REFORMING STATE-OWNED ENTERPRISES: WHAT ARE THE KEY PRINCIPLES?

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It has been said many times that the electricity utility, Eskom, is in a crisis. Repeating such sentiments would be an understatement of the deeper malaise the country is in as a result of years of under-investment, poor planning and management, and corruption. The condition of Eskom has become a barometer of the national mood. That is how deeply interwoven the utility is into the lives of South Africans.

From cradle to grave, many South Africans depend for their energy on Eskom, and in turn it survives on tariff increases that can only be granted by the energy price regulator, the National Electricity Regulator of South Africa (NERSA). It is the consumers that foot the bill irrespective of the underlying causes of these tariff increases. This is an additional burden on households that are already crushed by rise in cost of living. The other source of support for Eskom are state guarantees – which are fiscal resources – that act as a surety to enable it to raise capital from debt markets. However, Eskom has in the recent past developed a habit of lack of accountability and transparency about its programmes. The consumers who bear the responsibility for tariff increases have little say over the utility.

The grim reality today is that Eskom is firmly against the wall. The neglect of the past two decades, especially intensifying with rising corruption during the past 9 years of President Jacob Zuma's administration, has come back to haunt the utility. Even without the poor management and corruption that has marked the utility in the past 9 years, there were going to be challenges in the future given that this is a near monopoly that is vertically integrated and heavily reliant on coal as primary source of energy for nearly 90% of its power generation.

Eskom is made up of the trinity of generation (turning power to energy), energy transmission (grid lines), and distribution (wholesale). Inefficiencies across these dimensions are reflected in the price that the consumer has to pay in the end. Where there is poor management and planning at generation, including poor business decisions in coal procurement, the danger signals are spread across the organisation. If transmission lines age and they are not maintained, energy will become severely constrained.
In instances where Eskom cannot raise capital from the debt markets due to poor governance and financial mismanagement – or downgraded by rating agencies – it would suffer strain, and its sustainability under threat. Currently we have a cocktail of these different challenges.

During his state of the nation address on the 7 February 2019, President Cyril Ramaphosa announced that Eskom will be unbundled into three areas: generation, transmission, and distribution. Presumably this draws on the advice of the High-Level Energy Task Team that the president appointed in December 2018. Its recommendations were submitted at the end of January 2019. While the substance and details of what unbundling Eskom would entail, there is much speculation that this is a prelude to privatisation. Back in 1998, it was envisaged in the White Paper on Energy that Eskom should be unbundled and create a space for competition. This was to be done through an ISMO (Independent System and Market Operator) Bill that would have ended the monopoly of Eskom. Accordingly, Eskom would only be involved in in electricity generation, where it would compete with Independent Power Producers (IPPs), while another independent body would handle distribution. However, the ISMO Bill was introduced in 2012 as a path towards breaking Eskom monopoly, but two years later the governing party withdrew it.

Although the efforts at unbundling Eskom are not necessarily aimed at reviving the old ISMO Bill, it would seem that the objectives are broadly similar – to create a climate that would make it easier to sell of parts of Eskom, possibly partially, and appetise private sector players (IPPs) to participate in generation and distribution. As a sweetner to Eskom, the utility may also be given a greenlight to invest in renewable energy IPPs, something that may be necessary to avoid retrenching staff in large numbers. All of this is medium to long-term.

In the short-term, Eskom is bleeding badly. This is as a result of years of poor leadership and financial mismanagement. One major challenge Eskom faces is its mounting debt, estimated to be over R400bn currently. For example, a decade ago, Eskom produced 40 000MW of electricity; had 32 000 employees, with debt sitting at R40bn, and employee costs at about R9bn. Currently the picture is gloomy: production has risen by only 20% to 48 000MW, with 47 000 employees (about 40% increase), the utility spends R33bn in employee cost (over 300% increase), and with a debt at R440bn (1000% increase). Cost cutting over the next 3 years is estimated at between R25bn and R30bn. In the short-term, energies are likely to be directed at cost reduction measures, tariff increases, and the balance sheet calibration. These are likely to be supplemented with a bailout from the National Treasury. Foreign engineers and auditors help solve some of the identified challenges at Eskom. This suggests that South Africa has experienced a brain drain of its own engineers.

If these challenges are not attended to with urgency, South African will continue to suffer the effects of rolling black outs, with results showing in waning productivity and possibly job losses in other sectors that are reliant on consistent supply of energy. The rating agency Moodys has noted that Eskom's troubles will affect business investment, as energy is a critical enabler for both big and small businesses.

The trade union movement is divided on precisely how Eskom should go about its restructuring. Solidarity has come out in support of unbundling, whereas COSATU affiliates are opposed. What is important in these times is to engage with government since the Eskom crisis is not a sectoral but a national issue. Whatever framework emerges, this would need to have the input of the unions as key stakeholders especially given severe implications on the economy and workers if the utility fails.
Efficiency considerations should be balanced with the need to cushion the vulnerable workers, while also ensuring that South Africa does not lose its energy sovereignty. Long-term security of supply and sustainability should remain at the center of efforts to restructure the public utility. Where do we go from

here? At a broader level, there is a need to consider some of the principles that need to be followed in turning Eskom around.

Principle 1: Distinguish commercial and public good functions

The most important principle for reform is that state-owned enterprises such as Eskom must start distinguishing between their public good and commercial functions. Most SOEs have a blend of these two functions. Eskom, for example, sells energy to a wide range of consumers in South Africa. But it also plays a number of public good roles, such as extending electricity connections to underserved communities, providing low-cost energy to vulnerable energy-intensive industries, and procuring locally to support domestic industry.

These public good functions are an inevitable part of SOEs in South Africa, in which pressing social needs makes it difficult for state companies to act in the same way as purely commercial interests. If used correctly, these social good activities can be incredibly beneficial to the country and can be sustainably implemented by offsetting their cost against the income earned by the enterprise.

The problem is that social good functions are frequently used as cover for many of the core problems faced by SOEs. State enterprises such as SAA and Eskom have blamed their failure to operate properly on their need to meet their social-good mandate. When SOEs do this, they frequently use their social-good work to call for subsidies or bailouts from government, which creates a relationship of dependence on state funds that undermines any pressure to operate efficiently. The mix of commercial and social good functions also makes it difficult to build internal structures that are devoted to a set of coherent objectives. The all-out profit focus of commercial firms is diluted by the need to consider social good, while the social good objectives are diluted by the need to constantly consider costs and profitability.

These problems are not natural to the dual mandate of SOEs, but rather result from enterprises that are not designed to distinguish between the enterprise's two critical objectives: SAA claims to make losses on certain routes because they're important for the country, but the company does not distinguish between commercial and public good routes. The South African Bureau of Standards claims certain laboratories are for the public good but cannot distinguish these from its commercial labs. Eskom claims it needs higher tariffs because of all its public good work, but it cannot account for the share of this work in the tariffs they receive. Across the board, procurement officers target a blend of social and commercial objectives, but frequently lack clear rules on how to make these weigh-ups, and do not comprehensively report on their decisions and how the balance plays out in practise.

Distinguishing between their social good and commercial objectives must be a key part of SOEs's planning and reporting. Creating the distinction between these two sides is the only way that government support to SOEs can be managed in a way that is fair, sustainable, and that offers value for taxpayers' money. In response to the dual system, government must commit to offering strategic subsidies and other support to SOEs social good role. But, at the same time, they must commit equally to staying out of the business of the commercial operations, except in time of absolute crises.
Public reporting on the two functions must be open, transparent and rigorous - and must consistently return to the question why commercial operations should receive public support.

In the long term, the objective should not simply be to distinguish these two parts, but to make them work for each other. In particular, the ability to focus on commercial operations, and to improve the efficiency of these operations, should open up the potential for cross-subsidization between the commercial and social good functions, and ultimately allow SOEs to do more good with less public resources.

Principle 2: Reinforce multiple points of accountability

Accountability is clearly a major problem among state owned enterprises. SOEs have become notoriously riddled with corruption and state capture. There is extensive evidence of questionable deals done by SOEs - including multiple incidents among a network of the most famous culprits of Eskom, Transnet, Tegeta, Regiments, Mckinsey, KPMG, and many others. And yet despite all this evidence, no major legal findings have been made against any of the culprits. Where punishment has been meted out, it has mostly been voluntarily, by companies like Mckinsey or KPMG, in order to salvage their reputation from widespread public condemnation.

While ad hoc committees like the State Capture Commission may reveal and act on specific incidents, they don't offer the type of ongoing checks and balances that a functioning system of accountability would demand. Accountability, in this sense, should not simply mean procedural justice, in which a crime is met with a punishment. Rather, it should be seen as a system that quickly and effectively identifies and neutralises incidents of corruption or bad management before they can do lasting damage to SOEs. Without this type of system, the country could easily find multiple versions of the Eskom problem: where even after the guilty parties are pushed out of the organisation, the structural problems that they created remain.

The difficulty with building accountable SOEs is that many of the problems of corruption and capture occurred under what is already a sophisticated system of accountability. SOEs have at least three points of accountability: their boards, the Minister of Public Enterprises, and their regulators (such as Nersa for Eskom). In addition, financial management is overseen by the National Treasury, specific sectoral policy is determined by other departments (such as the Department of Energy for Eskom), and overarching oversight is vested with the National Assembly.

This system appears, on paper, to be relatively robust. And yet it consistently failed for two main reasons. First, is that all points of accountability are vulnerable to influence from the Executive branch of government. The Presidency appoints Ministers, who in turn appoint board members and, frequently, oversee regulatory bodies. While this system makes it hard for smaller incidents of corruption to infect the whole system, it makes the entire system vulnerable to intervention from the executive. Second, few of the oversight bodies have either ongoing monitoring systems or proven tools to enact change. Board members generally rely on reports provided by the executives of SOEs, with only limited oversight provided by independent auditors (many of whom were complicit in past failings of accountability). If board members suspect a problem and want to enact change, their only real power is to change the executive, which can destabilise institutions and doesn't target the type of structural problems that underpin many systems of corruption.

Regulators are the most insulated from both of these problems but are limited by the powers they have. Nersa, for example, can limit Eskom's ability to raise tariffs - but they can't impact the underlying costs involved in Eskom's energy generation business. The result is that often the regulator has no realistic choice

but to accept the demands of the SOE, because the underlying structural problems demand a set response from the regulator.

There is no easy solution to fixing accountability; but, as a key principle, every layer of accountability needs to be reinforced with greater independence and deeper powers to intervene as needed. Independence could be improved by measures such as increasing tenure terms for regulatory decision-making boards, rotating portions of SOE boards on a regular basis, and adding permanent oversight roles to Ministries at the civil service level. Intervention powers could be helped by adding tools such as the ability of boards to carry out special audits (including into the lifestyle of senior executives) and adding 'morality' clauses to procurement contracts, that punish companies that are found guilty of ethical violations.

Principle 3: Create sustainable competition

Perhaps the core reform question is whether SOEs should remain under the control of the state, or whether they should be offloaded to the private sector. Those who support privatization argue that the problems at SOEs are inherent to the structure of state ownership, and that limited competition, an assumed promise of a bailout from the state, and meddling in boards and oversight will regularly result in inefficient and costly SOEs, which the private sector could run better.

While this is a legitimate debate to have, there is a clear logic to keeping SOEs under state control, especially the transmission functions, with some hybrid model in generation and distribution. Strengthening regulation will also be important. A blanket Privatisation of SOEs effectively means that social benefit roles disappear, and there are no guarantees either that private players would not fail. For Eskom there will be a need for some role for government, especially to ensure that energy generation doesn't serve the narrow interests of those who can afford expensive tariffs, but also reaches the most vulnerable. While some of these benefits can be replicated through other policies (such as paying for the electricity the poor purchase from a private utility), it should not be assumed that privatization is the best option, when in many cases it can disempower the state and commercialise crucial services that need to meet the standard of both commercial viability and economic justice. The urgent need to improve efficiencies at Eskom, including governance, managing operational costs, management structures, and the balance sheet should not be conflated with the overall ownership structure of Eskom – public or private.

The key to adding competition will be to do so in a way that brings the commercial side of SOEs into competition with the private sector, while protecting the interests of SOEs public good role. The unbundling of Eskom could very well be a step in the right direction. It is the details that matter.

Conclusion

None of these principles can fix the core problems at the heart of many South African SOEs. Eskom will continue to be burdened by a huge debt burden and unfulfilled coal contracts, while an SOE like Transnet will continue to be a sprawl of enterprises that are virtually unmanageable, and SAA will still have to compete with a questionable asset ownership model. These problems will require two types of

interventions: the first is political – to make a call on the strategic objectives and future shape of these entities; and, second – to make specific interventions that will likely take up energies. In some instances, it may be important to set out a clear plan to restructure some of these enterprises.

Such restructuring may entail hybrid model similar to Telkom of partial private funding, depending on the strategic value, developmental imperatives, and viability of an enterprise. This could help in better reshaping and focusing some of these entities. As Samuel Johnson once remarked in the 18th Century: 'Depend upon it, sir, when a man knows he is about to be hanged in a fortnight, it concentrates the mind wonderfully'. Specific interventions include improving operational efficiencies, governance, and undertake cost cutting exercises. For Eskom, the immediate challenge is to improve efficiencies, address technical and operational challenges, and improve the balance sheet. The unbundling of Eskom could very well be an opportunity to open up spaces for various options that would balance efficiency imperatives and sustainability in the broader sense.