

CHAPTER 8

THE INTERNATIONAL OFFERS NEGOTIATING TEAM (IONT)

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CHAPTER 8

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This chapter deals with the evidence obtained during the public and forensic phases of the joint investigation. To avoid duplication, the evidence is referred to without specific reference about when and by which investigation agency it was obtained, unless it is deemed appropriate to do so.

8.1 BACKGROUND

During November 1998, Cabinet resolved that the recommendations on preferred suppliers as presented to it by the Minister of Defence, be accepted. Cabinet mandated the Departments of Defence, Finance, Public Enterprises and Trade and Industry to proceed with detailed negotiations with the preferred bidders with a view to achieving affordable agreements. To this end, IONT was constituted to negotiate with the preferred bidders.

8.2 SCOPE OF THE INVESTIGATION

8.2.1 The scope of the investigation was to conduct a high-level overview and to determine:

8.2.1.1 The prescribed procedures to be followed by IONT and the extent to which they were.

8.2.1.2 Whether the negotiating process conducted by IONT was documented.

8.2.1.3 The impact of IONT on the procurement process by comparing final contracts concluded with the original offers made.

8.3 PROCEDURES PERFORMED

8.3.1 The general forensic investigation procedures, as detailed in chapter 2 of this report, were performed in order to comply with the abovementioned mandate. In addition, the evidence in this regard of the Chief Negotiator - Mr Naidoo, and the Minister of Trade and Industry - Mr A Erwin, was presented during the public phase of the investigation.

8.3.2 The documentation perused included, inter alia, the following:

- Minutes of the meetings held by IONT.
- Minutes of the meetings held by the Ministers' Committee.
- The report submitted by the Affordability Team of IONT.
- Minutes of Cabinet meetings.
- The terms of reference of IONT.
- Reports by IONT to the Ministers' Committee.
- The Special Review of the SDP by the Auditor-General.

8.4 THE ESTABLISHMENT OF IONT

8.4.1 On 18 November 1998, Cabinet mandated the four departments involved in the SDP procurement to proceed with further detailed negotiations with the preferred bidders with a view to achieving affordable agreements.

8.4.2 On 23 and 24 November 1998, a work session was held where the terms of reference for IONT were drafted. It was decided that IONT would be headed by the Chief Negotiator, Mr J Naidoo. These terms of reference were to be followed by IONT during the negotiations with the preferred bidders.

8.5 THE STRUCTURE OF IONT

8.5.1 IONT was headed by the Chief Negotiator and its members were:

8.5.1.1 Mr S Shaik, Chief of Acquisitions of the DoD, who, in conjunction with Mr L Swan, CEO of Armscor, attended to the technical and DIP aspects of the negotiation. With regard to DIP, they were assisted by Mr J J van Dyk, Senior Manager: Counter Trade of Armscor.

8.5.1.2 Mr V Pillay of the Department of Trade and Industry, who attended to the NIP domain.

8.5.1.3 Mr R White of the Department of Finance, who attended to the financing aspects.

8.5.2 The terms of reference provided for the briefing of legal and financial experts to assist IONT. IONT procured the assistance of an international group of lawyers, White and Case, to advise and assist with the consolidation of the individual contracts into an umbrella agreement.

8.5.3 Warburg Dillion Read was appointed as financial advisors to IONT and assisted with the financing aspects.

8.5.4 The diagram below reflects the structure and composition of IONT as presented during the public phase of the investigation.



8.6 THE APPOINTMENT OF THE CHIEF NEGOTIATOR

- 8.6.1 The Minister of Trade and Industry and Mr Naidoo stated during the public phase of the investigation that Mr Erwin had approached Mr Naidoo, to request him to consider accepting the role of Chief Negotiator representing the Office of the Deputy President during the Defence Packages negotiations.
- 8.6.2 The Chief Negotiator was appointed during a work session of IONT, held on 23 and 24 November 1998.
- 8.6.3 According to the minutes of the work session, it was decided that the DoD was liable for the costs pertaining to the fees of the Chief Negotiator and other operational costs associated with his activities. As a result, the Armscor tender

procedures had to be followed with regard to the appointment of the Chief Negotiator, as Armscor normally procures on behalf of DoD. The Armscor tender procedures as prescribed in policy document STD 20 were not followed.

8.7 THE TERMS OF REFERENCE OF IONT (ToR)

8.7.1 During the work session of IONT on 23 and 24 November 1998, a draft negotiation plan was agreed. This draft negotiation plan, referred to as the terms of reference, was submitted to the Ministers of the Departments involved for their inputs before a final plan was submitted to higher authority, that being the Ministers' Committee.

8.7.2 The final terms of reference of IONT were approved during a meeting of the Ministers' Committee on 26 May 1999. It was noted that the Deputy President and the Minister of Public Enterprises did not sign the recommended terms of reference. The Ministers of Defence, Finance, and Trade and Industry signed the terms of reference.

8.7.3 The mandate of the negotiating team was to negotiate an achievable funding arrangement and an affordable package with the preferred supplier. It was to result in a final contract for the offered equipment to the SANDF.

8.7.4 The negotiating team was to negotiate and conclude an affordable set of contracts, which would satisfactorily combine the technical, industrial participation and financial imperatives.

8.7.5 The initial processes outlined in the ToR were:

- (a) The negotiating team was to define the character and schedule of the negotiating process.

- (b) Additional consulting and technical capacity was to be identified and appointed.
- (c) The team leaders of the negotiating work groups were to produce a schedule of tasks and responsibilities for each of the four domains.
- (d) Initial discussions between the preferred supplier and the negotiating workgroups regarding the negotiating process would then commence.
- (e) Technical preparatory work by the negotiating workgroups and the negotiating team would then be undertaken.
- (f) Local industry involvement in the definition of the DIP and NIP as well as the equipment programmes were to be progressed under the guidance of the negotiating team.
- (g) Commencement with the negotiations.

8.7.6 In accordance with the terms of reference, the Chief Negotiator reported directly to the Deputy President and to the Ministers' Committee.

8.7.7 The Chief Negotiator was often accompanied by Mr Shaik when reporting to the Ministers' Committee. The reports were in the form of presentations to the committee. These reports dealt with the four domains developed per equipment type.

8.8 REPORTS SUBMITTED BY IONT TO THE MINISTERS' COMMITTEE

8.8.1 Meeting of the Ministers' Committee held on 20 January 1999

8.8.1.1 During this meeting, IONT made a presentation and informed the committee that initial discussions with project teams indicated a possible increase in the overall procurement costs presented to Cabinet on 18 November 1998.

8.8.1.2 These increases in costs were directly related to the technical performance of the equipment and the programme management costs associated with equipment acceptance. DoD then undertook to ensure that all the technical performance-related costs would be accommodated within the programme costs as approved by Cabinet on 18 November 1998. However, DoD proposed that all the programme management costs should be addressed outside the approved SDP procurement costs.

8.8.1.3 It was recommended by the committee that all NIP, DIP, technical and financing discussions should proceed concurrently by the negotiating team members and that the Ministers' Committee should be briefed timeously to give guidance and direction.

8.8.1.4 The Ministers' Committee had to be consulted and briefed at all the major milestones of the negotiating process. This would include issues relating to the affordability and the structuring of the SDP. Final contracts would only be concluded with the respective bidders after approval had been obtained from the Ministers' Committee.

8.8.2 Meeting of the Ministers' Committee held on 26 May 1999

8.8.2.1 The Chief Negotiator presented a status report during this meeting. This report included the reports on all the domains except finance.

- 8.8.2.2 It was explained to the chairperson that the finance report was still being considered by the Department of Finance and that it would be available to the negotiating team shortly.
- 8.8.2.3 The Chief Negotiator informed the meeting of the progress on all the packages and the target dates for each package.
- 8.8.2.4 He recommended to the Ministers that the decision to defer the requirements for the ALFA should be re-considered. The Ministers decided to defer the Gripen decision and to allow the negotiating team to try to conclude a single contract with BAe for Hawks and Gripens.
- 8.8.2.5 The Chief Negotiator also recommended that, in view of the fact that the Minister of Defence would be leaving public office, the Minister be allowed to initial the submarine contract at a press conference. This was to mark his role as the initiator of the defence packages.
- 8.8.2.6 Only Mr Naidoo and Mr Shaik (secretary of the meeting) signed the minutes of the meeting.
- 8.8.3 Meeting of the Ministers' Committee held on 31 August 1999**
- 8.8.3.1 The Chief Negotiator presented the recommendations of IONT with regard to the affordability of the Defence Packages.
- 8.8.3.2 He highlighted key issues for further consideration by the Ministers. The re-introduction of the Gripen aircraft as a tranching option was discussed and its implications for the SAAF fighter capability were noted. IONT proposed three tranches for both Hawks and Gripens. He stated that the decision to separate tranches 2 and 3 from the initial approval of the "core" requirement was largely due to the unpredictability of the exchange rate and growth rate over a 10 to

15 year period. The approach also allows government to re-address the issue of the affordability of the total fighter aircraft requirement at a later stage if economic conditions deteriorate.

- 8.8.3.3 Three cost scenarios were used to do the affordability modelling, with each scenario having its own risk factors and multipliers.
- 8.8.3.4 Mr Naidoo advised the committee of the possible risk associated with the communication of the government's intent to acquire military equipment above the R16,5 billion expenditure level and the timing of such an announcement.
- 8.8.3.5 The Ministers' Committee recommended that the R21,6 billion scenario should be selected as the baseline figure and that the negotiating team should explore further minor reductions to the R21,6 billion option. It also recommended communicating to the international markets the full package requirement of all three tranches at a total cost of R29,9 billion with the option to cancel/acquire tranche 2 in 2003 and to cancel/acquire tranche 3 in 2005.
- 8.8.3.6 The legal position with regard to "option to acquire" vs. "option to cancel" had to be cleared with the Minister of Finance before the next Cabinet meeting on 15 September 1999.
- 8.8.3.7 It was further recommended that the SDP proposals be submitted to Cabinet on 15 September 1999.
- 8.8.3.8 The minutes of the meeting were signed by all the Ministers of the Departments involved.

8.9 THE APPOINTMENT OF EXPERT ADVISORS

8.9.1 The appointment of financial advisors

8.9.1.1 The Department of Finance approached seven institutions to submit bids for the provision of financial advisory services to IONT. A selection committee was appointed consisting of Messrs R White, A Donaldson and K Kruger.

8.9.1.2 The task of the selection committee was to rank all bidders, with the bidders scoring highest being the preferred bidder. After this exercise the committee submitted their recommended bidder to Armscor for the conclusion of a contract. The recommended bidder was Warburg Dillion Read.

8.9.1.3 A contract was entered into between Armscor and Warburg Dillion Read to provide financial advice to the Department of Finance. Therefore, prescribed Armscor tender procedures should have been followed.

8.9.1.4 Although Armscor tender procedures were not followed, the process adopted by DoF for the appointment of the financial advisors appears reasonable.

8.9.2 The appointment of legal advisors

8.9.2.1 According to the terms of reference of IONT, they needed experts to assist them in legal matters.

8.9.2.2 Armscor was the acquisition agency of the DoD. Funds for the provision of IONT personnel requirements were made available from the Special Defence Account. Armscor was obliged to follow its tender procedures when briefing legal advisors for IONT.

8.9.2.3 Armscor sent ten (10) proposals to law firms/legal advisors. Five legal firms submitted proposals, and the other five did not respond.

8.9.2.4 White and Case, one of the firms that were requested to submit proposals, was appointed.

8.9.2.5 Although the Armscor tender procedures, as prescribed in policy document STD 20 were not adhered to, the process followed appears reasonable.

8.10 THE CONTRIBUTION OF IONT

8.10.1 The improvement of the NIP system and establishing the credibility record of Industrial Participation.

8.10.1.1 During the public phase of the investigation, there was evidence that IONT had found that the industrial participation part of the tenders had certain deficiencies that allowed a contractor to exaggerate the proposed benefits, which was to the disadvantage of the people of South Africa. With the consent of the Department of Trade and Industry, IONT amended the NIP system with regard to the SDP. A 1:1 ratio between NIP plus DIP investments and the contract price was targeted. These improvements required the preferred bidders to improve on their offers significantly above the tender requirements. This was eventually achieved by agreement with them. IONT's negotiations in this regard produced NIP commitments that were improved by more than 100% and of a higher quality.

8.10.1.2 Together with the DIP investments it has the potential of creating an estimated 40 000 to 65 000 direct job opportunities over a 15 year period. Up to June 2001 an estimated 1300 jobs have already been created.

8.10.1.3 According to Mr Naidoo, studies conducted by IONT found sufficient evidence that, where there is a basic industrial and economic capacity to carry out such projects and where there is strategic direction to the projects, they will succeed. Countries such as Switzerland, Finland and the United States of America had very good experiences in this regard. The danger in these projects is to attempt to implant an industrial process into an economy that cannot support it. South Africa is becoming an extremely competitive manufacturing industrial economy and the projects offered as part of the procurement of the SDP fit perfectly into that mould. IONT also researched the record of delivery of the preferred bidders pertaining to industrial participation and could find no evidence of failure.

8.10.2 The financing contracts

8.10.2.1 According to the evidence, each offer for the supply of military equipment was accompanied by a financing package to fund the purchase. As far as the preferred bidders are concerned, their offers included financing the total contract in the form of foreign currency offshore loans consisting of:

- (a) Export finance officially supported by the Export Credit Agency of the supplying country (ECA loans).
- (b) Foreign commercial credits at normal market rates and terms (commercial loans).

8.10.2.2 The main objectives of IONT in this regard were to raise the ECA loan coverage to cover the total imported content of the packages; to avoid commercial loans and to achieve the best currency and interest rate options.

8.10.2.3 The result of these negotiations, according to Mr Naidoo, was that 100% of the imported content of the packages would now be covered by ECA loans, which

created a substantial cash flow benefit for the Government. The South African Government can also choose to effect payments in different currencies, depending on certain formulas. The currency used in most of the contracts is Euro. These improvements in the financing arrangements will result in a significant saving for the South African Government.

8.10.3 The review of defence equipment

8.10.3.1 Mr Naidoo testified that IONT consulted extensively with the Chiefs of the arms of service, the Chief of the SANDF and the Minister of Defence on the need for the defence equipment under consideration, the timing of these needs, alternative approaches to meeting these needs and the requirements of an affordable package. Having considered these matters, IONT recommended to the Ministers' Committee in May 1999, that the procurement of the ALFA be deferred. The basis for this recommendation was that the SAAF, at the time of the negotiations, still had a number of Cheetah fighter aircraft that could operate effectively until 2012. From a financial point of view, the view was held that there was a currency risk associated with procuring the Gripen in advance of requirements. The possibility that better priced alternatives might become available at the appropriate time was also considered.

8.10.3.2 However, cognisance was also taken of the fact that the planned procurement of the Gripen would generate significant industrial participation benefits for South Africa.

8.11 COMPARISON OF COSTS PRESENTED TO CABINET AND CONTRACTED COSTS

8.11.1 Corvettes

8.11.1.1 A comparison of the cost presented to Cabinet and the contracted cost pertaining to the Corvettes indicated that the amount presented to Cabinet on 18 November 1998 was R6 001 million. The cost presented to Cabinet on 15 September 1999 was R6 917 million. The difference in the cost was due to the non-inclusion of all the elements of the cost when presented to Cabinet on 18 November 1998. The complete cost elements are set out below.

- (a) Statutory costs, which consist of items such as freight, insurance and taxes. The largest portion is incurred in South Africa.
- (b) Project management costs incurred by the DoD and Armscor in managing the procurements.
- (c) Financing costs for deferring payments to suppliers so as to fit more closely into an optimum cash-flow schedule.
- (d) ECA premium, which is payable on all ECA-backed loans.
- (e) Escalation on all of the above payments made in future years.

8.11.1.2 Cabinet Memorandum No 14 dated 25 November 1999, was submitted to seek approval to contract formally with the preferred bidders. A set of costs was annexed to the memorandum. These costs were as follows:

	Sept 1999 R million	Nov 1999 R million
Tender price	5 469	5 412
Statutory and project management cost	1 030	1 010
Financing preferred cash flow	164	171
ECA premium	254	280
TOTAL	6 917	6 873

The reduction in the costs was primarily due to the reduction of the tender price from R5 469 million to R5 412 million because of the negotiations.

8.11.1.3 The contract price for the four Corvettes amounted to Euro 611 842 759 for foreign cost components, plus R1 496 227 105 for local cost components.

8.11.1.4 Converting from Euro to Rands using the exchange rate of R6.40 = 1 Euro, the foreign cost components amounted to R3 915 793 657,60 (611 842 759 x 6.4). The total contract price in Rand amounted to R3 915 793 657,60 + R1 496 227 105 = R5 412 020 762,60.

8.11.1.5 The actual contract price of the four Corvettes is equal to the tender price of R5 412 million included in the presentation attached to Cabinet Memorandum No 14 dated 25 November 1999.

8.11.2 LIFT and ALFA

8.11.2.1 With regard to LIFT and ALFA the following amounts were presented to Cabinet:

Equipment	Cabinet 18 November 1998 R6.25=US\$1 Rm	Cabinet 15 September 1999 R6.25=\$1 Rm
LIFT (24)	4 728	-
ALFA (28)	10 875	-
LIFT & ALFA (tranché)	-	15 772
Total	15 603	15 772

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8.11.2.2 In November 1998, the program cost presented to Cabinet for the LIFT and ALFA was R15 603 million and on 15 September 1999, when the program cost was presented to Cabinet, it was R15 772 million. It is important to note that the LIFT and ALFA programmes were tranced in 1999.

8.11.2.3 A schedule of cost was attached to Cabinet Memorandum No 14 dated 25 November 1999, and the following breakdown of costs was reflected:

	Sept 1999 Rm	Nov 1999 Rm
Tender price	12 711	12 711
Statutory and project management cost	2 445	2 557
Training equipment	616	648
TOTAL	15 772	15 916

The increased cost was in respect of increased statutory costs, project management and the training equipment.

The purpose of the memorandum was to seek approval to increase the program cost from R15 772 million to R15 916 million. The cost, as presented to Cabinet in November 1998, did not take into account all the elements as described above for each and every package.

8.11.2.4 During the negotiations by IONT, some of the essential functionalities of the aircraft in the LIFT and the ALFA packages had been excluded, thereby causing a reduction of the program cost. The cost of these items will have to be funded outside of the approved SDP.

8.11.2.5 The contract price is R13 359 million, which is equal to the tender price, plus the training equipment indicated in the table in paragraph 8.11.2.3.

8.11.3 LUH

8.11.3.1 A comparison of the costs for the LUH presented to Cabinet on 18 November 1998 and on 15 September 1999 is detailed below:

Equipment type	November 1998 Rm	September 1999 Rm
LUH (40)	2 169	-
LUH (30)	-	1 949

8.11.3.2 On 18 November 1998, Cabinet approved the procurement of 40 LUH at a program cost of R2 169 million. During the presentation to Cabinet on 15 September 1999, the number of LUH was reduced to 30 at a cost of R1 949 million.

8.11.3.3 The breakdown of costs as presented to Cabinet during September 1999, is as follows:

	Rm
Tender price	1 503
Statutory and program management cost	397
Financing preferred cash flow	0
ECA premium	49
Total	1 949

In Cabinet memorandum No 14 dated 25 November 1999, the cost was stated as follows:

	Rm
Tender price	1 503
Statutory and program management cost	400
Financing preferred cash flow	11
ECA premium	51
Total	1 965

8.11.3.4 The above mentioned difference between the cost presented on 15 September 1999, to that reflected on Cabinet Memorandum No 14 of 25 November 1999,

is due to the increase in the statutory cost and project management, financing preferred cash flow and ECA premium.

8.11.3.5 The final contract price for 30 LUH was US\$199 778 887. The contract included SACE premiums in US dollars and in South African Rands. The contract price for 30 LUH converted into Rands at a rate of R6.25 = US\$1 amounts to R1 248 618 043.

8.11.3.6 The implementation cost of R176 320 000 was not included in the program cost presented to Cabinet on 15 September 1999. The cost had to be incorporated in the normal SAAF operating budget, for which approval was only sought after the signature of the contract.

8.11.3.7 The difference between the program cost presented to Cabinet on 18 November 1998, and the program cost reflected in Cabinet Memorandum No 14 of 25 November 1999, is due to the reduction in the number of LUH from 40 to 30.

8.11.4 Submarines

8.11.4.1 A comparison of costs as presented to Cabinet during November 1998 and September 1999 respectively, is detailed below:

Equipment type	November 1998 Rm	September 1999 Rm
Submarine (3)	5 212,5	5 354

8.11.4.2 Upon comparing the cost presented to Cabinet with contracted cost, it was found that the amount presented to Cabinet on 18 November 1998, was R5 212,50 million. The cost presented to Cabinet on 15 September 1999, was R5 354 million. The difference between these figures is due to the omission of some elements of costs when presented to Cabinet on 18 November 1998.

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8.11.4.3 In Cabinet Memorandum No 14 dated 25 November 1999, the total cost reflected is R5 531 million. This increase in the cost was in respect of increased statutory and project management cost, financing cash flows and the ECA premium as indicated in the table below:

	Sept 1999 Rm	Nov 1999 Rm
Tender price	4 226	4 226
Statutory and project management cost	744	752
Financing preferred cash flow	97	197
ECA premium	287	356
TOTAL	5 354	5 531

8.11.4.4 The actual contract price of the three submarines was equal to the tender price of R4 226 million included in the presentation on 15 September 1999 and Cabinet Memorandum No 14 dated 25 November 1999.

8.12 FINDINGS

8.12.1 IONT was mandated by Cabinet to negotiate an acceptable funding arrangement and an affordable package with the preferred suppliers. Mr J Naidoo was appointed during November 1998, as the Chief Negotiator of IONT, representing the Office of the Deputy President.

8.12.2 The final terms of reference of IONT were approved by the Ministers' Committee on 26 May 1999.

8.12.3 In accordance with its terms of reference, IONT briefed legal and financial experts.

8.12.4 From the investigation it is clear that IONT made a positive contribution to improving the overall procurement process and its outcomes. However, it is not possible to make a conclusive finding on the total impact of IONT, because:

- Some functionalities of the packages were removed.
- The quantity of equipment for the LUH programme was reduced.
- Certain costs, for example management and statutory costs, had not been included in the presentation to Cabinet.

8.12.5 The negotiations conducted by IONT were not always minuted or recorded.

8.13 RECOMMENDATIONS

8.13.1 It should be prescribed that all procurement processes, including negotiations with preferred bidders, are properly documented to ensure a proper audit trail.

8.13.2 DoD should take steps to ensure that good procurement practices are adhered to and that compliance with the prescribed tender procedures is strictly controlled.

8.13.3 An approved negotiation strategy and terms of reference should be in place prior to the commencement of negotiations.

8.13.4 Proper consultation and an impact study should be done before equipment types or functionalities are reduced.