ability to handle ethical dilemmas so as to prevent these from occurring in the first instance. Organisations are expected to make ethics decisions in groups, make decisions public as appropriate, and integrate ethics management with other management.

Key roles and responsibilities in ethics management[144]

Depending on the size of the organisation, certain roles may prove useful in managing business ethics in the workplace. These can be full-time, or part-time functions assumed by someone already in the organisation. Small organisations certainly will not have the resources to implement each of the following roles using different people in the organisation. However, the following functions point out responsibilities that should be allocated somewhere in the organisation:

- *The organisation's chief executive must fully support the programme*. If the chief executive isn't fully behind the programme, employees will certainly notice. This apparent hypocrisy may cause such cynicism that the organisation may be worse off than before. Therefore, the chief executive should announce the programme and champion its development and implementation. Most importantly, the chief executive should consistently aspire to lead in an ethical manner.
- *Establishment of an ethics committee at the board level*. The committee should be charged with overseeing the development and operation of the ethics management programme.

[144] Dean, P.J. 1992. Making codes of ethics "real". *Journal of Business Ethics*.

- *Consider establishing an ethics management committee*. This committee would be charged with implementing and administrating an ethics management programme, including administrating and training on policies and procedures, and resolving ethical dilemmas. The committee should be comprised of senior officers.
- *Considering assigning/developing an ethics officer*. This role is becoming more common, particularly in larger and more progressive organisations. The ethics officer is usually trained in matters of ethics in the workplace, particularly about resolving ethical dilemmas.
- *Consider establishing an ombudsperson*. The ombudsperson is responsible for co-ordinating the development of policies and procedures to institutionalise moral values in the workplace. This position usually is directly responsible for resolving ethical dilemmas by interpreting policies and procedures.

Codes of ethics

A credo generally describes the highest values to which the company aspires to operate. It contains the “thou shalt’s”. A code of ethics specifies the ethical rules of operation. It’s the “thou shalt not’s”. Some business ethicists feel that codes have no value, as too much focus is put on the codes, and these codes are not influential in managing ethics in the workplace. Many ethicists note that *developing* and *continuing dialogue* around the code’s values are most important. However, when managing complex issues, especially in a crisis, having a code is critical.

In the development of code of ethics, large organisations may consider an overall corporate code and then a separate code to guide each programme or department. The following are some guidelines in the development of codes of ethics:

- Review values required by relevant laws and regulations
- Identify which values produce the top three or four traits of a highly ethical and successful product or service
- Identify values to address current issues in the workplace
- Identify any other values needed, based on finding during strategic planning
- Consider any top ethical values that might be prized by stakeholders
- Collect from the above steps, the top five to ten ethical values that reflect the priorities of the organisation

Examples of ethical values might include:

- *Trustworthiness*: honesty, integrity, promise keeping, loyalty
- *Respect*: autonomy, privacy, dignity, courtesy, tolerance, acceptance
- *Responsibility*: accountability, pursuit of excellence
- *Caring*: compassion, consideration, giving, sharing, kindness, loving
- *Justice and fairness*: procedural fairness, impartiality, consistency, equity, equality, due process
- *Civic virtue and citizenship*: law abiding, community service, protection of environment

In developing their code of ethics, organisations and corporations must focus on the top ethical values needed in the organisation, which will avoid the most likely potential ethical dilemmas. There are numerous examples of codes of ethics, but organisations should generate their own codes rather than review examples from other organisations.

Codes of conduct

Codes of conduct specify actions in business and in the workplace, as opposed to codes of ethics, which are generally guidelines. Developing codes of conduct for large organisations may entail developing an overall corporate code of conduct, and then a separate code to guide each of the organisation's programmes or departments.

The following recommendations may assist in the development of codes of conduct:

- Identify key behaviours needed to adhere to the ethical values proclaimed in the code of ethics
- Include wording that indicates all employees are expected to conform to the behaviours specified in the code of conduct
- Obtain review from key members of the organisation
- Announce and distribute the new code of conduct

Principles of Ethical Conduct[145]

The following principles of ethical conduct are recommended for consideration by SOEs, which should ensure their applicability to all employees. It is expected that by adopting such principles, SOEs will ensure that all stakeholders have confidence in the integrity of the institution:

- Service in public entities is a public trust, requiring employees to place loyalty to the Constitution, the laws, and ethical principles above private gain.
- Employees shall not hold financial interests that conflict with the conscientious performance of duty.
- Employees shall not engage in financial transactions using non-public internal information or allow the improper use of such information to further any private interest.
- An employee shall not, except pursuant to such reasonable exceptions as are provided by regulation, solicit or accept any gift or other item of monetary value form any person or entity seeking official action from, doing business with, or conducting activities regulated by the employee’s agency, or whose interest may be substantially affected by the performance or non-performance of the employee’s duties.
- Employees shall put forth honest effort in the performance of their duties.
- Employees shall make no unauthorised commitments or promises of any kind purporting to bind the organisation.
- Employees shall not use public office for private gain.
- Employees shall act impartially and not give preferential treatment to any private organisation or individual.
- Employees shall protect and conserve the entities property and shall not use it for other than authorised activities.
- Employees shall not engage in outside employment or activities, including seeking or negotiating for employment, that conflict with official entities duties and responsibilities.
- Employees shall disclose waste, fraud, abuse, and corruption to appropriate authorities.
- Employees shall satisfy in good faith their obligations as citizens, including all just financial obligations, especially those such as the state, or local taxes that are imposed by law.

[145] US Executive Order 12731. 1998. *Principles of ethical conduct.*

- Employees shall adhere by laws and regulations that provide equal opportunity for all regardless of race, colour, religion, sex, national origin, age, or handicap.
- Employees shall endeavour to avoid any actions creating the appearance that they are violating the law or the ethical standards promulgated pursuant to these principles.
- All the entity's information and records must be treated as confidential, and disclosure or dissemination thereof should be within the operation of applicable rules and procedures, and the law.
- Employees shall undertake to hold their office in the entities with honour and dignity, not to divulge directly or indirectly matters which are entrusted to them under secrecy, and that they will perform the duties of their office conscientiously and to the best of their abilities without fear, favour or prejudice.

Policies and procedures[146]

The development of policies and procedures should also entail the development of an overall policy manual. The following guidelines may serve in the development and application of policies:

- Update policies and procedures to produce behaviours preferred from the code of conduct
- Include policies and procedures to train employees on the ethics management programme
- Include a grievance policy for employees to use to resolve disagreements with supervisors and staff
- Consider establishing an ethics "hotline"
- Once a year, review all personnel policies and procedures

Resolving ethical dilemmas[147]

Perhaps too often, business ethics is portrayed as a matter of resolving conflicts in which one option appears to be the clear choice. However, ethical dilemmas

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[146] Dean, Genfan, Masden & Shafritz, and Strong, K.C. & Meyer, G. 1992. An integrative descriptive model of ethics. *Journal of Business Ethics*.

[147] Ibid.

faced by managers are often highly complex, with no clear guidelines in either law or religion. An ethical dilemma exists when one is faced with a choice between alternatives. Organisations should develop and document a procedure for dealing with such ethical dilemmas. Ideally, these dilemmas should be resolved by a group within the organisation, e.g. an ethics committee comprised of top leaders or managers and/or members of the board.

Training[148]

The ethics programme will not work unless all staff members are trained about what it is how it works and their roles in it. The nature of the system may invite suspicion if not handled openly and honestly. In addition, no matter how fair and up-to-date a set of policies is, the legal system will often interpret employee behaviour (rather than written policies) as de facto policy. Therefore, all staff must be aware of and act in full accordance with procedures.

The following guidelines should serve in the development and application of ethical training:

- Orientate new employees to the organisation’s ethics programme during new-employee orientation
- Review the ethics management programme in management training experiences
- Involving staff in review of policies (ethics and personnel policies) is strong ethics training
- Practice in resolving ethical dilemmas
- Ethical performance as a dimension in performance appraisals
- Give all staff a copy of guide to ethics management

Principles and characteristics of an ethical organisation[149]

The following are principles and characteristics of ethical and integrity organisations:

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148 Ibid.

149 Ibid.

- The existence of a clear vision and picture of integrity throughout the organisation
- Ownership and embodiment of the vision by top management, over time
- Alignment of the reward system with the vision of integrity
- Alignment of the policies and practices with the vision
- Understanding that every significant management decision has ethical value dimensions
- Expectation and commitment that everyone in the organisation works through conflicting values or perspectives

Integrating ethics and probity into corporate governance

Further to improving the general climate of corporate governance in the SOE environment, Government is committed to ensuring that the management and boards of the SOEs uphold appropriate standards of ethics and probity. Many of the SOEs have already established codes of conduct for their management and boards, and Government will use performance monitoring to ensure adherence to these codes. In ensuring that these standards are adhered to, SOEs will need to demonstrate that an ethics and probity management programme is in place. This programme should include the following measures applicable to boards and management, to be approved and monitored by Government:

- Code of ethics
- Code of conduct
- Ethical training programmes
- Process of probity investigation and procedures for actions to be taken
- A system of adequate and appropriate disciplinary steps and penalties

Moreover, through reference to international best practice, Government will encourage the SOEs to periodically review and update these ethics and probity management programmes. It will also ensure that those managing the restructuring process are subject to similar ethical standards to those expected of SOEs. They should also be subject to appropriate probity investigations, and any evidence of misconduct will be fully investigated and prosecuted where applicable. Not only will this focus on ethics and probity constrain corruption and rent-seeking behaviour but also, by encouraging adherence to international ethical standards, Government will reassure potential foreign investors that financial and other corporate misbehaviour will not be tolerated. Government's commitment to ensuring world-class standards of probity will be demonstrated through its emphasis on ensuring that the management of restructuring process will be both transparent and accountable. Investors and stakeholders will be able to monitor the process, and hold Government accountable for deviations from the published process and programme.

7

Improving the restructuring process

One final substantive area that the policy framework seeks to cover is the manner in which the restructuring process can be improved in order to ensure that the accelerated agenda can be achieved. The department has been consulting participants involved in previous and current restructuring initiatives to gather suggestions as to how the process could be improved. Although many good suggestions were received, these solutions will still need to be implemented. The broad consensus achieved from officials across Government departments and with managers from SOEs however indicates that implementation of these suggestions will enjoy considerable support.

Problem statement

There is general consensus in Government and with SOEs that the following problems can be associated with previous and current restructuring initiatives:

- the restructuring process has taken longer and used many more resources than was initially envisaged. If there is to be an accelerated agenda for restructuring the process will need to be considerably re-designed;
- restructuring did not necessarily address all Government's objectives and future restructuring initiatives should focus more attention on broadening the means for participation;
- the lack of clarity about the different roles both within Government and between Government and SOEs and other stakeholders has created significant bottlenecks which can, however, be overcome if roles and responsibilities are more clearly defined.

There was general agreement that if the restructuring process is to be accelerated, then it will need to be significantly re-engineered to remove current bottlenecks (to make it more efficient and effective).

Managing stakeholder involvement

Increased stakeholder involvement will be arranged through the Labour Relations Act, through the social plan framework negotiated at the 1998 Job Summit, and through the National Framework Agreement to address high-level political engagement. Government is committed to the National Framework Agreement as a vehicle for discussions with labour on strategic issues relating to the restructuring of SOEs. The National Framework Agreement will emphasise the sectoral level, facilitating the alignment of specific enterprise restructuring initiatives with the broader sectoral policy. These proposals will benefit the relationship between Government and affected stakeholders, such as employees and consumers.

Beyond the immediate concerns of the relationship with labour, the Department recognises that it needs to improve its communication processes with other stakeholder groupings around restructuring. The Department is looking into developing an alternative form of communication such as a web site on restructuring. The Department has already committed itself to making the information generated from its audit of SOEs available through this means, and it will be exploring ways of providing up-to-date information on the status of various restructuring initiatives by such means. It may also publish a quarterly bulletin on restructuring initiatives.

Streamlining the decision-making process

Within Government, some concerns were expressed on the decision-making process within restructuring. These have now been addressed through the revised structure of decision-making approved by the Office of the Presidency. Basically, it entails a two-stream process whereby the detailed day-to-day restructuring decisions would be processed by an oversight committee and then passed on to a Ministers' subcommittee for approval. The subcommittee would primarily involve the Ministers of Public Enterprises, Finance, Labour, Trade and Industry and the Ministers from the affected sectors, where necessary. In addition, all the major policy questions, like those of other departments, would be routed through the new FOSAD and Cabinet Committee structures.

Interrogation of restructuring proposals

The third area of concern is the extent to which there is mutual understanding of restructuring proposals across Government and between Government and the SOEs. Some officials feel that previous restructuring proposals have not been sufficiently studied, especially in relation to their links other initiatives. It is also felt that there has been insufficient debate on the broader longer-term impact of restructuring initiatives. Generally, there is a belief that the previous structures governing the restructuring process did not allow for this strategic debate. A common understanding of restructuring needs to be established between Government and SOEs, and there is possibly a need for forums where the restructuring (overall/sector specific) strategies could be debated.

It is suggested that Government should hold periodic workshops on sector-specific strategies. These in-depth strategy discussions could inform both government officials and SOE management. Departments responsible for different sectors could periodically produce a short sectoral document setting out the restructuring strategy it would like to pursue. These documents could be circulated within Government and the SOEs and be used for the periodic strategy workshops. Such sectoral documents would also need to be lodged with FOSAD. Although the oversight committee would deal mainly with transactions, it might also be worthwhile to introduce strategic discussions into the oversight committee to ensure that officials remain informed of the broader strategic consequences of their actions.

It has also been proposed that restructuring proposals more fully account for the micro- and macroeconomic and social impacts than is currently the case. Future proposals should include the following information:

- An explanation of why the restructuring is necessary in terms of an analysis of the enterprise performance related to local and international trends in the industry or sector.
- An assessment of new capacity requirements for regulation, management, employment and, if relevant, community and/or other private partners, with appropriate plans for providing training or other empowerment mechanisms
- An explanation of how the proposal may assist in meeting national objectives, including, as relevant, those related to economic performance, service delivery, employment, investment and income distribution, etc. (see Table 1 in Chapter 2)
- An analysis of the net impact on affected communities, regions and the national economy in terms of employment, prices, income distribution and economic growth

- An analysis of the direct and indirect implications for national and provincial budgets

Structures and roles

It has been noted that the IMCC Lekgotla in November confirmed that the Department of Public Enterprises is to be responsible for co-ordinating and leading the restructuring process, and that the Minister should report to Cabinet on restructuring. The Department will act as co-ordinator of the restructuring process, and its programme officers for specific sectors will work with the primary policy departments. However, it has also been noted that policy, regulation and shareholder functions are intertwined and that there is also a need for integration of key issues. Government as a whole needs to ensure that every restructuring process is dealt with in a sectoral context. The suggestions in the section above should be of assistance.

Parliamentary oversight

Parliamentary oversight is a critical feature of the restructuring function. The Ministry of Public Enterprises is to work in close collaboration with the two Parliamentary committees assigned to such oversight. These committees are the Portfolio Committee on Public Enterprises, comprising representatives from the National Assembly and the Select Committee on Public Enterprises, whose members are drawn from the National Council of Provinces.

Members of Parliament have taken a keen interest in the Ministry and its operations. Because the Ministry considers well-briefed and informed committees to be vital, it has been policy to disclose as much information as possible to oversight committee members without placing the competitive commercial interests of the SOEs concerned in jeopardy. To this end, detailed briefings are regularly provided to committee members by Ministry and departmental officials either at the instigation of the Ministry or upon request from the committee directed through its chairperson. Committee members have also pursued matters in respect of the process with the Ministry at these meetings or in private with ministerial officials.

Over and above briefings and occasional visits to the SOEs by the committees or representative groups drawn from the committees, it is customary to discuss the pending legislation in the committee prior to discussion and voting in the plenary session. Legislation emanates from the Ministry of Public Enterprises for drafting and approval by the state law advisers before being submitted to Cabinet by the Ministry of Public Enterprises and then to the Portfolio Committee on Public Enterprises. Once approved by the Portfolio Committee the Bill is forwarded for discussion and approval in the National Assembly. Thereafter, the President signs the legislation into effect.

The relationship between Government and the SOEs

A number of concerns about the relationship between Government and specific SOEs have been raised. These include questions around the roles of SOE management and Government's technical task teams, especially when the SOEs have technical expertise that is often lacking in Government. It has been noted that SOE management may have vested interests and, therefore, their participation would have to be carefully considered depending on the issue in question.

It has been accepted that the problem of clarifying roles will be addressed through the protocol on corporate governance and shareholder compacts (see the above discussion). However, these roles may differ during and after the restructuring phase. It has been argued that, although the shareholder appoints the board and the board has duties and is financially liable, the restructuring and transformation of SOEs vest with Government as shareholder. Government therefore needs to ensure that the views of the boards and management are solicited before initiating the restructuring process, and it may want the boards to take responsibility for driving transformation once a restructuring plan is agreed upon. These issues are likely to be better clarified once the shareholder compacts have been finalised.

Mapping the restructuring process

In order to gain a better idea of the restructuring process, the Department set out to map the main processes involved in restructuring. (The high-level process maps are included in the Appendix.) There are four main processes involved in restructuring:

1. Strategic analysis

2. Enterprise restructuring planning
3. Transacting
4. Post-restructuring management

Each of these processes has been further defined to cover the main activities of the Department of Public Enterprises, although links to the work of other departments, Cabinet, stakeholders and the SOEs are indicated on the maps.

1. Strategic analysis involves developing a list of restructuring priorities from an analysis of the SOE information collected in the SOE database maintained by the monitoring unit. This list is also defined through reference to an SOE operating environment report (comprising macroeconomic, sectoral and legislative and regulatory reviews). Once the set of restructuring priorities has been defined, the Department of Public Enterprises requests a restructuring plan from the SOE concerned. This plan is assessed against the SOE operating environment report and updated by the SOE where necessary. Stakeholder engagement takes place around the restructuring plan and once an acceptable plan has been developed, Cabinet approval is sought.
2. The Department of Public Enterprises receives the high-level restructuring plan after Cabinet approval and appoints advisers who prepare a detailed enterprise restructuring plan. This process will largely involve due diligence research and the identification of appropriate restructuring mechanisms. There will also be stakeholder involvement around the detailed restructuring plan, which is then approved by Cabinet.
3. After receiving Cabinet approval for the detailed restructuring plan, a detailed work plan is formulated. The Department of Public Enterprises then moves into the transaction management phase where it largely project manages the process. Cabinet approval is sought for the portfolio of potential bidders, the portfolio of potential buyers and, finally, the selected purchasers, after which the deal is concluded and proceeds collected.
4. Finally, the SOE portfolio is managed. This includes developing shareholder compacts and performance agreements, monitoring SOE performance in terms of the compacts and the PFMA, and evaluating the impact of restructuring. The Department of Public Enterprises takes responsibility for maintaining the database of SOE information and the share, guarantee and indemnity portfolios for Government. Stakeholder engagement is again sought in assessing SOE performance. The Department periodically reports on SOE performance to Cabinet and other relevant government structures.

Conclusion: improving the restructuring process

There is general agreement that the restructuring process that has developed since 1995 could be substantially improved. Suggestions include the following:

- Arrangements to improve stakeholder involvement could take advantage of the LRA and Social Plan and the NFA to address high-level political engagement.
- Government should seek new methods for communicating with other stakeholders, including quarterly bulletins and a web site.
- The new two-stream structure that distinguishes between day-to-day decisions and those that require a strategic or policy input would expedite decision-making.
- Periodic strategic workshops and the circulation of short sectoral strategy documents would improve the overall strategic understanding of restructuring priorities in Government and between Government and the SOEs.
- The Department of Public Enterprises would lead the restructuring of SOEs and co-ordinate the activities of policy departments and Finance through a number of sector-specific programme officers.
- The roles and responsibilities of Government and the boards and management of SOEs in the restructuring process should be identified and then clarified by the proposed shareholder compact and a revised protocol on corporate governance.
- The new maps of the restructuring process (see the Appendix) should assist all stakeholders in understanding how restructuring will proceed.

8

Focus on four key enterprises

Cabinet has instructed the Department of Public Enterprises to give priority to the restructuring of the four largest SOEs, Eskom, Transnet, Telkom and Denel. This will enable Government to maximise the effects of the restructuring programme. Other SOEs will be restructured concurrently with the four enterprises mentioned above. It is envisaged that the major elements of the restructuring programme will have been completed towards the end of 2004. All restructuring proposals are, however, subject to Cabinet approval. The table below describes the situation for the top 30 public sector firms.[150]

Table 2: Top state-owned enterprises

Firm	Total assets (Rm)	Turnover (Rm)	Net income (Rm)	Employees
Eskom	69 975	21 071	2 750	37 311
Transnet	42 779	21 680	2 165	100 592
Telkom	27 107	20 160	2 427	57 496
IDC	17 049	3 567	765	502
DBSA	12 002	925	423	465
Land Bank	5 775	2 377	371	98
Denel (1997)	4 253	3 013	82	14 200
Impofin	3 297	220	9	-
Rand Water	3 212	1 900	258	4 000
Findevco	2 770	485	21	-
Konoil	2 337	82	180	-
Post Office	1 793	2 469	-272	29 195
Airport Co	1 695	710	228	1 718
SABC	1 617	2 474	105	3 217
Foskor	1 323	1 297	135	2 163
Safcol	808	569	9	5 362
Atlantis	683	907	80	2 275

[150] The table is slightly misleading since the *Financial Mail* includes Transnet and its subsidiaries as separate firms. For purposes of this discussion, only Transnet is included.

Sapekoe	201	119	0	11 000
Alexkor	200	175	-23	1 078
Abakor	115	290	-55	2 200
Aventura	111	146	-8	1 610
Total	174 102	84 636	9 650	274 482
Total (non-financial)	130 872	76 980	7 881	273 417

Source: Financial Mail Special Survey Top Companies, 25 June 1999.

Three points should be noted. First, the important SOEs are Eskom, Transnet, Telkom and Denel. They comprise approximately 91 per cent of estimated total assets, provide 86 per cent of turnover and 94 per cent of net income and employ 77 per cent of all employees in the top 30 SOEs. While it can be expected that the estimated 300 other public enterprises can obviously contribute to meeting Government objectives on restructuring, these four companies will have the greatest impact. Second, with the exception of the four large SOEs, the Post Office and Sapekoe, which also have large employee complements (making up 91 per cent of the top 30 companies), the number of employees affected by the restructuring of the other SOEs is not particularly significant. Given that the proportion of employees in SOEs only accounts for approximately 5 per cent of non-agricultural employment, apart from the six large employers identified in the table above, the restructuring of SOEs is unlikely to have a major impact on overall employment trends.[151] Finally, it should be noted that enterprises such as Eskom, Transnet and Telkom have a developmental role to play in addition to promoting economic growth.

A summary of the "big four" and the sectors in which they operate is provided below. Details of other restructuring initiatives are described briefly thereafter.

The energy sector

International trends

Significant international shifts have occurred in post-oil-crisis energy policies. Perhaps the most important shift in international thinking is a realisation that

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[151] These observations are made without the benefit of an audit of SOEs, and may need to be modified once more accurate figures have been compiled. It is unlikely that the conclusions reached will change substantially.

commercial energy will not become scarce in the short or even the medium term. Energy security is now being achieved through greater diversification and flexibility of supply, including increased cross-border energy trade. One of the implications of this trend is that national uneconomic energy industries are no longer being protected. As a consequence, the role of the state in the energy sector is being redefined and restructured.[152]

Another trend is the increasing realisation by governments that they do not have to be the providers of services. Governments can achieve their national goals through ensuring that services are delivered rather than providing them themselves.

Greater emphasis is being placed on commercialisation, incorporation and, in some cases, privatisation. Energy markets are being restructured to encourage greater competition, even in the grid-based electricity and natural gas industries, which have traditionally been regarded as natural monopolies. Heightened competition has necessitated the development of increasingly sophisticated regulatory regimes for the licensing of the industry. This has resulted in a trend towards re-regulation of the energy sector. At the same time, however, increasing competition has meant that there is less need for the regulation of prices. Restructuring initiatives in the industry have involved the unbundling of generation, transmission and distribution. A further trend is the convergence of gas and electricity companies.

The energy sector has significant environmental impacts, and these have become an international issue. For example, the reduction of emissions is becoming increasingly important. Energy investments are subjected to greater environmental scrutiny and there is greater focus on energy end-uses, with policies for encouraging energy efficiency and demand-side management. The research and development of alternative and renewable energy sources are also being promoted. The energy sector is increasingly being funded with private finance. This has had profound effects on the structure of energy investments and energy markets, as domestic and international investment has to be attracted.

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[152] Department of Minerals and Energy. 1998. *White paper on energy policy of the Republic of South Africa*. Pretoria: Government Printer.

As with most sectors of the global economy, technological developments are taking place rapidly. In the electricity industry, size and scale are important in accessing the latest technology. In several markets there has been a trend towards re-aggregation in the industry. In the United Kingdom, for example, the electricity restructuring in the early 1990s resulted in a disaggregation of the industry into a number of companies. More recently, some of the companies have either been taken over or have merged.[153] In the case of the fossil-based power generator, National Power, however, there has since been further disaggregation.

Legislative and regulatory framework in South Africa

The 1998 *White Paper on Energy Policy*[154] sets out the policy objectives of the energy sector. The policy priorities for the energy sector are:

- Increasing access to affordable energy services
- Improving energy governance
- Stimulating economic development
- Managing energy-related environmental impacts
- Securing supply through diversity

The White Paper supported taking gradual steps towards a competitive electricity market in the short term while investigation into the desired form of competition is completed. It notes that Eskom will be restructured into separate generation and transmission companies, and that Government supports the development of the Southern African Power Pool.

The White Paper notes that customers should be given the right to choose. Government should initiate a comprehensive study on future market structures for the South African electricity supply industry. In particular, the electricity distribution industry requires urgent restructuring. Competition should be introduced into the industry, especially into the generation sector. Open and non-discriminatory access to the transmission system should be permitted. The private sector should be encouraged to participate in the industry. The White Paper states that, from an energy point of view, natural gas is an attractive option

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[153] Deutsche Bank. 2000. *Where next for Eskom? An international perspective on the restructuring options*. Johannesburg: Deutsche Bank.

[154] Department of Minerals and Energy (1998).

and that Government is committed to the development of this industry. It will legislate for the transmission, storage, distribution and trading of piped gas. Limited vertical integration will be permitted.

A National Electricity Regulator (NER) was established in 1995 to regulate pricing, national tariff systems and national service and technical standards. The White Paper notes that complete details of the regulatory regime have yet to be finalised. The Department of Minerals and Energy is currently finalising a policy document on the reform of the electricity supply industry.

Background information on Eskom

Eskom is South Africa's dominant electricity utility and ranks among the world's top five utilities in terms of capacity. Its regulated business is structured into three main groups, each of which is a ring-fenced business:

- Generation, whose function is to generate electricity
- Transmission, whose function is to transmit electricity across the country via transmission lines
- Distribution, which distributes the energy to its customers

In addition, Eskom has a number of subsidiary companies.[155] A wholly owned subsidiary, Eskom Enterprises, was created to house all those commercial services that will not be regrouped and that could be developed into viable businesses.

Eskom is at present reputed to be one of the lowest-cost producers of electricity in the world, and ranks among the five top utilities in the world in terms of capacity and sales. It has 24 power stations, with a nominal capacity of 38 872 megawatts. It sells approximately 40 per cent of its electricity to local authorities, which resell it to end-users. It also sells electricity to neighbouring countries (Lesotho, Swaziland, Botswana, Mozambique, Namibia and Zimbabwe) representing 2,4 per cent of total sales. Eskom supplies more than 95 per cent of South Africa's electricity, which it transmits across the country to customers via 26 443 km of transmission lines. Of the electricity supplied, 90 per cent is generated by fossil fuel fired stations, 7 per cent by nuclear power, 1 per cent by

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[155] Department of Public Enterprises. 1999. *Presentation to the Interministerial Cabinet Committee Lekgotla on the Restructuring of State Assets*. Pretoria.

hydro-stations and a small portion is imported. Eskom has 40 399 km of distribution lines and 214 168 km of reticulation lines. It receives revenue of R21 billion. Of this revenue, 39 per cent is from redistributors of electricity, 28 per cent is from industrial customers, 18 per cent is from mining and 7 per cent is from residential and commercial customers.

Restructuring of Eskom

The restructuring of the electricity supply industry needs to be looked at in terms of generation, transmission and distribution activities. Currently, there is a generation oligopoly, a transmission monopoly and distribution is fragmented. As a first step Eskom will be corporatised, with generation, transmission and distribution becoming separate corporate entities. Investigations into achieving this have already begun.

It has been agreed that it is necessary to introduce competition into the generation market by creating independent competing generating companies. This would result in greater market efficiencies. The most appropriate model is still to be evaluated.

Transmission appears to be a natural monopoly, and this function will probably remain in the hands of the state. This is likely to take the form of a separate independent transmission company. The introduction of a strategic equity partner or of an IPO will have to be evaluated in future.

In terms of distribution, a number of regional electricity distributors (REDs) will be created. These REDs would distribute electricity to the customers, most of whom would be municipalities. It may be possible for large customers to have their electricity distributed directly from the transmission company without going through a RED. A number of issues will have to be addressed in structuring REDs, including the contractual or commercial arrangements between the REDs and customers, as well as between the REDs and the transmission company. More work will have to be undertaken with regard to the regulatory regime for electricity.

Investigations still need to take place into the restructuring of Eskom to ensure that all the objectives of the restructuring are achieved and the benefits are maximised.

Actions by Government

- Eskom will be corporatised, with transmission, distribution and generation each forming a separate corporate entity.
- A full evaluation of the different models for restructuring Eskom is currently being undertaken by the Department of Public Enterprises, based on a review of the electricity supply industry undertaken by the Department of Minerals and Energy.
- Different generating companies will be formed to promote internal competition prior to the introduction of private sector participation in generation, in conjunction with new power requirements;
- The Department of Minerals and Energy is currently co-ordinating the design and implementation of the REDs.
- Strategic equity partners will be introduced into different Eskom Enterprises business units.

Likely impacts of restructuring Eskom

If the above model for restructuring Eskom is applied, the impacts of the restructuring will be as follows:

- The separation of Eskom into generation, transmission and distribution will result in more transparency and accountability in the electricity supply industry.
- Different generation companies will ensure that there is competition in generation, which should result in enhanced efficiency and effectiveness in this sector.
- The creation of REDs should result in better service delivery to customers and eventually to better prices.
- Government is aware of the social services offered by Eskom in terms of the provision of electricity to the poor in both urban and rural areas. The restructuring plans will ensure that the rollout of electricity to these sections of the population continues.

The transport sector

International trends

One of the most important recent trends in global transport is that many countries have been liberalising and deregulating various aspects of their transport systems. This has particularly been the case in aviation, with growing numbers of countries permitting open skies agreements with little or no protection for national flag carriers. There has also been wide-scale liberalisation of road transport and, in some cases, rail transport. A related trend has been the privatisation and/or commercialisation of parastatal transport operations. Japan and New Zealand, for example, have both completely privatised their rail systems. In other countries, like Argentina, there has been concessioning.[156] Global shipping lines tend to be privately owned and operated, and there has been increasing competition in maritime transport. In addition, shipping lines are integrating with other modal partners and moving towards bigger ships that require bigger harbours and fewer ports of call. This has led to economies of scale and reduction in prices.

Transport operators tend to consolidate globally through alliances, joint ventures or outright acquisition. There is increased integration between modes, as well as integration within the value chain. This is partially to reduce costs and gain market share but, more importantly, to meet the needs of global customers. Global high value-added manufacturers have increasingly been able to move towards "just-in-time" manufacturing processes and reducing inventory costs. Sophisticated information technology and transport logistics enable global manufacturers to source their production from multiple sources around the world. For this they need global high-precision, flexible, integrated transport services and logistics that deliver to multiple global locations. Technological developments now allow transport operators to offer more precise information to customers.

Legislative and regulatory framework in South Africa

In August 1996, a *White Paper on National Transport Policy* was released. This was followed in September 1998 by the release of *Moving South Africa*, which is a 20-year strategy for transport in South Africa to achieve the goals of the White

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[156] Department of Transport. 1998. *Moving South Africa – towards a transport strategy for 2020: report and strategic recommendations.* Pretoria: Department of Transport.

Paper. One of the major goals is “to improve South Africa’s competitiveness and that of its transport infrastructure and operations through greater effectiveness and efficiency to better meet the needs of different customer groups, both locally and globally”. To achieve this, it would be necessary to ensure that the region’s competitive advantages could be accessed and marketed. The transport element of the cost of agricultural products, raw materials and manufactured goods can be a significant and deterring proportion of the final cost of both exports and imports. This goal will require a decrease in transport costs for a given level of service, or an increase in quality of service for a given level of cost, or where possible, both an increase in service and a decrease in cost. It is Government’s view that these goals can best be met by ensuring competition in the provision of infrastructure and operations.

The White Paper notes that intermodal co-ordination, co-operation and sharing of information will be encouraged in both infrastructure provision and operations to optimise customer service, reduce duplication, reduce destructive competition, minimise total costs, and maximise social and economic return on investment. A key driver of reducing costs of transport is capacity utilisation. As such, a goal of infrastructure and modal planning will be to optimise capacity utilisation and to achieve a level of integration between modes. In principle, intermodalism will be fostered by incentives and not by regulation. The White Paper noted that in the past, Government’s dominant role has been that of a regulator of bureaucratic detail, provider of infrastructure, and transport operator, but it has been weak in policy formulation and strategic planning. Government intends to reverse this legacy and to focus on policy and strategy formulation (which is its prime role) and substantive regulation (which is its responsibility) with a reduced direct involvement in operations, and the provision of infrastructure and services (to allow for a more competitive environment).

The White Paper states that a port authority with specific responsibilities for the maintenance and development of port infrastructure will be established. The principle of competition within a port will be supported. The existing policy of economic deregulation of land freight transport within the country is reaffirmed, subject to strict and effective regulation in respect of traffic quality and safety matters. The key issue regarding level playing fields between the transport modes is equity in the recovery of infrastructure provision, management, operation, and maintenance costs. An equitable distribution of infrastructure cost recovery (capital, management, operating and maintenance) will make a positive contribution to reducing artificial modal shifts and distorted tariff structures created by cross-subsidisation. Government will encourage integration, intermodalism, and partnerships between the modes, provided this does not result in monopolies.

Civil aviation should promote the national interests of the country in general, and facilitate and enhance the expansion of trade and tourism. In particular, civil aviation policies should promote the development of an efficient and productive aviation industry that is capable of competing both domestically and internationally. Economic decisions should, as far as possible, be subject to general competitive principles applicable to all industries, with a view to maximising consumer choice and needs satisfaction. Maritime transport policy should attempt to foster and maintain a competitive climate wherever appropriate, and Government will avoid protectionist maritime practices and maintain an “open ports” policy.

The South African transport industry

The South African transport industry is dominated by the parastatal Transnet. Railway operations are critical to South Africa’s economy, carrying 59 per cent of total freight transport volumes. The rail sector has, however, been declining, as it is experiencing increasing competition from road hauliers. It is argued that the playing fields are not level because road transport does not meet the full costs of utilising road infrastructure. There is a widespread view that the railways reflect old national priorities and do not adequately serve the needs of society. This manifests itself in an oversized network with a high degree of low-density branch lines that are not economically sustainable. At present, freight flows are highly concentrated, particularly on the Gauteng–Durban route. *Moving South Africa*’s vision of densified corridors for freight based on lowest transport costs to support the South African economy has to be achieved within a sustainable environment. Spoornet currently invests a mere 20–25 per cent of the long-term capital needed to ensure a sustainable network.

Rail passenger numbers have been falling to the extent that they currently account for about 15 per cent of public transport passenger journeys in urban areas. Bus passenger numbers have also dropped significantly. Over 60 per cent of urban public transport passengers make use of mini-bus taxis, which are privately owned and do not receive any direct subsidies. South Africa is also experiencing a rapid growth in the number of cars on the road. Between 1972 and 1996, the number of motor cars increased by 72 per cent and indications are that these rates of growth are continuing unabated.

There are seven commercial ports in South Africa, all of which are owned and managed by Portnet. In 1998, these ports handled over 153 million tonnes of cargo, of which 1,6 million tonnes were container traffic. They handled 13 559 vessels in the same year. There are growing concerns about bottlenecks at those ports handling container traffic. It is very costly for ships to have to wait to dock and these costs add considerably to the cost of trade with South Africa. It should be noted that all shipping is in private hands and theoretically South Africa operates on an open port system (in practice, congestion at the ports means that liners are not necessarily free to use the ports). Safety in shipping is regulated by the South African Maritime Safety Agency.

There has been a rapid growth in the number of international airlines serving South Africa. Airline operation into South Africa is regulated through bilateral air service agreements. Currently, South African airports handle approximately 180 flights per week operated by foreign carriers. South African Airways (SAA) operates over 230 international flights per week. The Airports Company of South Africa (ACSA) owns and operates the country's major airports. A strategic equity partner, Aeroporti di Roma, was brought into ACSA and owns a 20 per cent share of the company.

Transnet

Transnet comprises 13 companies involved in multimodal transportation and related services and has over 100 000 employees. It was incorporated in 1990, with Government being the main shareholder. As South Africa's largest transport operator, Transnet dominates the sector and contributes 3,2 per cent to GDP. Its total operating assets were valued at R43 billion in 1998, its turnover at R22 billion, its profit after financing costs (but excluding pension fund interest charges) was R2,2 billion, and its capital expenditure was R2,9 billion. A major feature in Transnet's financial position is the pension fund liability relating to the South African Transport Services (SATS) pensioners. There are debentures of R8, 471 billion outstanding plus an additional liability of R3, 442 billion relating to medical aid costs for these pensioners.[157] Transnet's profitability is severely affected by this outstanding debt and Government has developed a strategy for resolving this situation.

Spoornet is the largest division of Transnet. It comprises a general freight business (GFB), a heavy haul coal line (Coallink), a dedicated heavy-haul iron ore line (Orex), an intercity passenger service operation (MLPS), the Blue Train luxury train service (LuxRail) and an operation that will address the issue of branch lines (LinkRail). In addition, Spoornet has a division, Rail & Terminal Services (R&TS), which maintains and operates the working railway. Spoornet has faced increasing competition in its general freight business as a result of the deregulation of road hauliers. As a result, GFB has had a large negative cash flow. In the past, such losses were mitigated by strong cash generation by Coallink and, to a lesser degree, by Orex. The results for the year ended 31 March 1999, however, show that Spoornet is R210 million cash negative.

Portnet and Petronet are both highly profitable and cross-subsidise the other divisions of Transnet. Portnet continues to make large profits despite a reduction in net profit in 1999. There is, however, a concern that Portnet has been underspending on capital owing to its need to cross-subsidise the other divisions. *Moving South Africa* estimates that current capital spending on ports is only 25 per cent of the long-term capital requirements. Petronet owns, manages and operates a network of 3000 km of high-pressure petroleum and gas pipelines. Petronet continues its annual increase in profitability. Unfortunately, because of its need to cross-subsidise other divisions, it has been less able to play a role in the future development of new infrastructure.

Restructuring of the transport sector

The key bottleneck to Transnet restructuring is the pension fund debt, but Government believes that it has a resolution to the debt problem.

SAA has been subject to a turnaround strategy which has reversed its loss-making situation. Government has realised R1, 4 billion from the sale of 20 per cent of SAA to Swissair, SAA's new strategic equity partner.

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[157] All figures are from Transnet's annual reports.

Within Spoornet, the current practice of cross-subsidisation – where losses generated by general freight business (GFB) amounted to R1, 7 billion in the 1999/2000 financial year are offset by the profits generated by Coallink and Orex – places the entire rail system in jeopardy. The restructuring of Spoornet focuses on maximising value for the existing shareholder, securing investment in the underlying business and introducing new management skills. In order to realise these objectives, however, it is necessary to transform Spoornet and, in particular, GFB, prior to restructuring. Initially Spoornet's various divisions will be corporatised (or, in some cases, shadow corporatised). GFB and the Rail and Terminal Services (R&TS) will be corporatised as one entity. The medium-term intention is to bring a strategic equity partner into GFB and R&TS. There is a possible option of releasing further value in the future through an IPO. LinkRail, the structure that Spoornet proposes to use to operate surplus branch lines of the Spoornet core network, should be concessioned in separate packages, comprising rolling stock and infrastructure. Long-term concessions should be entered into for Coallink, Orex, MLPS and LuxRail.

Currently, a policy process is under way for the restructuring of the ports sector. The intention is to separate the port authority functions from those of port operations; the latter will then be privatised.

ACSA is partially privatised, with Aeroporti di Roma being its strategic equity partner. An IPO for ACSA is being planned.

Actions by Government

- Transnet debt restructuring is being dealt with. Significant progress in dealing with the pension fund debt has already been made.
- Spoornet will be corporatised, with its different business units becoming separate corporate entities.
- Coallink, Orex, LuxRail and LinkRail will be concessioned.
- Spoornet's general freight business will be commercialised and then, either an initial public offering (IPO) or a strategic equity partnership (SEP) will be entered into.
- A new ports policy and a ports regulatory framework are being drafted. Portnet will be corporatised to form a port authority entity and a port operations entity. The port operations will then be privatised.

- Subject to shareholder approval, the processing of an IPO for SAA will commence.
- Petronet will be corporatised. There will be an assessment of the synergies with other pipeline projects, and restructuring options will be developed.
- Deadlines for the disposal of non-core units within Transnet will be ongoing.
- The airports regulatory framework is being revised and once this is completed, subject to shareholder approval, an IPO will be processed for ACSA.

Likely impacts of restructuring Transnet

The above restructuring plan is likely to have the following impacts:

- The restructuring of Transnet's debt will enable the enterprise to operate on commercial principles. It will enable the various divisions to operate as independent business units without cross-subsidising each other's contributions towards the debt. Transnet and its various business units will be able to make market decisions.
- The concessioning of Coallink, Orex, LuxRail and LinkRail will mobilise private sector capital and expertise (both locally and internationally).
- The commercialisation of Spoornet's GFB will ensure that it operates on market principles. This should enable it to offer more efficient and effective services. Should it be decided that GFB must offer certain social services, then these will be subsidised in transparent manner rather than through cross-subsidisation. A future IPO or SEP will attract private sector capital.
- Because of the high levels of overemployment in Spoornet, the current transformation process and the envisaged restructuring will result in job losses. Where possible, alternative job opportunities are being investigated.
- The restructuring of the ports is likely to improve their service levels, as well as ensuring that South Africa has ports that are able to meet the needs of a growing economy.
- The separation of the ports into a port authority and port operations will separate the landlord function from the operation of the ports.
- The privatisation of port operations should improve the level of service and the competitiveness of the ports. Private operators of different port services will be better able to focus on the needs of the customers and offer them a more efficient and effective service.

- The restructuring of SAA has already shown benefits in terms of the airline's efficiency. An IPO for SAA will bring more private sector and international investment into the country.
- The incorporation of Petronet will ensure that it offers a cost-effective service.
- The disposal of non-core units within Transnet will ensure that it focuses on its core business and improves its effectiveness.

The telecommunications sector

International trends

The telecommunications sector is among the fastest growing sectors in the global economy. It is a key platform for the development of all other socio-economic sectors.

Since the late 1980s, there have been trends towards the restructuring of nationalised telecommunications services. New technology has meant that telecommunications is no longer a natural monopoly, and the international trend is towards private sector development in the telecommunications sector and privatisation of state-owned monopoly providers. There is a trend toward vigorous competition, which has lowered prices and improved services. Independent regulatory institutions have been set up.

International markets have been increasingly willing to provide large amounts of capital for privatised telecommunications companies in countries with sound regulatory frameworks. The growth of mobile services is having a major effect on opening up the telecommunications sector to competition and bringing about rapid structural change. There is an international push towards liberalisation of the telecommunications industry. South Africa is a signatory to the World Trade Organisation, which requires it to liberalise trade in telecommunications. Technology is also driving the need to liberalise. Satellite operators permit direct access by users, which means that large users can bypass domestic telecommunications networks. Voice telephony via the Internet is also possible.

The South African legal and regulatory framework

In 1991, the South African government separated the activities of the Department of Posts and Telecommunications into the South African Post Office and Telkom. Telkom duly became a legal entity incorporated under the South African

Companies Act. In 1994, the granting of two cellular telephone licences heralded the liberalisation of the South African telecommunications sector. Telkom's land lines were now subject to competition from mobile telephones, although it retained exclusivity for the provision of fixed-line services.

Consistent with international developments, the 1996 *White Paper on Telecommunications Policy* and the Telecommunications Act (Act No. 103 of 1996)[158] established a framework for separating the regulatory, operational and policy-making functions of telecommunications. A regulator, the Independent Communications Authority of South African (ICASA), was established to regulate telecommunications and broadcasting in the public interest. In addition, a universal service agency was set up to promote universal service within the broad framework of development planning. The Department of Communications is responsible for advising the Minister on policy matters, including the nature of competition. ICASA has day-to-day responsibility as the regulatory watchdog and is responsible for issuing licences, monitoring compliance and rectifying non-compliance. Customer premises equipment was completely deregulated in terms of the Act, subject only to type approval by the regulator to ensure that no danger is posed to the network. The White Paper also advocates complementarity in the use of the facilities of Telkom and the parastatals, Transtel and Eskom.

Background to Telkom

The South African fixed-line telecommunications industry has grown from over 3,8 million lines in 1995 to over 5,5 million lines currently. This rapid growth can be at least partially ascribed to the aggressive roll-out targets set out for Telkom when an SEP was introduced in 1997. Telkom's revenue has more than doubled over the last five years from R11 billion to R22, 6 billion.[159] On the technological front, cellular phones, the Internet and e-commerce have significantly contributed to growth. The growth in the cellular market has been remarkable, with over 4,65 million cellular customers signing up since the technology was introduced in 1994.

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[158] Department of Communications. 1996. *White Paper on Telecommunications Policy*. Pretoria: Government Printer.

[159] Deutsche Bank Securities. 2000. *Telkom and Vodacom – the big picture*. Sandton: Deutsche Bank.

Telecommunications revenue in South Africa (both fixed-line and cellular) grew from R8, 4 billion in 1994 to R30, 4 billion at the end of March 1999. This gives a compound annual growth rate (CAGR) of 30 per cent over the last five years. Over the same period, the CAGR for the fixed line sector was 18 per cent and that of the cellular sector 187 per cent. As a proportion of GDP, the telecommunications sector contributed about 4 per cent in 1999. South Africa's wireline penetration (or teledensity) grew from 9 per cent in 1994 to 11 per cent at the end of March 1999. If Telkom keeps to its agreed roll-out of an additional 2,8 million lines and 120 000 payphones over five years, the teledensity should be approximately 16 per cent by 2003. Although South Africa has one of the highest teledensities in Africa, it lags behind most developed and developing nations. There are predictions that its teledensity will peak at 20 per cent by 2009.

Telkom consists of a traditional fixed-line operation. In addition, it owns a 50 per cent share in Vodacom, the larger of the two cellular telecommunications currently licensed to operate in South Africa. (A third mobile operator is soon to be licensed.) It also has a strong Internet presence in the form of Intekom, the third largest internet service provider in South Africa. Government, which owns 67 per cent of Telkom, has approved Telkom's listing on the stock exchange in 2001. Seven per cent of Telkom has been earmarked for empowerment groups and employees, and the sale of this share is currently under way.

A decision was taken in 1995 to introduce a strategic equity partner (SEP) into Telkom. A competitive tender process was held but only one final offer was received. In 1997, a 30 per cent stake in Telkom was sold to SBC (18 per cent) and Telkom Malaysia (12 per cent). The interests of SBC and Telkom Malaysia are held via an investment holding company, Thintana Communications LLC. SBC is the premier local access operator in the United States and Telkom Malaysia is one of the largest Asian telecommunications operators. Three per cent of Telkom was sold to black empowerment groups.

At the time, Telkom was granted exclusivity for the provision of local and long distance telecommunications services, exchanges, international services and public payphone services for five years. Telkom is licensed to operate the public switched telephone network (PSTN) and the public switched data network (PSDN) for the period of exclusivity. Telkom does not have exclusivity for the value added network sector (VANS), which has been opened up to full competition. Telkom agreed to meet stringent licence targets. These include the installation of 2,7 million new telephone lines, the digitalisation of 1,25 million analogue lines and the installation of 120 000 new payphones, as well as customer service targets. According to the licence, Telkom can obtain an additional year of exclusivity if it achieves 90 per cent of the targets set by the end of the fifth year. There are also penalties if the targets are not met.

Telkom has a 50 per cent share in Vodacom, the leading cellular operator in South Africa. It is estimated that Vodacom has an active subscriber base of 2,65 million and 120 000 Internet subscribers, which makes it the second largest Internet service provider in the country. Vodacom is an unlisted company. In addition to its 50 per cent ownership by Telkom, its other shareholders are the Vodafone AirTouch group (31,5 per cent), with the remainder of the shares being owned by the Rembrandt group (13,5 per cent) and Descarte Investment (5 per cent).[160] Vodacom currently has approximately 57 per cent of the 4,65 million cellular subscriber market, while MTN has 43 per cent. A third operator is due to enter the market shortly. Vodacom's subscriber mix is currently 55 per cent prepaid and 40 per cent contract.

In terms of international standards, Telkom productivity per employee is relatively low. Lines per employee have improved from 74 in 1997 to 83 in 1999. This is, however, considerably below the ratio of most operators in the OECD area and Asia, which tends to be in excess of 120 access lines per employee. Telkom's capex/sales ratio is 47 per cent. This is at the top end of its peer group, but in line with most emerging market operators that are undergoing expansion and modernisation. This ratio is expected to decline in the long run.

Restructuring of Telkom

In August 1999, the IMCC granted the Minister of Telecommunications approval to engage the Telkom minority shareholder, Thintana Communications, in discussions with a view to conducting the necessary preparatory work and processes for arranging an initial public offering (IPO) for Telkom.

Telkom's exclusivity agreement ends in May 2002. A second network operator will then be introduced. Investors in the planned IPO will need evidence that

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[160] Ibid.

Telkom can compete once its monopoly has ended. As the market is liberalised, competitors will naturally target the most profitable segments of the market, namely business customers, international services and national long distance callers. The local network requires very large capital expenditure and is only marginally profitable, so competitors are unlikely. Government is currently looking at consolidating the telecommunications capability of the state housed in Eskom and Transtel, with the possibility that these could form a portion of the second network operator.

Future actions by Government

- Work on the proposed IPO for Telkom is in progress.
- Work on a policy and a process for determining the second national operator is already quite advanced.
- Given the possibility of other SOEs becoming involved in the SNO, the Department of Public Enterprises will ensure that a full investigation is undertaken into the costs and benefits, and that appropriate synergies are achieved.

Likely impacts of restructuring Telkom

If the above restructuring plan is followed, the likely impacts are as follows:

- With 30 per cent of Telkom having been sold in 1997, some of the effects of restructuring are already in place.
- The proposed IPO for Telkom will result in a significant sum of private sector capital being mobilised.
- The introduction of a second network operator will increase competitiveness in the telecommunications sector, which should result in increased efficiency and effectiveness.
- An SNO will ensure that customers receive a higher level of service, as they will have a choice of fixed-line service providers.

The defence industry

International trends

With the end of the Cold War, there has been a reduced need for large-scale military operations. In addition, since the early 1990s there has been a decrease in international requirements for armaments, resulting in enormous overcapacity in the global defence and ordnance industries. Globally, defence expenditure has shrunk and the increase in the competition between defence suppliers has eroded the profitability of the industry. Customers often demand total systems capability from suppliers. Developing major weapons systems involves high costs owing to growing technological sophistication. Global aerospace and defence annual sales were US$240 billion in 1999. The ordnance and land systems market is worth approximately 6 per cent of these sales ($15 billion, excluding spares). Of this, approximately $2 billion is spent on light ordnance, $2 billion on heavy ordnance, $4 billion on ammunition and $7 billion on vehicle platforms.

Different threats to security are emerging, including terrorism, the spreading of weapons and failed nation states. Changes in the types of equipment are required. Equipment must preferably be self-contained and portable, interoperable and serviceable at a distance. While defence spending is stagnant, equipment spending is growing.[161]

The ordnance and land systems market remains globally fragmented, having one or more key producers in each of the major aerospace and defence nations. The top five producers are significantly larger than the others. There has, however, been considerable consolidation and reorganisation in the aerospace industry. Despite the lack of consolidation in the ordnance and land systems, a significant number of product-level alliances reflect the capabilities of each producer. There are, however, several drivers in the industry that are likely to trigger international consolidation in the near term, for example:

- Structural changes in the industry, including converging national requirements for future systems and increasing development costs for next-generation systems
- Lack of internal or export demand

There has been an increase in joint development programmes between countries and companies to share costs. Mergers and acquisitions have increased the average size of companies while decreasing their numbers. Many defence companies have either downsized or closed down. A few large defence companies in the United States and Europe now dominate the industry. Owing to

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[161] Berger, R. & Partner GmbH. 2000. *Republic of South Africa: issues in the aerospace and defence industry*. London.

the requirement for long-term support over the full life cycle of systems (which can be 30 years), smaller players find it increasingly difficult to convince customers of their capability. Smaller players are therefore expected to join forces with major international players. They will either have to form part of larger conglomerates and/or fall back to subsystem-level supply positions in niche areas.

The South African regulatory framework

In 1999 Government published the *White Paper on South African Defence Related Industries*.[162] The White Paper uses the term "defence industries", since there is a growing tendency for companies producing defence equipment to make use of civilian technologies or to manufacture dual-use products that can be sold to both defence and non-defence markets. There is also increasing overlap between defence and civilian production within companies. The industrial capability of the South African defence is not a distinct sector of the economy. The White Paper notes that:

> …Government recognises that defence-related industries are an integral part of South Africa's defence capability. Government also recognises the strategic value of having a local defence industrial capability. However, due to budgetary constraints, and within the framework of broader national industrial strategy, Government will be very selective of which technologies and capabilities are to be retained on the basis that they are strategic or that they constitute a national asset.

Government also has a duty to exercise control over any product, service or technology can be termed an armament.

The White Paper notes that the various broad government goals should be considered when restructuring defence industries. Government needs to articulate a clear vision for the future of defence-related industries, in particular the extent to which it is prepared and willing to support these industries. In order to achieve economies of scale, obtain new technologies and gain entry to international markets, Government will encourage rationalisation in the public and

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[162] Department of Defence. 1999. *White Paper on South African defence-related industries*. Pretoria: Government Printer.

private sectors of the local industry, coupling this to joint ventures with overseas partners and new local empowerment equity partners. Industrial participation obligations of foreign governments arising from major defence equipment replacement programmes offer an ideal opportunity for achieving the above.

The White Paper notes that a restructuring of the public sector defence-related industries, including complete or partial privatisation, will have a profound effect on the nature, composition, ownership, structure and profitability of the domestic defence market. Government will therefore have to consider how such restructuring will impact on private sector defence-related industries. Government should not, however, dictate the nature, pace or process of the restructuring of the latter industries which may occur as a result of the restructuring of the public sector industry.

Background to Denel

Denel is the major player in South Africa's defence industry-related organisations, having about 50 per cent of the defence industry turnover. Denel dominates four of the seven major areas of the domestic defence market, namely aerospace, ammunition, weapon systems and military vehicles.

The decline in international defence expenditure and the international defence industry environment has caused major international mergers and acquisitions in the last few years. This has resulted in fierce competition for South Africa's defence industry. Between 1989/90 and 1997/98, the South African defence spending decreased from 4,5 to 1,4 per cent of GDP, which translates to a decline of more than 50 per cent in real terms. With respect to Denel, orders from the SANDF decreased by 57 per cent in real terms between 1992/93 and 1998/99. Expenditure on defence research and development declined by more than 70 per cent during the same period. The decline in South African defence spending made Denel more reliant on the international market, in which it has operated reasonably successfully in the past ten years. It has, however, been detrimentally affected by the slump in the economies of the "Asian Tigers" in 1996/97 and by the effect of declining international oil prices on the economies of the Middle Eastern countries. In the last few months, due to recent defence contracts, there has been an upturn in business for Denel.

Denel comprises a holding company structured into three main groups: Aerospace, Ordnance, and Commercial and IT Business. In order to compensate for the decline in defence spending, Denel embarked on a major drive to increase exports of military products and services, and also initiated a major diversification and commercialisation drive. It had reasonable success with commercialisation in the areas of information technology, properties and electronic manufacturing. Government believes that it is imperative for the restructuring of Denel's military business to be part of the globalisation trend to ensure adequate capital injection, increased access to overseas markets, a broader product range and increased capacity utilisation within Denel's manufacturing facilities.

The Denel Aerospace Group consists of Denel Aviation, Kentron, DPS (Pty) Ltd and OTB, the test range at Arniston. Denel Aviation consists of three business units: Military Aviation, Airmotive and Transport Aircraft Maintenance. It has been recommended that an international equity partner be sought for Denel's aerospace business.

As South African aerospace industries are smaller than most other similar international industries, they are faced with questions about consolidation. There is not much to be gained from a local consolidation, however, as there are not many organisations with the same focus.

Restructuring of Denel

The *White Paper on Defence-related Industries*[163] states that Government's preferred restructuring option for Denel is to break it up and sell off less than 100 per cent of the shares in each cluster (e.g. aerospace, heavy ordnance, light ordnance) or divisions as separate entities. Those clusters or divisions that are easy to privatise, or those defence-dependent divisions that are attractive to local and foreign investors, will be restructured first.

Future actions by Government

- Denel will be corporatised and an initial strategic equity partnering at the business unit level of Denel Ordnance is expected.

[163] Department of Defence (1999).

- There may be a need for some consolidation of the local ordnance industry, followed by a search for international equity partners at the corporate level.
- An investigation into the consolidation of aircraft maintenance synergies between SAA and Denel is currently being undertaken.
- The Department of Trade and Industry is currently co-ordinating a study into the consolidation of the South African aerospace industry.
- The process of finding a strategic equity partners for Denel Aerospace is currently under way.

Likely impacts of restructuring Denel

If the above restructuring plan for Denel is implemented, the likely impacts would be as follows:

- The introduction of an international equity partner into Denel Ordnance will result in an increase in foreign direct investment in South Africa and also mobilise foreign expertise for Denel. This will improve Denel's access to international markets.
- Consolidation of aircraft maintenance synergies between SAA and Denel should result in cost savings and should encourage the sharing of skills.
- The introduction of an international equity partner/s for Denel Aerospace will increase foreign direct investment in South Africa and bring new skills into Denel Aerospace. Partnering with other international players will provide access to new markets.
- The restructuring of Denel should improve its competitiveness in international markets.

Other restructuring initiatives

- *Safcol:* The sale of three packages is being concluded; the remainder will be consolidated and re-offered.

- *Information technology consolidation:* Options for the consolidation of the information technology capabilities of Datavia, Ariel Technology and Eskom are being assessed.

- *Alexkor:* A turnaround strategy is being effected with a strategic management partner.

- *Aventura*: A turnaround strategy is being effected with a strategic management partner; this will be followed by the sale of the entity.

- *Post Office:* A turnaround strategy is being effected with a strategic management partner.

- *Sentech Signal Distribution:* The Department of Communications is undertaking a study into a restructuring strategy for the entity.

- *SOE property portfolio:* The property portfolios of Denel, Eskom and Propnet are being studied with a view to identifying restructuring options.

9

Summary and conclusions

The main conclusions of each section are summarised below.

Factoring the effects of restructuring into the process

The growing consensus allows Government to pursue an accelerated programme of restructuring that should incorporate the following principles:

- The promotion of competition and competitive markets should be an integral element of any restructuring strategy.
- The need for a mixed economy to address the legacies of apartheid should be acknowledged; the state will continue to play a role in the economy.
- Although the scope for promoting competition has increased with globalisation and technological change, in those business areas where competition is not feasible (residual natural monopolies) a regulatory framework needs to accompany any restructuring initiatives. The establishment of such regulatory regimes should assist in ensuring that these residual natural monopolies do not distort the development of competitive markets in the non-regulated sectors of the economy.
- Government's relationship with restructured SOEs and its intentions when restructuring should be clearly spelt out in individual shareholder compacts between enterprises, in a framework for corporate governance for all SOEs, and in a clear policy framework and programme for restructuring.
- As far as the microeconomic benefits of restructuring are concerned, Government should explore a range of options to ensure that productivity, profitability, investment and innovation are enhanced. While this will often entail equity sales (full or partial privatisation) in order to access additional funding, technology or markets, where this is not required, approaches such as incorporation, joint ventures, employee participation schemes and community participation, may be found to be more beneficial.
- In terms of the macroeconomic benefits, Government should maximise the ultimate return to the shareholder (fiscus), whether through the proceeds from equity sales, dividends and/or tax returns. This should not, however, be at the expense of the poor and marginalised and neither should it affect the

access to services and wider coverage. By adopting the optimal approach to restructuring, Government can maximise its ultimate long-term returns on its shareholding by trading off short-term gains from equity sales in depreciated assets for medium- to longer-term gains (dividends, taxes, deferred equity sales) from successfully restructured SOEs.

- In order to account for the implications of public goods and services (or externalities) on the lives of all South Africans, restructuring proposals should incorporate a rigorous cost-benefit analysis of their impact on overall social welfare.
- Lastly, Government should address its social objectives (social plans, employment creation, price subsidies, optimisation of public goods, empowerment, etc.) through transparent means, so that all stakeholders can reach agreement on the logic and methods of the restructuring process. This will enable both Government and the restructured SOEs to account for their individual actions towards meeting their objectives, and will ensure that poor performance can be identified and remedied.

Recommendations on competition and regulation

There is a clear need for a sector-specific regulatory regime within the broader framework of current competition policy, based on the type of industry and the potential for competition, as well as the competence of the regulator in question. In the interim, Section 3 (1)(d) of the Competition Act should be removed and concurrent jurisdiction should prevail in all regulated industries. Both authorities should approve mergers, and abuses of dominance require a sector-specific approach. In the longer term, regulators could concede jurisdiction on competition matters to competition authorities and seek their advice and opinions regarding other regulatory decisions.

A better regulatory environment in the key sectors dominated by SOEs (energy, telecommunications and transport) should benefit all. South Africa’s globalising economy will benefit from lower prices and/or improved service outputs, which will enable it to become more competitive and to create more employment and investment opportunities. All people, but especially unemployed and poor people, will benefit from increased job opportunities and more affordable and available services. Greater certainty will stimulate investment and customer satisfaction, ensuring that the quality of life of all is improved.

Promoting empowerment

This policy paper proposes a multi-faceted approach to empowerment through three kinds of intervention in SOE restructuring processes:

- SOE ownership can be broadened through the National Empowerment Fund and other kinds of unit trust structures, in ways that address the problems in existing empowerment-related financial engineering. These new approaches can take the best lessons (and avoid the most serious drawbacks) of international experiences of collective investment vehicles, to provide a range of equity schemes for those previously excluded from mainstream economic participation.
- Operational empowerment strategies should be improved to ensure that beneficiaries are not merely absentee owners. They should be able to gain meaningful access to state-regulated activities, through training and skills development, affirmative action in management, and entrepreneurial opportunities through outsourcing, partnerships, affirmative procurement and easier access to financing.
- Combining the first two strategies, alternative vehicles for empowerment, such as employee share ownership plans and community trusts should be piloted. This will improve enterprise self-management and community involvement, and in the process raise investment in and take advantage of social capital.

Improved corporate governance, ethics and probity

The 1997 Protocol on Corporate Governance covers most of the issues commonly found in other corporate governance frameworks, but it should be refined to be in line with international best practice. It is, however, still sufficiently sound to be used to establish the foundations for corporate governance in the SOE sector over the next few years.

The largest four SOEs (Eskom, Transnet, Telkom and Denel) have been asked to sign off on the 1997 Protocol. They have also been requested to conclude a shareholder compact with the shareholder departments. Since the shareholder compact will primarily serve to develop an enterprise-specific relationship between Government and the SOE, most if not all the limitations of the 1997 Protocol can be addressed in the shareholder compact. The compact is understood to be an interim agreement designed to assist Government in managing the restructuring process. As the restructuring proceeds, a revised protocol on corporate governance is drawn up and adopted by the SOEs, the compact will be revised and/or superseded by more formal corporate governance practice. Furthermore, since the compacts will largely define the relationship between specific SOEs and Government, each compact will be tailored to the distinct requirements of each enterprise.

Through reference to international best practice, Government will encourage the SOEs to periodically review and update their ethics and probity management programmes. Government will also ensure that those managing the restructuring process are subject to appropriate probity investigations, and that any evidence of misconduct is fully investigated and prosecuted, where applicable. Government's commitment to ensuring internationally acceptable standards of probity will be enhanced by its transparent and accountable approach to managing the restructuring process. Investors and stakeholders will be able to monitor the process and hold Government accountable for deviations from the published process and programme.

Improving the restructuring process

Suggestions for improving the restructuring process include the following:

- Arrangements to improve stakeholder involvement to take advantage of the Labour Relations Act, Social Plan and National Framework Agreement to make provision for high-level political engagement.
- Government will seek new methods of communicating with other stakeholders, including quarterly bulletins and a web site.
- The new two-stream Government decision-making structure, which distinguishes between day-to-day decisions and those that required a strategic or policy input, will expedite decision-making.
- Periodic strategic workshops and the circulation of short sectoral strategy documents will improve the overall strategic understanding of restructuring priorities in Government and between Government and the SOEs.
- The proposed shareholder compact and a revised protocol on corporate governance will clarify the roles and responsibilities of Government and the boards and management of SOEs in the restructuring process and afterwards.

- The process described in the process maps (see Appendix) should assist in overcoming many of the previous restructuring bottlenecks.

Actions being taken by Government around enterprise restructuring

Subject to Cabinet approval, a programme for the restructuring of all major SOEs has been put in place, signalling the political intent of Government. It is envisaged that the majority of the restructuring activities will be completed by 2004. A summary of specific restructuring actions is presented below. Although the focus will be on the four key sectors, the restructuring of other sectors will take place concurrently.

Transnet/ACSA

- Transnet debt restructuring is being dealt with; significant progress has already been made in dealing with the pension fund debt.
- Spoornet will be corporatised, with its different business units becoming separate corporate entities;
- Coallink, Orex, Luxrail and Linkrail will be concessioned.
- Spoornet's General Freight Business will be commercialised and either an Initial Public Offering (IPO) or a strategic equity partnership (SEP) entered into.
- A new ports policy and a ports regulatory framework are being drafted. Portnet will be corporatised to form a port authority entity and a port operations entity; the latter will then be privatised.
- Subject to shareholder approval, the processing of an IPO for SAA will be commenced with.
- Petronet will be corporatised, its synergies with other pipeline projects assessed and restructuring options developed.
- Deadlines for the disposal of non-core units within Transnet will be ongoing.
- The airports regulatory framework is being revised; once this has been completed, subject to shareholder approval, an IPO will be processed for ACSA.

Telkom

- Work on the proposed IPO for Telkom is proceeding.

- Work on a policy and a process to determine the Second National Operator (SNO) is already quite advanced.
- Given the possibility that other SOEs may become involved in the SNO, the Department of Public Enterprises will ensure that a full investigation is undertaken into the costs and benefits, and to ensure that appropriate synergies are achieved.

Eskom

- Eskom will be corporatised, with transmission, distribution and generation each forming a separate corporate entity.
- A full evaluation of the different models for restructuring Eskom is currently being undertaken by the Department of Public Enterprises.
- Different generating companies will be formed to promote internal competition before the introduction of private sector participation in generation.
- The Department of Minerals and Energy is currently co-ordinating the design and implementation of the regional electricity distributors.
- Strategic equity partners will be introduced into different Eskom Enterprises business units.
- Private sector participation will be introduced specifically into the generation and transmission entities, either through strategic equity partners or through IPOs.

Denel

- Denel will be corporatised, and an initial strategic equity partnering at the business unit level of Denel Ordnance is expected.
- The local ordnance industry may need to be consolidated; this will be followed by a search for international equity partners at the corporate level.
- The consolidation of aircraft maintenance synergies between SAA and Denel is being investigated.
- The Department of Trade and Industry is co-ordinating a study into the consolidation of the South African aerospace industry.
- The process of finding a strategic equity partner for Denel Aerospace is currently under way.

Conclusion

The current stage of development of the South African economy necessitates a mixed economy model, with both the state and the market playing key roles; this sets the context for the restructuring of SOEs. The restructuring programme will take into consideration a range of models, choosing a model that, on the balance of evidence, will best meet the overall objectives and strategy for restructuring. While it draws on international best practice and experience, the approach is primarily in response to the internal and external factors that affect the South African economy.

This document outlines the policy framework that will guide the restructuring of SOEs. Restructuring plans for individual enterprises are being developed in line with this framework, while at the same time considering the individual attributes of each enterprise.

Government will use this framework to achieve its objectives, as set out in this document. While each individual restructuring may not achieve all the stated objectives, the overall restructuring programme will enable Government to achieve its aims.

Government is committed to an agenda that will accelerate the restructuring process. The past five years have represented a steep learning curve for Government. Having established a solid foundation, it can now set the framework for the accelerated restructuring agenda, as reflected in this document.

Appendix 1: Process flow charts

The attached process flow charts map out the process that the Department of Public Enterprises will be following in the restructuring of SOEs. The following charts are attached:

1. *Overall process flow chart*

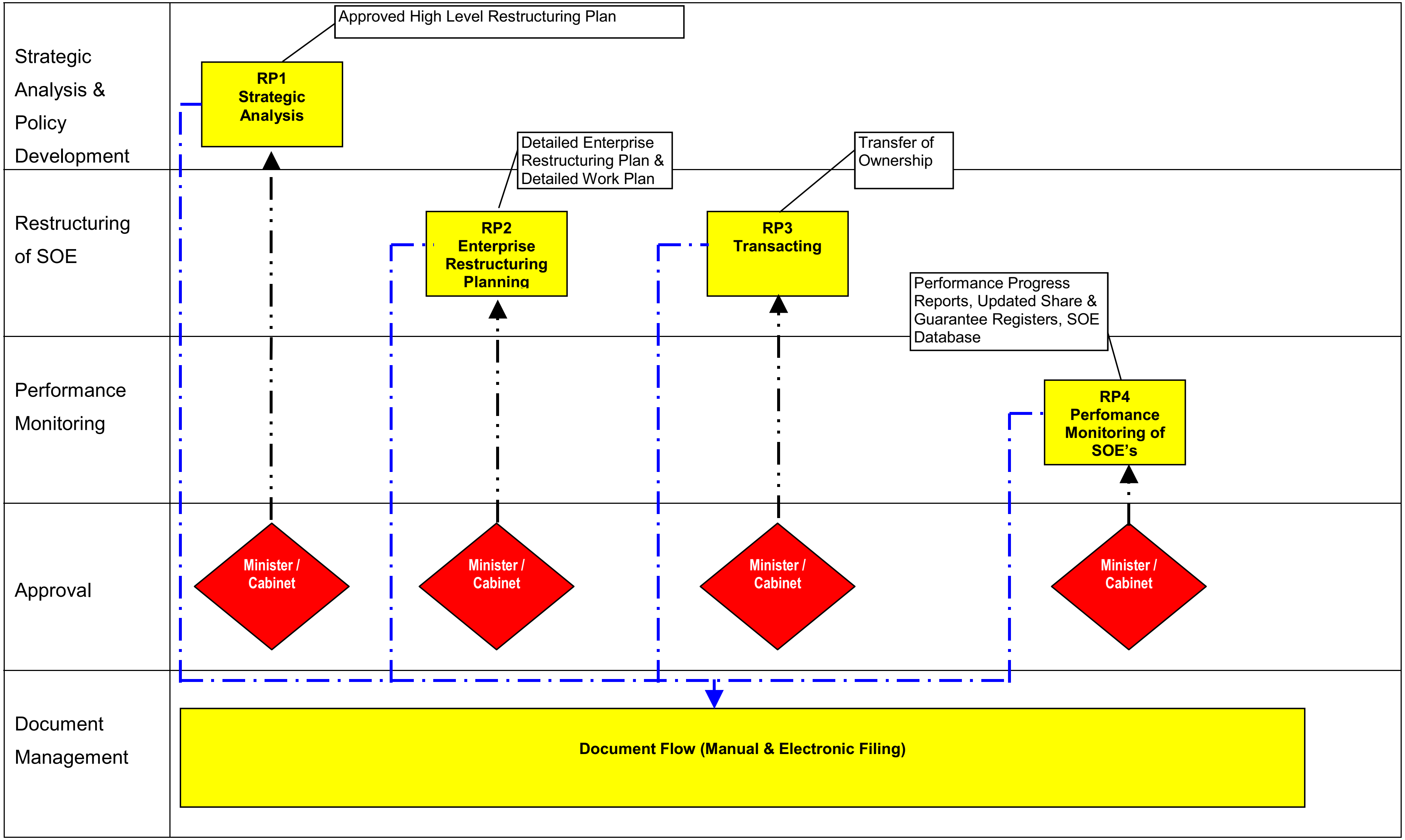
2. *Strategic analysis process*

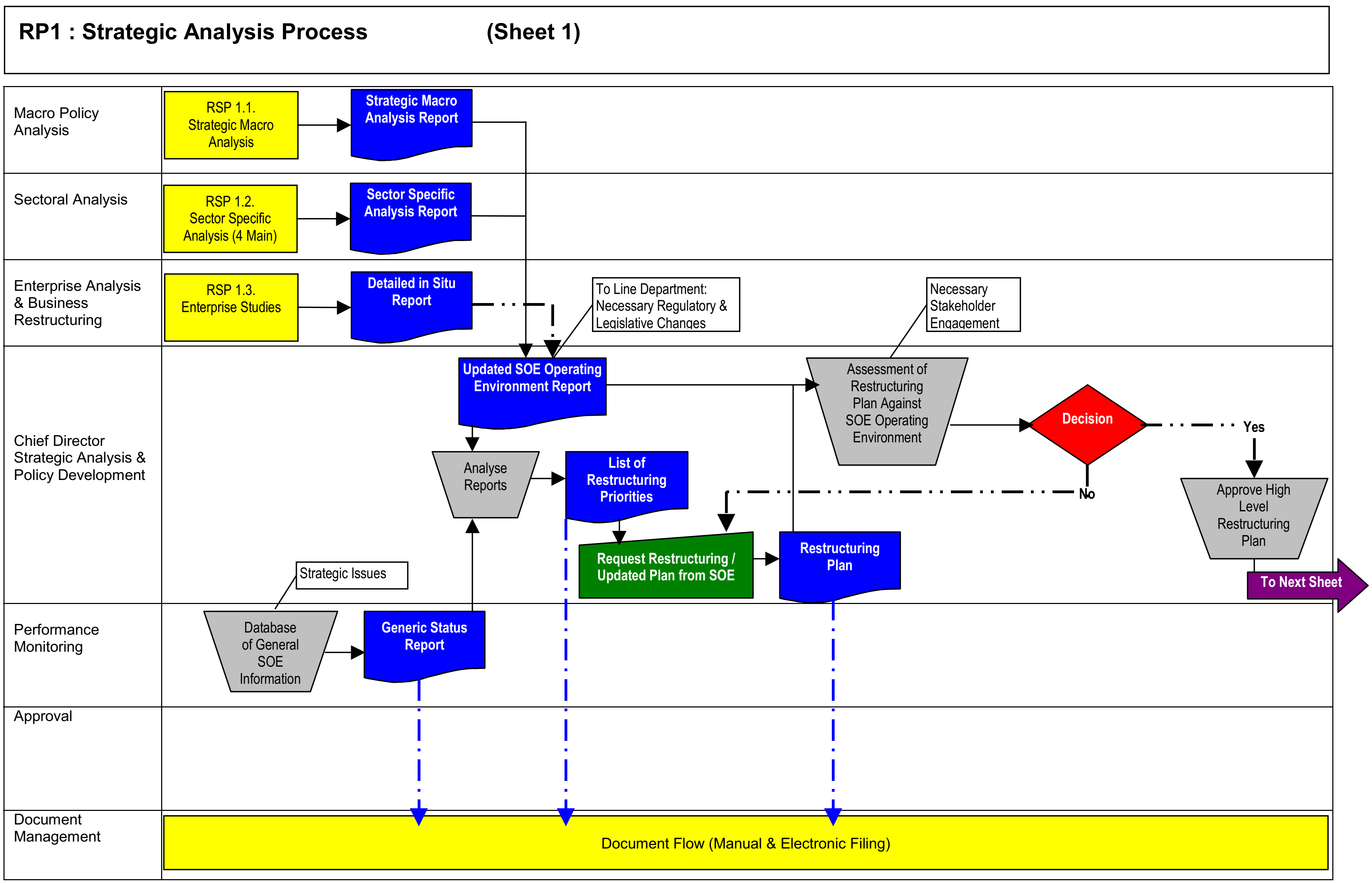
3. *Enterprise restructuring planning*

4. *Transacting process*

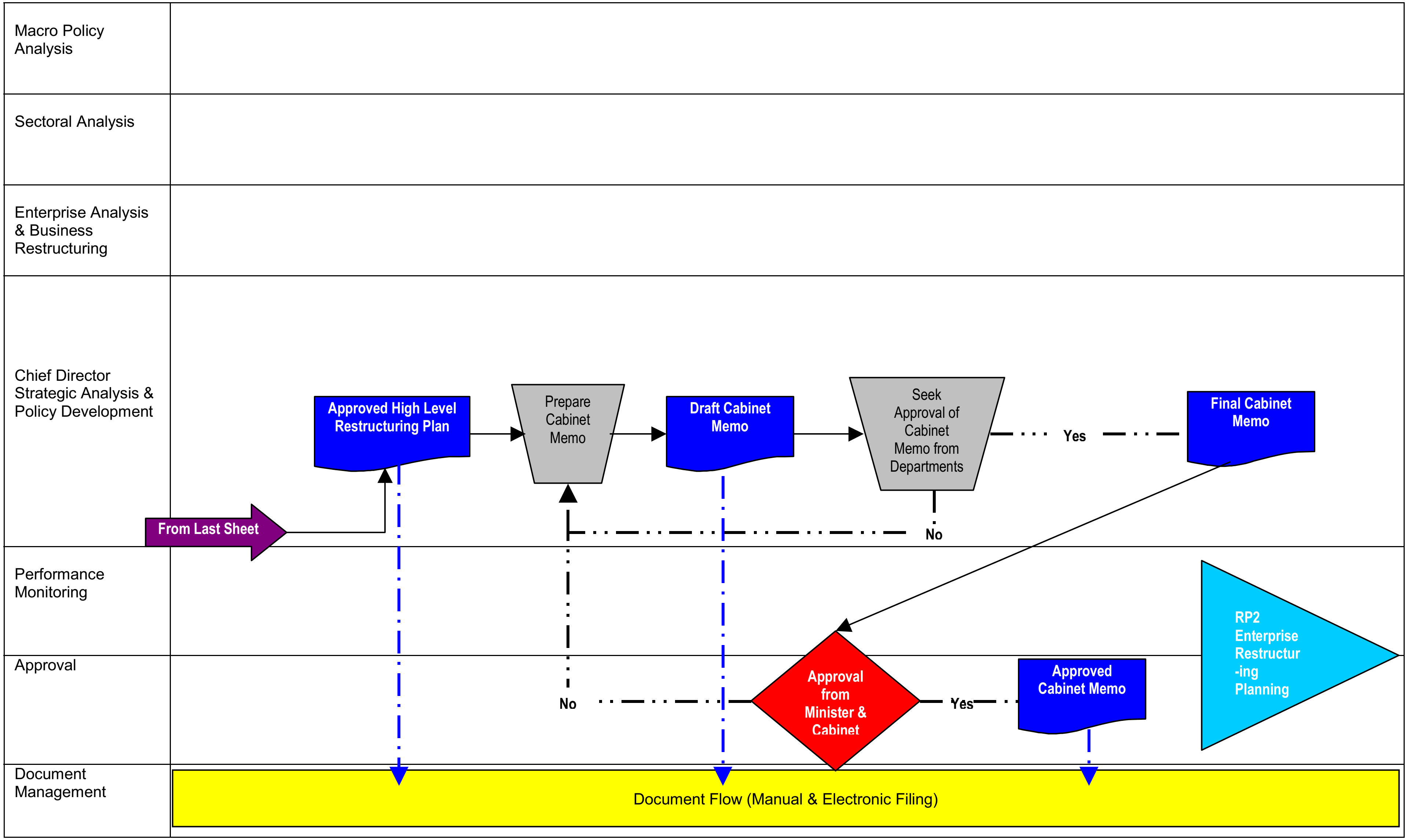
5. *Post-restructuring evaluation process*

PROCESS FLOW CHART : Restructuring & Monitoring of State Owned Entities

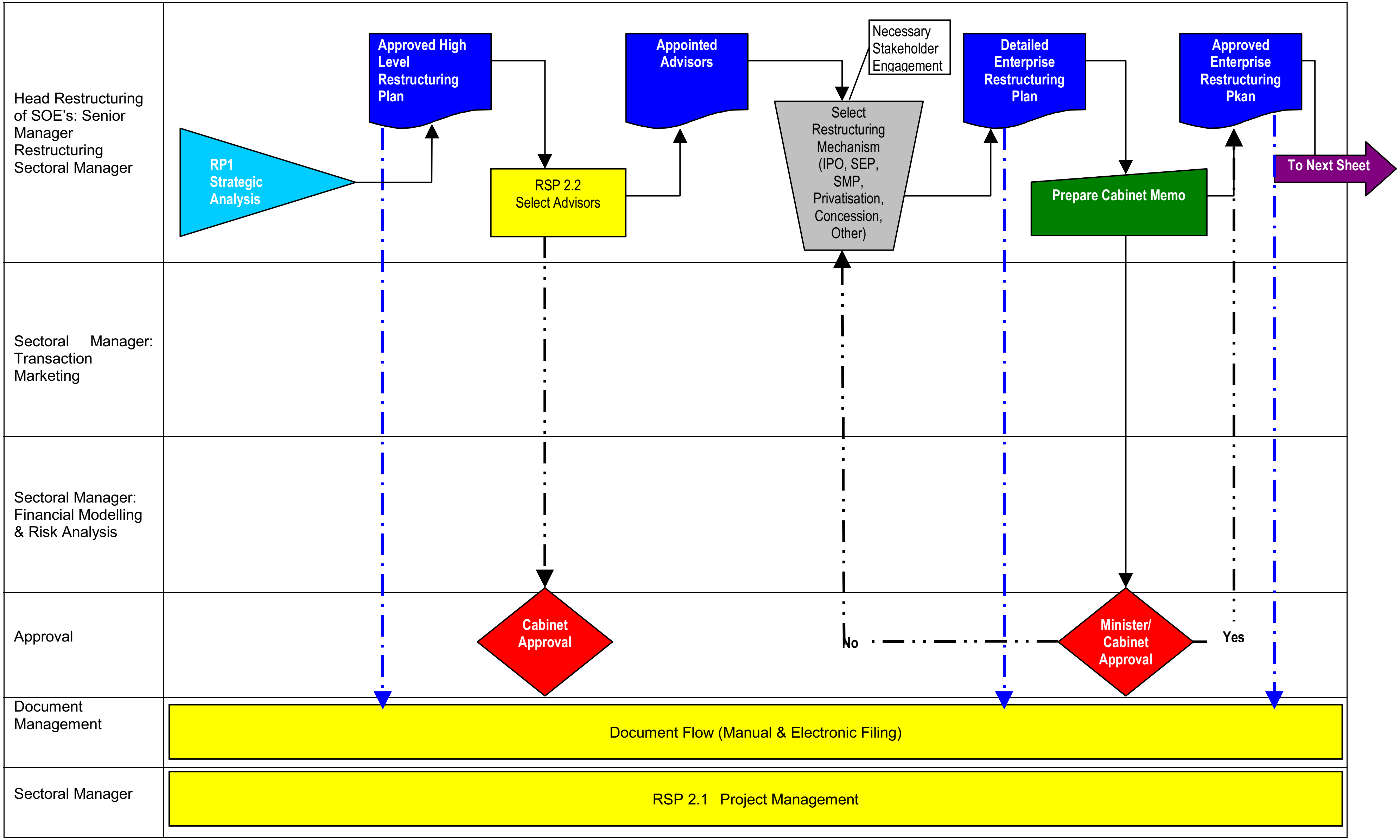



RP1 : Strategic Analysis Process
(Sheet 1)
Macro Policy Analysis
Sectoral Analysis
Enterprise Analysis & Business Restructuring
Chief Director Strategic Analysis & Policy Development
Performance Monitoring
Approval
Document Management
RSP 1.1. Strategic Macro Analysis
Strategic Macro Analysis Report
RSP 1.2. Sector Specific Analysis (4 Main)
Sector Specific Analysis Report
RSP 1.3. Enterprise Studies
Detailed in Situ Report
To Line Department: Necessary Regulatory & Legislative Changes
Necessary Stakeholder Engagement
Updated SOE Operating Environment Report
Assessment of Restructuring Plan Against SOE Operating Environment
Decision
Yes
No
Approve High Level Restructuring Plan
To Next Sheet
Analyse Reports
List of Restructuring Priorities
Request Restructuring / Updated Plan from SOE
Restructuring Plan
Strategic Issues
Database of General SOE Information
Generic Status Report
Document Flow (Manual & Electronic Filing)

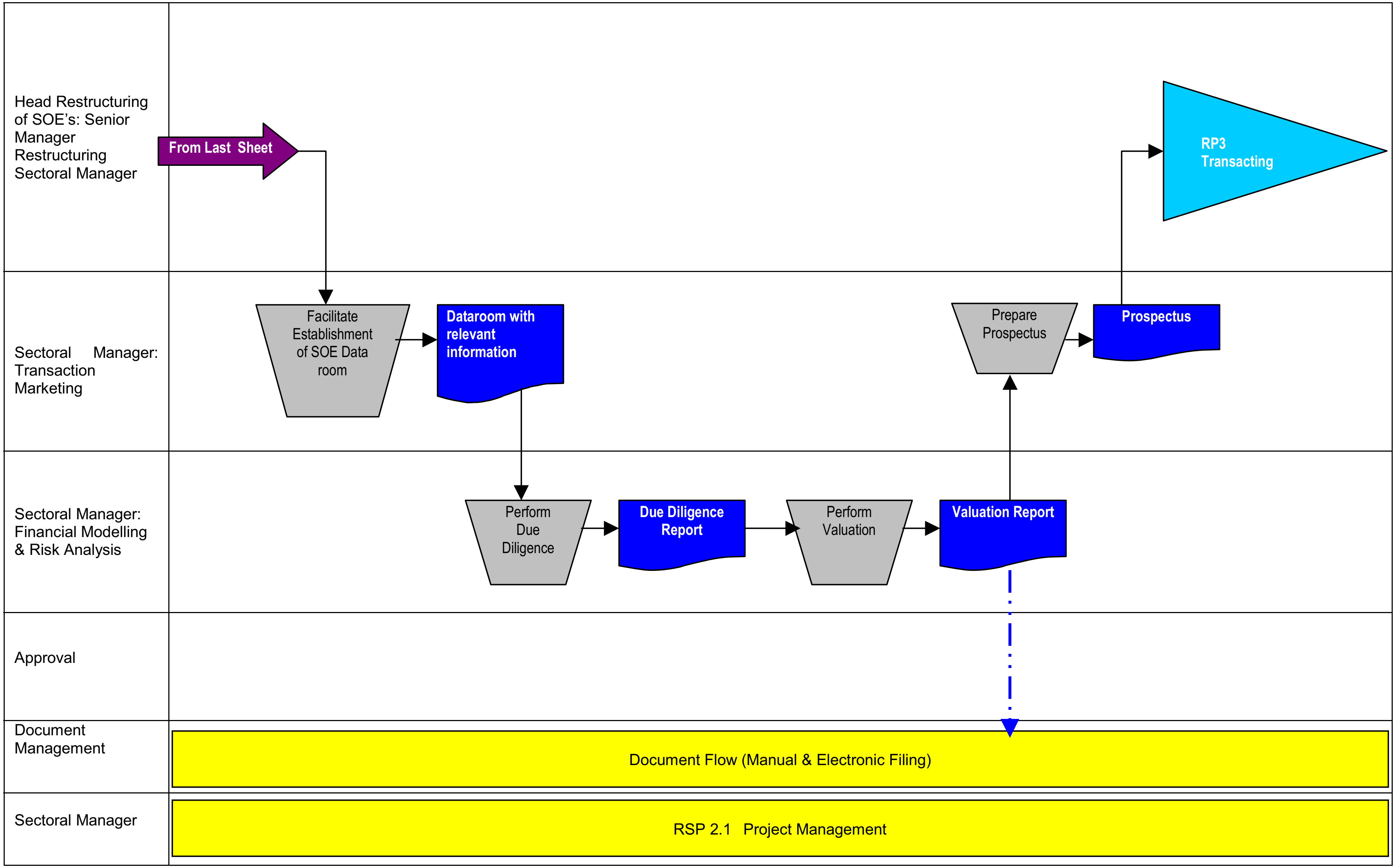
RP1 : Strategic Analysis Process (Sheet 2)



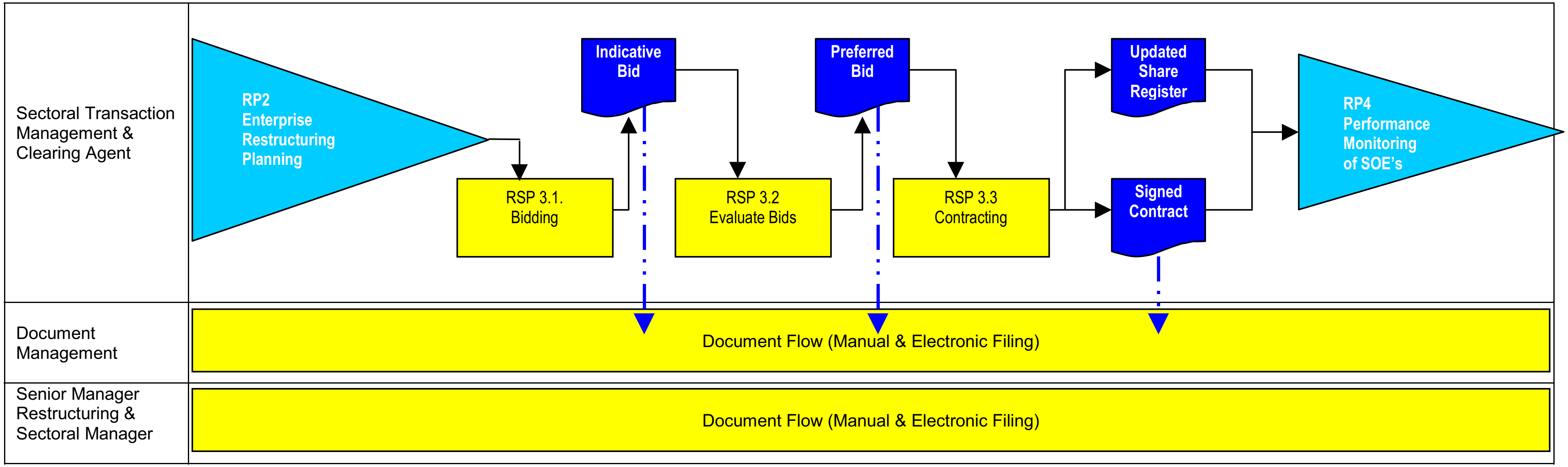
RP2 : Enterprise Restructuring Planning (Sheet 1)



RP2 : Enterprise Restructuring Planning (Sheet 2)



RP3 : Transacting



RP4 : Performance Monitoring of SOE's