

## CHAPTER 9

### COST TO STATE AND THE FINANCIAL AND FISCAL IMPLICATIONS OF THE STRATEGIC DEFENCE PACKAGES

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## CHAPTER 9

### COST TO STATE AND THE FINANCIAL AND FISCAL IMPLICATIONS OF THE STRATEGIC DEFENCE PACKAGES

#### 9.1 THE PUBLIC PHASE OF THE INVESTIGATION

##### 9.1.1 The involvement of the Department of Finance and the Affordability Team

9.1.1.1 From the evidence presented to the Public Protector during the public phase of the investigation, it appeared that the former Department of Finance (now National Treasury) was requested in June 1998, by SOFCOM to assist in the evaluation of financing offers that were received as part of the tenders for the SDP. The evaluations were done in terms of a value system developed by Armscor. Two officials of the Department of Finance assisted in completing the evaluation score sheets that were subsequently used by Armscor's finance team to calculate the financing index for each of the offers for the supply of equipment.

9.1.1.2 In November 1998, a Senior Manager of the Department of Finance, Mr R White, was asked to join IONT, representing the Department of Finance. The decision regarding his involvement was taken at ministerial level. At first, Mr White's task within IONT was to head the finance negotiations working group which had the responsibility of looking into loan and financing agreements.

9.1.1.3 In March 1999, the Ministers' Committee decided to establish a separate Affordability Team to look into the issues of the affordability of offers, alongside IONT. Mr J Naidoo, who was also the Chief Negotiator of IONT, headed the Affordability Team.

# Strategic Defence Packages

## Joint Report



- 9.1.1.4 The Affordability Team was assisted by internationally renowned experts in the field of financial strategy and the European export credit market. They were also assisted by an international firm of attorneys who looked after the legal issues pertaining to agreements. The output of this team was an extremely favourable set of loans for the South African Government to acquire the SDP. These agreements eliminated the need for Government to borrow any hard currency on commercial terms. What was achieved by the Affordability Team and IONT in this regard is unprecedented in the international credit market. It ultimately means that the loans agreed to would be a great deal cheaper with substantially lower risk to Government. A saving of over R600 million, in 1999 prices, was achieved in this regard.
- 9.1.1.5 The assessment of the affordability of the SDP, involved devising methods to increase affordability and assessing the budgetary and financial implications and fiscal impact of the proposed acquisition. The Affordability Team, was in this regard, also assisted by the Bureau of Economic Research of the University of Stellenbosh. The final affordability assessment was submitted to the Ministers' Committee in August 1999. It was a voluminous document that dealt comprehensively with all the relevant issues. It also superseded all previous reports and inputs that were submitted on the matter of affordability. It sufficiently equipped the Ministers concerned to make a properly informed decision, as far as issues of affordability were concerned. Affordability is ultimately a question of political choice. The task of the Affordability Team was not to make that choice, but to enable the ultimate decisionmakers to make a well-informed choice about what the country could and could not afford.
- 9.1.1.6 The procurement of the services of experts to assist the Affordability Team was ultimately the responsibility of Armscor. However, the Department of Finance assisted in selecting candidates that had a history of exposure specifically with regard to the European export credit market.

- 9.1.1.7 As far as the impact of industrial participation benefits is concerned, the Affordability Team took into account a certain percentage of risk that all of these benefits would not materialise. The risks pertaining to the economic impact of the procurement were also dealt with in some detail. Different scenarios were thus considered in the economic analysis that was submitted to the Ministers' Committee as part of the affordability assessment of August 1999. However, it was not the intention to evaluate all the possible scenarios as the many variables of the packages made it virtually impossible. The purpose of referring to some scenarios was only to alert the decisionmakers to what may happen under certain circumstances.
- 9.1.1.8 The affordability assessment dealt with additional expenditure to be financed, but not the cost of financing. Financing costs do not form part of the expenditure of DoD on the SDP, but are accounted for as "state debt costs" and charged against the National Revenue Fund.
- 9.1.1.9 The depreciation of the Rand against other major currencies will cause the cost of the procurement to escalate. The Ministers' Committee was made fully aware of this risk by the Affordability Team in August 1999, and was fully satisfied with the report submitted to them.
- 9.1.2 **The total cost of the procurement**
- 9.1.2.1 According to the evidence, the cash price of the procurement at the time of the signing of the contracts (3 December 1999) was R30 300 million. This figure differed substantially from the cost estimates that were submitted to Cabinet in November 1998, as those figures did not include a number of items such as freight insurance, taxes, project management costs, financing costs and loan premiums.

- 9.1.2.2 The cost estimates that were submitted to the Ministers' Committee in August 1999 were done on two different bases. The first assumed a Rand exchange rate at the August 1999 rate to calculate a nominal or cash price. That is the cost should a single payment be made at the time of the signing of the contract.
- 9.1.2.3 The second cost estimate was calculated taking into account the risk that the Rand could depreciate in real terms over the duration of the procurement period. There are a number of currencies involved in the procurement, such as Euro, Pounds and US Dollars. This cost estimate was based on a proven scientific model and its purpose was to alert the Ministers' Committee to the possible impact of future Rand weakness on the aggregate cost of the procurement. Its calculation was based on a depreciation of the currency along the market forward exchange rate curve, which exceeds the likely inflation differential between South Africa and the supplier countries, resulting in an increase in the present value of the contractual commitments.
- 9.1.2.4 The commitment to industrial participation by the contractors is also in foreign currencies, which means that when the Rand depreciates against them, the Rand value of the counter investments increases.
- 9.1.2.5 The Ministers' Committee regarded the affordability assessment that was presented to them by the Affordability Team in August 1999, as a professional and very precise document that could be relied on. The contents of the assessment and the implications of the cost of the procurement were extensively debated and considered. These debates and considerations included issues such as the risk of the depreciation of the Rand against other currencies over the life of the contracts, the risk of interest rate increases in the economy and the risk of non-performance by contractors in relation to industrial participation commitments. These issues were fully addressed in the risk analysis that was submitted to Cabinet in October 1999.

## 9.2 THE FORENSIC INVESTIGATION BY THE AUDITOR-GENERAL

### 9.2.1 Scope of the investigation

9.2.1.1 To determine the costs presented to Cabinet and the basis on which Cabinet took the decision to approve the expenditure, including the contents of any reports on the assessment of the impact of the procurement on the economy and its affordability.

9.2.1.2 To determine whether the amounts calculated by the model used in the affordability assessment are reasonable and reliable, taking into account that this formed the basis for the decision taken by Cabinet.

9.2.1.3 The macro-economic and other assumptions and variables used.

9.2.1.4 The completeness of the model used.

9.2.1.5 The treatment of the financing charges.

9.2.1.6 The full financial and fiscal implications of the SDP.

### 9.2.2 Procedures performed

9.2.2.1 The minutes of the AASB, AAC, CoD, and the Ministers' Committee were perused to ascertain the cost as presented to it.

9.2.2.2 Presentations to Cabinet were perused to ascertain the cost presented to it and the affordability report was studied.

9.2.2.3 Various consultations were conducted with relevant role players in order to understand the calculated cost of the procurement at various stages.

9.2.2.4 Two independent economists were appointed to assess the reasonability and appropriateness of the models used by the Affordability Team.

### 9.2.3 Evidence obtained

#### 9.2.3.1 *Presentation made to the AASB on 8 July 1998*

SOFCOM was tasked with the consolidation of the evaluation results pertaining to the SDP made in the presentation to the AASB on 8 July 1998. The costs presented, according to the minutes, included all applicable costs, and were based on quantities other than those eventually contracted for in respect of some programmes. The AASB resolved not to make any pronouncement on the presentation, but that the Minister of Defence and AAC should be advised of the progress. The total costs presented to the AASB included the financing costs, which were in respect of all the bidders. The details of the costs presented are dealt with in paragraph 9.2.3.2.

#### 9.2.3.2 *Presentation made to the AAC on 13 and 16 July 1998*

(a) The presentation made to the AASB on 8 July 1998 was also made to the AAC on 13 July 1998, with the latter presentation including an additional spreadsheet detailing the costs pertaining to the successful bidders. The total amount presented was US\$10 761,10 million, which was made up of US\$7 273,5 million in programme costs and US\$3 487,6 million in finance costs. These costs were based on the selection of the Aermacchi MB339FD for the LIFT programme. If the BAe Hawk were to be selected, the total cost would have been US\$11 402,5 million, comprising US\$7 652,3 million and US\$3 750,2 million in programme costs and financing costs, respectively. No Rand equivalent was mentioned in the presentation or the minutes.

- (b) During a meeting of the AAC on 16 July 1998, the chairman ruled that the negotiations should proceed without eliminating any of the contenders or exposing the results.

### 9.2.3.3 *CoD meeting of 21 August 1998*

At this meeting, Mr S Shaik, the Chief of Acquisitions of DoD, informed CoD that the total package deal, excluding financing charges, amounted to R66 718 million. This amount did not account for the elimination of the main battle tank (MBT) programme and the reduction of quantities on other programmes. The amount is based on cost of US\$10 761,10 million referred to in paragraph 9.2.3.2. In a response received by the investigation team from the Government it was stated that this financial cost was a first level attempt to estimate the cost of financing without any hedging or alternative repayment structures.

### 9.2.3.4 *Ministerial briefing on 31 August 1998*

A special ministerial briefing was held on 31 August 1998, at which the cost of the SDP was presented by the co-chairperson of SOFCOM, Mr Shaik. The cost presented was R27 406,3 million, based on the selection of Aermacchi MB339FD as the LIFT, and R29 773,8 million, based on the selection of the BAe Hawk as the LIFT. The Rand/Dollar exchange rate used in the presentation was US\$1 = R6.25, which resulted in dollar amounts of US\$4 385 million and US\$4 763,81 million, respectively. These amounts were programme costs and were exclusive of financing costs. The difference between the amounts in paragraph 9.2.3.2 and those above is due to:

- (a) The inclusion of the amounts of the MBT on 13 July 1998 which amounts were excluded on 31 August 1998.

- (b) The inclusion of four submarines on 13 July 1998, and only three on 31 August 1998.
- (c) The probable difference in exchange rates between the two dates.

### 9.2.3.5 *Presentation to Cabinet on 18 November 1998*

A presentation was made to Cabinet on 18 November 1998, with the objective of obtaining approval for the recommendation of the preferred bidders and for DoD, DTI and DoF to enter into contract negotiations. The total programme cost of the SDP indicated in this presentation amounted to R29 773,13 million. This cost did not include the financing costs of the SDP. Cabinet resolved that the proposals of the preferred bidders be accepted in the interim, and that DoD, DoF, Department of Public Enterprises and DTI should proceed with further detailed negotiations with the preferred bidders to achieve affordable agreements.

### 9.2.3.6 *Affordability report of 31 August 1999*

- (a) An "*Affordability of the Defence Strategic Armaments Packages*" report was compiled and issued by the Affordability Team of IONT on 31 August 1999. The report consisted of an assessment of the SDP's economic, fiscal and financial impacts. The total cost of the procurement according to the report, comprised:
  - (i) The contract price, which is the actual military equipment as procured from the suppliers.
  - (ii) Statutory costs, consisting of freight, insurance and taxes.

- (iii) Project management costs incurred by DoD and Armscor in managing the procurements.
  - (iv) Financing costs for deferring payments to suppliers.
  - (v) ECA premiums which are payable on all ECA-backed loans.
  - (vi) Escalation on all of the above payments made in future years.
- (b) According to paragraph 2.1.2 of the affordability report, the costs as presented to Cabinet in November 1998, did not take into account all the elements as described above for each and every package. The report further states that *"consequently the total full cost is substantially higher than that originally presented to Cabinet"*. The total cost indicated in the affordability report as at August 1999 at an estimated forward exchange rate, is:

Equipment Type	Quantity	Costs Aug 1999 (Fwd fx rate estimate) Rm
Submarines	3	6 088
Corvettes	4	7 361
Maritime Helicopter	4	967
Light Utility Helicopter	40	2 446
Lead-in-fighter trainer (LIFT)	24	5 469
LIFT & ALFA- Tranche 1	12 & 9	8 502
LIFT & ALFA- Tranche 1,2,3	24 & 28	19 620
<b>Total – Excl Gripen</b>		<b>22 331</b>
<b>Total – Tranche 1 only</b>		<b>25 364</b>
<b>Total – Tranche 1, 2 &amp; 3</b>		<b>36 482</b>

- (c) According to the report, the amounts above include all known costs as outlined above.

### 9.2.3.7 Briefing of the Ministers' Committee on 31 August 1999

According to the minutes of the above meeting, the recommendations were the following:

- (a) The scenario of some R21,6 billion was selected as the baseline figure. It should be stated that it is not indicated in the minutes whether this figure includes financing costs or not. The amount, however, appears to include project management, ECA premium and statutory costs and is based on tranche 1 only. This conclusion is based on the comparability of the baseline figure with the tranche 1 figure.
- (b) The cost of the full package requirement of all three tranches was R29,9 billion, with the option to cancel/acquire tranche 2 and 3 in 2002 and 2004, respectively to be communicated to the international markets. The above figure also excludes financing costs.
- (c) The negotiation team should further explore a minor reduction to the R21,6 billion option.
- (d) The legal position with respect to "option to acquire" vs "option to cancel" should be cleared with the Minister of Finance before the next Cabinet meeting on 15 September 1999.
- (e) The negotiating team should conclude the final set of agreements with the respective suppliers for contract signature.
- (f) The recommendation of the Ministers' Committee on the SDP should be tabled in Cabinet on 15 September 1999.

### 9.2.3.8 Cabinet briefing on 15 September 1999

- (a) On 15 September 1999, Mr J Naidoo, the Chief Negotiator of IONT, briefed Cabinet on the SDP's affordability. According to the minutes, Cabinet approved that the total price for the equipment should amount to R29 992 million. This total amount includes two options to cancel - decisions to be taken by the Government in 2002 and 2004.
- (b) According to the minutes, Government was further committed to the respective suppliers for tranche one only at this stage at a cost of R21 330 million. The amount of R21 330 million does not include financing costs.

### 9.2.3.9 Cabinet Memorandum No 14 of 25 November 1999

In terms of the memorandum mentioned above, the cost of the equipment package was R22,2 billion over an eight-year period. This was based on the transfer of the leasing of the simulator equipment for the Hawk and Gripen from tranche 2 and 3 to a full purchase agreement in tranche 1. If the option to procure the additional equipment in tranche 2 and 3 was exercised, the total equipment cost would rise to R30,3 billion (the amount is rounded off to the nearest R100 million; the full amount is R30 285 million) over 12 years. The totals include statutory and programme management costs and ECA premium where applicable, but not the financing costs.

### 9.2.3.10 Cabinet decision on 1 December 1999

- (a) On 1 December 1999, Cabinet discussed Cabinet Memorandum No 14 of 1999, dated 25 November 1999, the objective of which was to obtain Cabinet approval to contract formally with the preferred bidders. Cabinet, according to the minutes, granted the permission required by DoD to sign

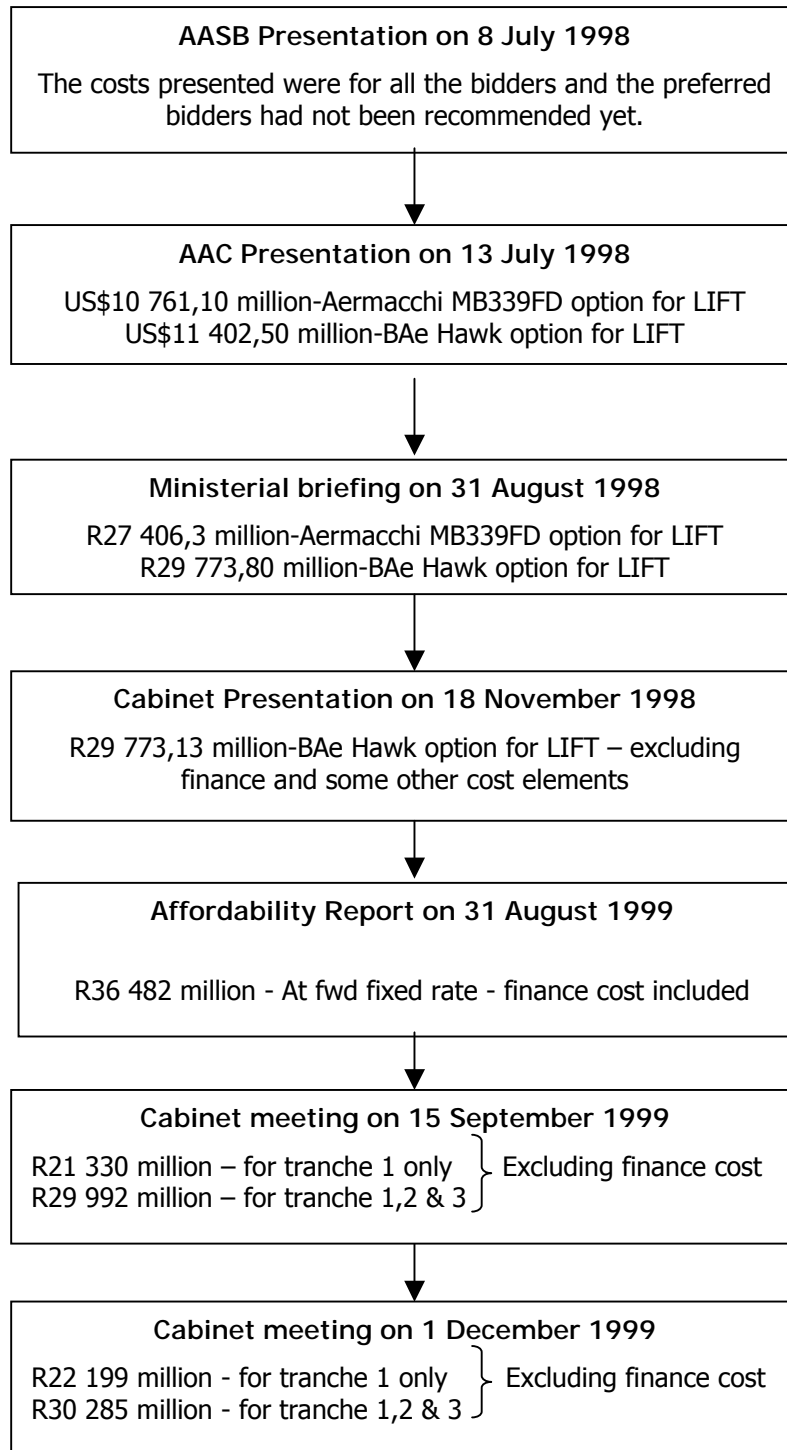
supply, Non-DIP, DIP and umbrella agreements. Cabinet also noted the cost associated with the supply of the defence equipment, to be as follows:

	24/11/99 Rm	15/09/99 Rm
Total Tranche 1 Only	22,199	21,330
Total Tranche 1,2 & 3	30,285	29,992

- (b) The difference in cost between the two columns was mainly due to the transfer of the leasing of the simulator equipment for the Hawk and Gripen from tranche 2 and 3 to a full purchase agreement in tranche 1.

### 9.2.3.11 Graphical Representation of the Costs Presented

A graphical representation of the costs of the SDP presented to the various bodies at the various stages is set out below:



### 9.2.3.12 Reasons for variations in amounts presented

The different amounts presented to Cabinet and the Ministers' Committee are as follows:

	18/11/98 Rm	31/08/99 Rm	31/08/99 Rm	15/09/99 Rm	25/11/99 Rm
Tranche 1 costs	-	25 364	-	21 330	22 200
Total costs	29 773,13	36 482	29 900	29 992	30 300

(a) According to the affordability report the reasons for the differences in the amounts presented on the various dates are the following:

(i) Total costs

- The total costs on 18 November 1998 did not take into account all the elements of costs and are based on real Rand values.
- The total costs on 31 August 1999 (column 3: that is, the costs as per the affordability report) are apparently based on all the elements of costs and are stated at a forward estimated rate of exchange.
- The costs on 31 August 1999 (column 4: that is, costs as per the Ministers' Committee recommendation) as recommended by the Ministers' Committee are apparently based on real Rand values.
- The costs on 15 September 1999 are based on real Rand values.

### (ii) Tranche 1 costs

- The basis for these costs as presented on 31 August 1999, is the same as for the total costs above.
- The basis for these costs as presented on 15 September 1999, is the same as for the total costs above.
- The tranche 1 costs presented on 25 November 1999, are based on the transfer of the leasing of the simulator equipment for the Hawk and Gripen from tranche 2 and 3 to a full purchase agreement in tranche 1; hence the increase.

9.2.3.13 The contract price (cash price) at the date of the signing of the contracts (3 December 1999) was R30,3 billion. This figure was based on real Rand value. Evidence provided by R Adm Verster to SCOPA in October 2000, indicated that this figure would be approximately R43 billion based on the exchange rate at that time. It is on the basis of this statement that the procurement was often referred to as *"the R43 billion arms deal"* in the media. It would be extremely difficult to fix a value because of the continuous fluctuations in the exchange rate.

### 9.2.3.14 *Implications of the Procurements on the Fiscal, Financial and Economic Conditions*

The affordability report compiled by the Affordability Team for submission to the Ministers' Committee on 31 August 1999 included specialised inputs on economic models by the Industrial Development Corporation and the Bureau of Economic Research at the University of Stellenbosch. Inputs by independent experts, Warburg Dillon Read and Locker and Associates were also considered. The assessment of this report with regard to the adequacy

of the information and appropriateness of the financial and economic model used therein was performed by two independent economists during the forensic investigation.

### *9.2.3.15 Reasonability of the financial and economic model used*

Two independent economists were appointed during the forensic investigation to assess the reasonability and appropriateness of the models used by the Affordability Team. The economists were of the view that the models used by the Affordability Team were reasonable under the circumstances. The economists made the following comments:

- (a) Certain errors, such as the accounting for the packages in the national and balance of payments accounts, crept into the assumptions used in the affordability scenarios.
- (b) A substantial impact on affordability that could materialise in future is the unsuccessful restructuring of DoD's budget and the effect on DoD's budget of underestimating the long-term full cost of ownership of the packages.
- (c) The affordability report was presented in a fragmented fashion. The implication of this is that no clear set of low to high-risk scenarios, incorporating as many as possible of the major risk factors was available for evaluation. This limits a clear understanding of the potential future costs and associated risks of the procurement process.
- (d) The general results of the affordability report also highlight the negative effect of unproductive expenditure on military equipment on the economy in general and its impact on government finance in particular.

- (e) The fact that the major elements of the affordability analysis were not available at an earlier stage of the negotiations limits the usefulness of the analysis.
- (f) The impact of expenditure on armaments is generally negative in terms of growth, employment and the budget deficit.
- (g) The industrial participation packages have a potentially positive impact on Gross Domestic Product and employment creation. However, the extent of this is uncertain.
- (h) The model did not include all relevant costs, such as price escalations, cost of negative foreign exchange movements.
- (i) The exchange rate projections by Warburg Dillon Read were found to be overly optimistic. Notwithstanding the benefit of hindsight, no high-risk scenarios relating to exchange rates were factored into the report.
- (j) Very little attention seems to have been paid to the opportunity cost analysis of spending on SDP.

### 9.3 FINDINGS

9.3.1 The costs of the SDP presented to Cabinet on 18 November 1998, amounted to R29 773,13 million that excluded financing costs amounting to 49% of the procurement costs.

9.3.2 The contract price (cash price) of the SDP on the date of the signing of the contracts (3 December 1999) amounted to R30,3 billion.

- 9.3.3 Although two independent economists criticised elements of the financial and economic models used, they confirmed that the model as a whole was reasonable.
- 9.3.4 The model did not include all relevant costs, such as price escalations, cost of negative foreign exchange movements, etc.
- 9.3.5 Certain aspects of the financial and economic model used by the Affordability Team in their presentation to the Ministers' Committee in August 1999, can be criticised to an extent. However, even though there might be different views and models explaining future projected costs and effects, it appears from the investigation that the Affordability Team and IONT took adequate measures under the circumstances to present to the Government a scientifically based and realistic view on these matters. The Ministers' Committee was put in a proper position by the Affordability Team to apply their minds in essence as to the financial impacts of the procurement. Ultimately, the decision as to what the country can and cannot afford is one of political choice.