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Republic of South Africa
Systematic Country Diagnostic

An Incomplete Transition: Overcoming the Legacy of Exclusion in South Africa

Background note

Corporate Governance in South African State-Owned Enterprises

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Introduction

State-owned enterprises (SOEs) play an important role in the South African economy. Since 1994 SOEs have been a significant vehicle for achieving economic growth and poverty reduction. They are especially important vehicles for addressing market failure and for delivering key infrastructure services such as energy, transport, and water that allow the economy to grow while ensuring equity through access and quality of social services to all citizens.

Strengthening their role and performance is a key component of the Developmental State agenda. This agenda addresses the key challenges facing South Africa: high poverty and unemployment levels; skewed distribution and maintenance of infrastructure; unequal distribution of land and capital; and growing disparities between the rich and poor. The Government's New Growth Path (NGP), which sets a target of creating five million additional jobs by 2020, specifically calls on SOEs to play a key developmental role. Other policies such as the National Development Plan (NDP), the Medium-Term Strategic Framework (MTSF), and the Industrial Policy Action Plan also highlight the role of SOEs as major contributors to infrastructure development and to economic restructuring, while the Nine-Point Plan, which outlines Government priorities, includes addressing the electricity challenge and supporting reforms in SOEs. Through these initiatives, the Government's goal is to ensure that SOEs deliver on broader developmental goals and that they support the transformation and competitiveness of the economy.

A Presidential Review Commission (PRC) on SOEs was established in 2014 to examine SOE performance and address the question of whether SOEs are responding appropriately to the Developmental State agenda. The PRC Review provides a detailed analysis of key SOE issues and highlights how attempts to integrate and promote the role of SOEs in the economy have been stymied by the lack of clear policies and by concerns about SOE governance more broadly. Based on a thorough evaluation, the Review highlights several challenges facing SOEs: excessive politicization, multiple and conflicting objectives, inadequate financing policies and framework, lack of adequate oversight and accountability, severe weaknesses in board composition and functioning, and lack of transparency and accountability. Thirty-one recommendations to improve SOE performance are provided. In line with good practice, they focus on: defining and rationalizing the size and scope of the SOE sector, developing a stand-alone SOE law along with a modern state ownership framework, professionalizing SOE boards, imposing financial and fiscal discipline, and improving performance monitoring to enhance transparency and accountability. A key overall recommendation is to develop a coherent SOE plan and strategy anchored in the Developmental State agenda.

The worsening of the South African economy since 2014 has created further pressures to identify additional interventions that will support implementation of the Government's plans. While progress has been made in some areas, more needs to be done to achieve the objectives of infrastructure development and economic transformation. Implementing interventions contained in the NDP and other key policies will be essential to improving the trajectory of the economy. A key intervention is improving the capacity and performance of SOEs that are increasingly viewed as key implementers of the policies. SOE improvements will be crucial to the delivery of basic services and to fostering economic growth, generating employment, and increasing the fiscal space to address inequality.

[1] World Bank

Drawing from the PRC Review, and from other available materials, this Note synthesizes the key issues and recommendations for improving SOE performance, focusing on the largest national level commercial SOEs in infrastructure and other key sectors. Based on available materials, the Note provides an overview of key governance constraints affecting SOE performance and suggests areas for improvement. It begins with a brief review of the size, scope and performance of infrastructure and other key SOEs (Section II). The bulk of the Note focuses on key areas for improving the governance of SOEs (Section III), including: clarifying SOE objectives; establishing a legal/regulatory framework for SOE governance; reforming the state's ownership role; professionalizing SOE boards and management; enhancing the financing capacity of SOEs; and enhancing transparency and accountability by improving the performance monitoring system. The analysis and recommendations draw heavily from the exhaustive PRC Review, but the Note also draws on good practices as per the OECD Guidelines on the Corporate Governance of SOEs and on international experiences. Section IV concludes with a few observations on reform implementation.

Overview of SOEs

As of May 2012, there were approximately 715 SOEs in South Africa at all levels of Government, including commercial and non-commercial SOEs and their subsidiaries. Commercial SOEs include four types of incorporated and non-incorporated entities: (i) state-owned companies (SOCs) operating under the Companies Act, which are the focus of this Note; (ii) state interest companies (SICs) in which the State has a material interest but no control; (iii) statutory corporations (SCs) that provide goods and services of a strategic nature; and (iv) financial intermediaries (FIs). Non-commercial SOEs carry out public functions and include research entities, regulatory entities, and advisory bodies. Together the asset base of all SOEs is reported to be over R1 trillion, equivalent to about 27 percent of GDP.[2]

The most important commercial SOEs are the 20+ SOCs at the national level (Schedule 2 of the 1999 Public Finance Management Act, PFMA) and the 14 water boards and water companies (Schedule 3b of PFMA). These SOEs play a significant role in the economy, contributing more than 8.5 percent of GDP and maintaining networks and services in key sectors such as infrastructure, finance, national security, and social sectors. Key among infrastructure SOEs are Eskom, Transnet, Water boards, Airport Corporation of South Africa (ACSA), South African Airways (SAA), and SANRAL (roads, a statutory corporation under Schedule 3a of PFMA). Other SOEs in the group include: (i) financial SOEs including Development Bank of South Africa and the Land and Agricultural Bank; (ii) SOEs in the national economic security space including Denel (defense), Central Energy Fund (CEF), PetroSA, Armscor, and Trans-Caledon Tunnel Authority (TCTA); and (iii) social and developmental SOEs including the South African Post Office (SAPO), Post Bank, South African Broadcasting Corporation (SABC), and South African Forestry Company Limited (SAFCOL).

Commercial SOEs as a whole have had mixed performance results. The PRC Review for the period 2006-2010 shows that the overall performance of commercial SOEs in terms of revenue and profits was positive but return on assets was low. During this period, total aggregate revenue grew by a compound annual growth rate of 6.9 percent, while the average net profit margin was 13.8 percent, although it falls to 2 percent when the proceeds in 2010 from the unbundling of Vodacom are excluded. Return on assets was low, with an average of 0.7 percent. A few SOEs delivered significant returns, but others performed poorly and incurred losses. Among the profitable SOEs were Transnet, CEF, DBSA, and SAPO. However, SAFCOL and SABC made significant losses for two of the five years, SAA had two years of losses, and Denel and Alexkor incurred losses all five years.

For Schedule 2 SOEs that are exposed to commercial discipline and stakeholder oversight, the achievement of strategic objectives was significantly better than Schedule 3b SOEs. But performance in general shows

[2] Budget 2016: Clampdown on SOEs, 2/25/2016. Newspaper article….[full citation to be provided]

that there is scope for SOEs to become more effective. Engagement with customers and the private sector indicated dissatisfaction with SOEs' service delivery while levies and fees kept growing. For example: In transport, where Transnet and SANRAL are major players, addressing the costs of transport is critical for export success but inefficiencies combined with access and pricing policies and delays in the ports and rail network have eroded the competitiveness of exporters and negatively affected trade. Inefficiencies stem from: underinvestment; fragmented regulatory framework and lack of competitive pricing due to the absence of an economic regulator for rail (Transnet sets its own tariffs and performance standards monitored by the DPE through the shareholder compact); weak institutional structure; and a monopoly in the rail and port network and resultant cross-subsidization between Transnet's operating divisions;3 and

In energy, Eskom, a vertically integrated utility company providing 96 percent of South Africa's electric power needs, construction delays and deferred maintenance have led to a decline in capacity which in turn have weakened its financial situation. Moreover, not all costs are covered by tariffs. Heavy borrowings and limited liquidity have further compounded Eskom's financial situation, while a lowered credit rating in November 2014 limited Eskom's access to capital markets. One of the factors that resulted in the lower credit rating was a weakening of Eskom's corporate governance following the resignation of the Chairperson of the board and the suspension of senior executives.

The Government has implemented various developmental and transformation policies, strategies, and programs through SOEs aimed at overcoming economic inequalities and underdevelopment but performance challenges remain. SOEs are expected to provide capital for the attainment of BEE objectives, but the PRC Review indicates that BEE programs have not worked optimally, which has led to the enactment of the B-BEE Act and the establishment of the B-BEE Advisory Council to provide leadership and direction for implementation. While SOEs are aware of their role in supporting social, economic and political objectives, financial and resource constraints are an impediment to achieving results on the ground. Operational and financial challenges affect SOE performance but there is growing recognition that weak governance frameworks and practices are the root cause. SOE performance is hindered by the lack of technical skills; lack of financing capacity to sustain operations; inadequate infrastructure; and lack of long-term planning. To this end, efficiency or productivity improvement programs need to be put in place to enable SOEs to achieve their objectives. At the same time, the key issue is one of governance—i.e. the underlying rules, processes, and institutions that govern the relationship between SOEs and government as their owner/shareholder. Run more like government departments rather than as efficient, autonomous, and professionally run enterprises, SOEs typically face governance problems that include: (i) multiple and competing objectives, such as balancing commercial and developmental objectives outside their core mandate and preventing interference in SOE management; (ii) lack of a clearly defined state ownership framework combined with a decentralized and heavy oversight structure; (iii) politicized boards and management with rising levels of corruption; (iv) uncertainty on funding strategies and tariff policies resulting in lack of financial sustainability for SOEs; and (v) lack of a proper performance management system and disclosure practices to ensure transparency and accountability.

Improving governance frameworks and practices will be key to achieving better SOE performance and to realizing the broader goals of infrastructure development and economic growth. Improved governance should help SOEs access commercial financing for investments and growth through the capital markets and become financially sustainable. Better governed SOEs would also make it easier to attract private sector participation and investment in SOE operations, especially in critical sectors such as energy where the Government has committed to implement sustainability and profitability reforms. And by improving SOE performance, good governance should help SOEs deliver on the State's developmental goals. As discussed in Section III below, improving SOE governance will require addressing the following key areas:

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[3] Piertse, Duncan, Thomas Farole, Marin Odendaal, and Andre Steenkamp, 2016. "Supporting Export Competitiveness through Port and Rail Network Reforms: A Case Study of South Africa." World Bank Group. Trade and Competitiveness Practice.

- Clarifying SOE objectives;
- Improving the legal and regulatory framework for SOE governance;
- Strengthening the State's role as owner/shareholder;
- Professionalizing SOE boards and management;
- Promoting the financial sustainability of SOEs; and
- Enhancing the transparency and accountability of SOEs.

Key Areas for Improving SOE Governance

Clarifying SOE Objectives

OECD Guidelines and international practices show that many countries are taking steps to clarify their objectives and formalize the treatment of any developmental goals or public service obligations (PSOs) required of SOEs. SOEs typically have both commercial objectives and broader public policy objectives but balancing these goals can be difficult and lead to negative effects on efficiency and performance. Pursued through SOEs rather than through regular budget channels, PSOs typically include: providing basic services to underserved communities; offering services at a price below cost; promoting industrialization; generating employment; and supporting social transformation. While such PSOs reflect the State's policy and developmental goals, they create conflicts for SOEs as they are usually not explicitly defined and are included as part of the SOE's overall commercial activities. Several problems arise as a result: (i) the cost and funding are borne by the SOE rather than the budget; (ii) decisions about the funding of PSOs are not rigorous and are seen as implicit subsidies that reduce SOE efficiency and impose a fiscal burden on government; (iii) PSOs may lead to losses and be cross-subsidized by other SOE operations; (iv) PSOs make it difficult to monitor and assess the SOE's commercial performance; and (v) budget transfers to SOEs may crowd out more effective public spending for disadvantaged groups.

As in other countries, South African SOEs have faced challenges in balancing commercial and non-commercial objectives. The PRC Review highlights several factors that have led to difficulties. There is no clearly defined policy guidance for the treatment of PSOs, leading to the use of non-standardized approaches across various ministries. Performance assessment of public policy objectives is also not standardized and output indicators for developmental objectives are not clearly defined. A heavy oversight structure with multiple internal and external stakeholders has further weakened performance oversight. Lack of clearly articulated output indicators for SOEs, particularly those of a developmental nature, and ad hoc collaboration between ministries and SOEs has further compounded the difficulties in balancing the competing objectives. As a result, SOEs have tended to focus more on managing commercial objectives in line with return requirements while ignoring longer-term developmental goals.

Developing clear policy guidance will be essential to help SOEs balance commercial and non-commercial objectives. The development of a PSO policy is a key recommendation of the PRC Review. A first step is to review the mandate and goals of SOEs as these may have changed in line with changing government priorities. Enhanced clarity on SOE mandates will allow for better balancing of objectives and greater clarity on the funding needs of the SOE to deliver on its objectives. In line with good practice, the PRC Review highlights the main principles of such a policy, which are to: (i) recognize the unique nature of SOEs; (ii) identify and articulate the developmental objectives in line with the developmental goals of the state; (iii) require that core objectives are delivered in a viable and sustainable manner; (iv) include objectives in shareholder compacts and assess performance against the objectives; and (v) identify the costs and funding arrangements for PSOs for each SOE.

A formal policy for the treatment of PSOs also serves to ensure greater accountability. In addition to formalizing PSOs in SOE mandates and in legislation or regulations that are disclosed to the public, it is

important to ensure that delivery of PSOs is properly monitored and evaluated. The costs of PSOs and the budget transfers to the SOE should be made explicit, both in the government budget and in the financial statements of the SOE. Monitoring the performance of PSOs is critical to enhance transparency and ensure their relevance and effectiveness. For commercial objectives, profit maximization and return on the market value of equity is the key performance indicator. But for policy objectives, return requirements are usually balanced with other targets related to the efficiency and coverage of service delivery. Public disclosure of the costs and benefits of PSOs is important for transparency and accountability.

Improving the Legal and Regulatory Framework for SOE Governance

OECD Guidelines and international practices indicate that a sound legal framework is a necessary foundation for good SOE governance. The key aim of such a framework is to make the broad policy directions of the state and the "rules of the game" clear for everyone—and to strike the right balance between SOE autonomy and SOE accountability. Many countries have reformed their legal frameworks and in so doing have created new frameworks that remove inconsistencies and conflicts, put SOEs on a level playing field with the private sector, and bring modern harmonized corporate governance principles and practices to both the state as an owner and to SOEs. The goal is to communicate expectations and good practices to SOE shareholders, boards, and management as well as to other stakeholders and to the public at large.

Contrary to good practice, the PRC Review indicates that the legal framework for SOEs consists of a myriad of overlapping laws and regulations that inhibit good governance. For the most part, SOEs are governed by the Public Finance Management Act (PFMA) of 1999 and by the Companies Act. In addition, almost all major SOEs were established by founding and/or sector legislation. Various other laws and regulations also apply to SOEs, including the: Preferential Procurement Policy Framework Act; Treasury regulations and policy guidelines; Public Audit Act; Employment Equity Act; Skills Development Act; the Constitution; other public law statutes; general legislation (e.g. employment and tax laws); and various regulatory acts. Among the key laws and regulations:

The PFMA provides the framework for financial reporting and accountability and has helped bring uniformity across SOEs. The Act covers procurement, budgeting and financial planning, guarantees and securities, and delegation of powers and responsibilities of officials other than directors. However, there are major gaps. It does not cover other key areas addressed by SOE founding acts such as: the establishment of SOEs; board and CEO appointment; selection of government officials on the boards; and the treatment of developmental mandates and objectives. As per the PRC Review, PFMA also puts a heavy compliance burden on SOEs. In addition, while SOE subsidiaries are subject to the Act, the Act does not address their establishment, governance, and operations. PFMA allows SOEs (except schedule 1 institutions) to form subsidiaries, which has led to the emergence of different subsidiary formations. There is no legislative account of the number of subsidiaries established by SOEs. Moreover, many subsidiaries have established their own subsidiaries that fall outside the ambit of the PFMA;

The Companies Act contains provisions which are applicable to incorporated SOEs, some of which are also contained in SOE founding acts and in PFMA. However, while the Companies Act applies to SOEs, it does not provide for the significant differences between incorporated SOEs and private companies. Differences include the: treatment of developmental and social mandates of SOEs; need for higher degree of accountability of SOEs; delineation of the role of the owner/shareholder in directing SOE objectives and strategies; and the process for divesting SOE shares. Moreover, while the Act provides a framework for the creation of corporate subsidiaries, it does not do so for SOE subsidiaries;

In addition to the above laws, various other laws and corporate governance protocols apply to SOEs. These include the Auditor General's Act and the Accounting Standards Board. The 1997 Protocol on Corporate

Governance in the Public Sector was applicable only to SOEs under the Department of Public Enterprises in Treasury (only 9 SOEs fall under the DPE) while the 2002 Protocol applies to all SOEs listed in Schedules 2 and 3 (b) and (d) of the PFMA. The King III Report on Corporate Governance for South Africa, and the 2016 Draft King IV Report, applies to all SOEs on a comply or explain basis, whether commercial or not.

The multiplicity of laws combined with the absence of a dedicated SOE law has severely impacted SOE governance and undermined the Government's role as owner/shareholder. Overlapping and conflicting provisions and lack of uniformity have led to confusion in interpretation and application. Amendments to the Companies Act are not applied uniformly by SOEs. In addition, the founding acts contain provisions that are in the Companies Act, but they restrict SOEs' powers and responsibilities and impose additional procedural requirements that would not have been necessary had the SOE been regulated solely by the Companies Act. Governance provisions in the founding acts are also not uniform across SOEs, while many acts have not been updated since they were established. The PRC Review highlights that these inconsistencies and ambiguities have had an adverse impact on SOEs and on the Government. SOE legislation is also burdensome and time-consuming to comply with.

Developing a comprehensive and modern governance framework will therefore be a critical step in improving SOE governance and performance. As in other countries, this can be done by developing a stand-alone SOE law that spells out the state's objectives and role as owners/shareholder and that is aligned with the governance provisions of the new Companies Act. Such a law has is under consideration by the Government. Treasury had initially proposed a new PFM Bill with dual financial oversight and governance provisions, while the Department of Public Enterprises (DPE) in Treasury had developed a Government Shareholder Management (GSM) Bill to complement PFMA with governance provisions. However, the GSM Bill was not introduced to Parliament and the PFMA has not yet been amended. Barring an SOE law, another option is to develop secondary legislation (such as a decree or regulation on key governance issues) or an Ownership Policy that could be converted into law. To strengthen SOE oversight and governance, the DPE has been tasked by Cabinet to lead the effort in developing a Government Shareholder Oversight Policy and the subsequent SOC Bill. Establishing such a framework will be central to improving SOE governance.

Strengthening the State's Role as Owner/Shareholder

OECD Guidelines and international practice show that ownership approaches have been steadily evolving towards centralizing the state's ownership functions with the goal of providing better oversight and consistency in the management of state assets. Good practice indicates that the State should act as an informed and active owner, ensuring that the governance of SOEs is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness. Centralization of the State's ownership functions helps to achieve these objectives and insulate companies from political interference in commercial decision-making while holding them accountable for results.

South Africa has a fragmented ownership structure with several bodies involved in exercising the State's rights as owner/shareholder. In the current structure the various bodies and the shortcomings are as follows: Various line ministries exercise the State's ownership rights—such as voting the state's shares, nominating board members, monitoring performance and holding SOEs accountable for results—and the line minister, as the shareholder representative, has executive authority over SOEs. Several problems arise with such a decentralized model. Potential conflicts arise when line ministries act as shareholder, policy-maker, and regulator. In addition to overseeing SOEs, they may also exercise considerable control in day-to-day commercial matters that should be left to the board and management. Having several ministries in charge of SOEs also leads to lack of standardization and fragmentation of the state's ownership role, opens the door for political influence, and results in a lack of ownership focus and duplication of roles;

DPE in the Treasury is the shareholder representative and provides oversight of six SOEs in its portfolio, including Eskom, Transnet, and South African Express Airways, as well as Alexkor, Denel, and SAFCO. While the DPE is a key shareholder, it too faces challenges in carrying out its shareholder role, including unclear roles and responsibilities, lack of synergy among departments, lack of coordination in internal processes, and limited information technology structures.[4] At the same time the Department is taking steps to move from a compliance driven approach to providing strategic direction and support to the SOEs in its portfolio and to developing a stronger shareholder function

- In addition to line ministries and DPE, several other entities are also involved in SOE matters. These include:
- Parliament – which provides Constitutional oversight of SOE performance through the Standing Committee on Public Accounts (SCOPA) and portfolio committees;
- The Auditor General – which provides audit reports on SOEs and is accountable to Parliament;
- Cabinet and policy departments – which have the authority to direct policy and give policy directives; and
- National Treasury, Department of Public Services and Administration, and various regulators—who provide support in the monitoring of policy implementation through respective financial, public service, and regulatory mandates.

The involvement of many different bodies and the lack of a coordinated and unitary oversight framework creates several problems highlighted in the PRC Review. These include: a lack of uniformity in ownership practices and in the monitoring, evaluation, and reporting of SOE performance and its impact on the economy; inefficiencies for SOEs as SOEs must meet the different requirements and requests of each of the bodies; wide disparity in oversight skills and capacity among ownership units; and weak coordination within the Government. The current legislation also does not recognize the distinct role of the Government as owner/shareholder, which impacts the Government's ability to assert is role and oversee performance, opens the door for undue interference in SOEs, and blurs the roles and responsibilities of the state shareholder and the board.

Moving to a centralized model covering the 20+ most important commercial SOEs will provide better consistency and oversight of SOEs. For such SOEs, centralization would help separate the state's ownership role from its policy-making and regulatory roles and better insulate companies from political interference while holding them accountable for results. This would help the government become a more active shareholder and improve its capacity to manage the SOE reform process effectively through a centralized approach that brings coordination, uniformity, and transparency to the State's ownership role. The DPE has embarked on a preliminary process to develop a centralized model for all large commercial SOEs, where the fiscal oversight role would remain with the National Treasury while the shareholding role would be the responsibility of the central oversight authority (currently DPE, whose scope could be expanded and capacity strengthened). In such a model, the role of line ministries would be to establish sector policies and provide technical oversight which are critical for sound SOE performance.

The centralized agency would focus on exercising core ownership functions while leaving day-to-day operational decision-making to SOE boards and management. Among the main functions are to: develop an SOE law or clear ownership policy for SOEs (as discussed above); vote the state's shares; develop a structured and transparent process for nominating and appointing SOE boards; develop and monitor other policies and corporate governance guidelines; monitor the performance of SOEs through an improved performance management system; promote and monitor good governance practices at the SOE level; publish an annual report on the SOEs; guide and promote SOE reform by drafting an SOE reform strategy and overseeing its implementation.

[4] DPE, 2014/2015-2018/2019 Strategic Plan.

Experience shows that ensuring the effectiveness of the centralized is dependent on several factors. Such entities themselves can face constraints such as political interference, imposition of social obligations, lack of economic and political clout, and weak capacity and lack of resources. Overcoming these constraints requires: high level political support and backing; a clear and focused mandate; recruitment of professional staff with the necessary financial, legal, and technical capabilities; dedicated financial resources; and proper monitoring and accountability arrangements for the entity itself.

Professionalizing SOE Boards and Management

OECD Guidelines and international practice call for SOE boards to have the necessary competencies, objectivity, and authority to carry out their core functions of providing strategic guidance and monitoring of management, and to act with integrity and be held accountable for their actions. Effective corporate governance requires boards composed of qualified and competent members, appointed based on a clearly defined nominations process and capable of exercising objective and independent judgment in guiding SOE strategy and business plans. Professionally appointed boards should have the competence and authority to oversee the SOE and improve SOE governance and performance.

Good practice calls for SOE boards to be composed primarily of members from the private sector, with business, professional and, other relevant backgrounds, based on a structured and transparent nominations process. SOE boards should be properly composed so that they can exercise objective and independent judgment. Increasingly, countries have none or only a small number of civil servants on SOE boards. They also have explicit requirements to include non-executive members that meet formal definitions of independence, usually covering at least one third and sometimes significantly more of the board. These exclude civil servants, the representatives of major shareholders, or those with financial and/or other links to the SOE. To ensure properly appointed boards, the board nominations process itself has moved to become more transparent and merit based through a properly outlined board nominations policy and procedures.

In contrast to good practice, the existing legal framework for board appointments in South Africa is scattered across various documents and there is no single legislation or policy in place, leading to confusion and conflicts in the process. In many cases, the founding legislation of an SOE gives the executive authority the power to appoint and dismiss the board and CEO. Meanwhile, the Protocol on Corporate Governance for the Public Sector states that the board should appoint one of its members, preferably an independent non-executive director as the chair, which may conflict with the founding legislation. An SOE's articles of association may also codify the recruitment and appointment process. Where the policy department and the executive authority are two different ministries, conflicts could arise about the choice and as to who should be the appointing authority. And for listed SOEs and SOEs with other shareholders, in addition to the articles of association, JSE listing requirements and the King III Code also carry weight.

For SOEs of a significant nature, full Cabinet approval of board appointments is necessary, usually with the President's approval. Cabinet approval is required for institutions where the Constitution expressly requires Cabinet approval or consultation and for institutions that are of a significant size (more than 500 employees and/or operational budgets of more than R200 million, asset base of more than R1 billion), are of a transversal nature (where several departments may have an interest), and perform functions of a strategic nature. The executive authority responsible for an SOE may approve certain appointments, including of: (i) a public service official (who is not head of a department or a deputy DG) to a board, except a government enterprise; (ii) private persons if the appointment is not of a significant nature; and (iii) persons whom the enabling act of the institution requires the authority to appoint. The executive authority formally appoints board members. Only on rare occasions is the Parliament involved (e.g. SABC), although the President's approval is sought by Cabinet for the appointment of most Schedule 2 boards.

Putting in place a structured and transparent board appointments policy is essential to minimizing political interference and ensuring that the board is properly composed with the right competencies and abilities. An attempt to harmonize board recruitment practices was undertaken in 2008 through the publication of the Handbook for Appointment of Persons to Boards of State-Controlled Institutions. However, as per the PRC Review, use of it has been sporadic as it is not aligned with the laws that provide for appointment. Moreover, there is no monitoring mechanism in place to ensure compliance and some critical elements needed for successful application of the Handbook, such as databases of directors, have not been established.

Centralization should make it easier to develop a board nominations policy to overcome the current problems. In line with good practice, such a policy would contain: (i) properly defined selection criteria, such as a minimum requirement of a degree in economics, finance, or law; business and sector specific experience; proven integrity and probity; and additional proficiency and suitability requirements for large and complex businesses; (ii) requirements for the number of independent directors; (iii) provisions for the use of open advertising and hiring of professional selection firms to short-list candidates; (iv) delegation of the process to the centralized ownership entity or to a specialized independent body; and (v) the development of a directors' pool of pre-qualified board members. Increasingly boards are also creating nominations committees as they become more involved in developing board skills profile and identifying prospective candidates for board positions.

Professionally composed boards means that boards should can carry out their legitimate and fundamental functions of setting strategy, appointing and overseeing management, and managing conflicts of interest, all of which are intrinsic to the governance process of any enterprise. Day-to-day operational matters should be left to the management of the company. Boards should be assigned a clear mandate and have ultimate responsibility for the company's performance. Many countries have reinforced the role of the board and increased both its autonomy with respect to the government and its authority over management. In addition to explicitly empowering the boards to set strategy and choose and oversee the CEO, boards of SOEs, especially the large and more profitable ones, are also being given greater autonomy and substantial discretion on approving major decisions, such as capital expenditures and mergers and acquisitions. To exercise their responsibilities and fiduciary duties effectively, boards are typically required to develop and abide by a code of ethics.

Appointing qualified top management is critical for sound SOE performance. The appointment of CEOs of almost all SOEs is approved by the executive authority as per founding legislation and the PFMA. But there is no consistent process for CEO selection. Most ministers delegate the recruitment process to the board who then delegates it to the Human Resources and Nominations Committee of the board. Depending on the size of the SOE, the common practice is to run the process internally. For significant SOEs, the process is outsourced to a recruitment agency. A shortlist of 3-5 candidates is sent to the Nominations Committee, which selects the preferred candidate and sends it to the Minister and to the Cabinet for approval. A contract with the CEO is drafted and signed by the Minister, and not by the board as per good practice—leaving the CEO beholden to the Minister and not to the board.

Remuneration of executives and senior staff is usually set by the board but in the absence of clearly defined guidelines remuneration levels vary widely among SOEs. Guidelines exist only for the six SOEs under DPE, but they are not always followed. The PRC Review notes that the absence of a centralized authority to manage remuneration has contributed to these problems. The result is that the boards and CEOs define their salaries themselves, and these differ significantly from the market and equality lines. In some instances, but not all, the executive authority or Minister is required to approve the board's recommendations, as in the case of the remuneration policy framework for Water Board CEOs issued by the Department of Water Affairs in 2010.

Instituting sound management and remuneration practices is needed to ensure good SOE performance. A clearly defined SOE remuneration framework should be developed, based on the categorization of SOEs and considering factors such as their size, nature or complexity of the organization, strategic importance, and level of autonomy. In line with international trends, the PRC Review supports the approach of pegging SOE salaries to the market to attract suitable candidates and providing clear guidelines and parameters within which the board may have discretion, especially for large commercial SOEs operating in key sectors of the economy. It also recommends that SOEs undertake an extensive education and awareness project for all staff on the pay scales and benchmarks relative to the broader market, and that Government establish a central remuneration authority with a strong degree of autonomy to direct SOE practices and act punitively when directives are not followed.

Enhancing the Financing Capacity of SOEs

The backlog in infrastructure and other essential services has created a major financing challenge for SOEs. Undercapitalized at the time of their corporatization and saddled with a legacy of debt, SOEs remain insufficiently capitalized to invest in infrastructure not only to increase capacity but also to maintain existing capacity. DFIs also fall short of the required capital needed to finance developmental goals.

As per Treasury policy, commercial SOEs are required to function sustainably on the strength of their balance sheets but they continue to depend on Government for financial support. The PRC Review indicates that most Schedule 2 SOEs have relied on capital market debt to fund capital expenditures (typically for under 50 percent of their funding requirements), while only a few SOEs inject long-term equity capital through the sale of non-core assets. Such SOEs continue to depend on Government support in the form of explicit guarantees to back up debt funding and/or subsidies. Many SOEs doubt their ability to meet future funding requirements without Government support, but South Africa's self-imposed limit on a debt/equity ratio of no more than 40 percent constrains the extent to which the Government can support SOEs. The poor financial viability of some SOEs combined with huge backlogs, poor maintenance, and poor asset utilization also pose constraints to raise financing. Schedule 3(b) entities, mostly water boards and utilities, run their operations on a semi-commercial basis. In addition to tariff revenues, they require permanent State subsidies and grants to carry out their mandates.

SOEs have generally been successful in obtaining tariff increases but tariff increases alone are not sufficient to meet the financing needs. While increased income and retained earnings from tariffs are used to finance capital programs, alternative methods of funding are needed to address the current debt burden and to reduce reliance on tariff increases that put pressure on the inflation rate, may have adverse impact on consumers, and prove to be unsustainable. Moreover, there is strong opposition to adopting the "user pay principle" for economic infrastructure where most people have limited means.

Development financial institutions such as DBSA and IDC are possible financial partners but their capital resources are a fraction of those of the big five banks and the capital markets. Financial institutions have also expressed concern about the role of DFIs and indicated that they should mainly address "market failures," as it is debatable that infrastructure investment requires DFI financing and support and at the same time reduces the commitment to competitive neutrality.

To bridge the financing gaps, SOE attempts at partnerships with the private sector were made in the past but were unsuccessful. The PRC Review cites examples of problematic cases, such as the SA Post Office management contract with New Zealand Post and the involvement of a strategic equity partner to acquire 20 percent of ACSA. These failed attempts have created the need for developing a balanced public-private partnership policy with broad public acceptance that would enable the State to access capital for long term infrastructure projects.

The PRC Review made several recommendations to enhance the financing capacity of SOEs to meet infrastructure financing needs. These include:

- Rationalization of State holdings: To free up resources, the goal should be to focus on SOEs that provide public goods and address national priorities and interests, while carrying out phased diversification or exit from sectors where market failure no longer exists and absorbing entities whose functions can be cost-effectively carried out by Government departments into line function programs;
- Effective oversight structures for commercial SOEs:
- Centralization of the State's ownership role would be more conducive to developing a consolidated funding model for commercial SOEs and providing them bargaining power and market influence to secure improved finance and trading terms;
- Greater mix of debt and equity finance: Most Schedule 2 SOEs raise their funds from open markets in the form of debt without Government support. From 2006 to 2010, total debt of Schedule 2 entities increased by over 220 percent. As this is not sustainable, SOEs will need to pursue equity funding options such as partial listing of SOEs on the JSE as well as PPPs which will require the development of a clear framework to ensure success;
- Clear policy for treatment of non-commercial objectives: Problems of unfunded mandates and inefficient and inappropriate capital investment decision-making are one of the main causes of poor SOE performance and increasing prices. Having a clear policy for PSOs will be essential;
- Strategic partnerships with the private sector: The need to pursue PPPs to promote direct investment in projects is urgent as SOEs reach a limit on their balance sheets. However, despite Government's stated commitment to private participation, SOEs are not inclined to undertake PPPs on "good" assets as they would lose the ability to cross-subsidize loss-making activities by more profitable ones. Actively promoting PPPs would require that there is a clearly defined framework and an economic regulator in place to ensure that PPPs are executed in the best interests of the society.
- User pay tariff systems: Funding basic infrastructure through substantial increases in tariffs, as in the case of Transnet, Eskom, and SANRAL, is unsustainable. Government usually takes responsibility and users are not required to pay directly for infrastructure investments. While economic infrastructure is funded on a user pay basis and taxes, social infrastructure, such as roads, relies less on user pay and more on taxes. Policy options other than user pay and taxes should be explored and approved by the SOE Council of Ministers guided by Treasury.
- Framework for economic regulation: An Infrastructure Economic Regulation Bill should be prepared to replace the relevant sections in the legislation that govern economic regulation in the transport (airports and ports), energy (electricity, gas, and petroleum pipelines and storage), and telecommunication sectors, and thus be applicable across key infrastructure sectors. The framework should also promote the independence and competence of regulators.

Enhancing Transparency and Accountability of SOEs

OECD Guidelines and international good practices suggest that an effective performance monitoring system is essential to drive SOE performance and enhance transparency and accountability in the use of public funds. A sound performance monitoring system sets objectives and targets that provide clarity to SOE boards and management about the performance expectations of the Government as owner. Clear goals establish a framework in which the SOE board can set and execute strategy with an appropriate degree of autonomy, while providing government with sufficient assurance that SOEs will be held accountable for their performance. Such monitoring is central to ensuring that SOEs produce the best possible outcomes, like the way equity holders are responsible for investments in private sector companies.

In South Africa, responsibility of oversight agencies in performance monitoring is established in the PFMA. As per PFMA regulations, the system is based on: (i) strategic objectives derived from the SOE's mandate;

(ii) business strategy objectives of the authority the SOE reports to; and (iii) national objectives. Treasury regulation 29.1 provides that the accounting authority of a Schedule 2 and 3b entity must submit a three-year corporate plan annually to their authority and Treasury that covers: strategic objectives and outcomes; strategic and business initiatives; KPIs; risk management plan; fraud prevention plan; and financial plan with projections of revenue, expenditure, borrowings, asset and liability management, cash flow projections, capital expenditure programs, and dividend policies. The plan should be agreed upon by the executive authority and becomes an annual shareholder compact signed between the executive authority and the SOE. Performance is analyzed on a quarterly and annual basis. Treasury requires regular review of the implementation of the recommendations of the oversight authority, and ministries are required to offer support where needed. All quarterly reports are included in the annual report.

As per Treasury guidelines, commercial SOEs (Schedule 2 and 3b entities) are required to have a shareholder compact. For commercial SOEs, the requirements include effectiveness (delivery on mandate) and efficiency (cost-effectiveness, maximum returns, but not at the expense of service quality). Despite the requirement, the PRC Review notes that some national SOEs do not submit compacts, partly to accommodate the preference of their ministries for fluid deliverables, changeable whenever required by the executive authority/Minister concerned. SOE performance is evaluated at two levels: (i) achievement of their strategic objectives; and (ii) contribution to the State's transformational agenda.

The PRC Review indicates that the achievement of strategic objectives was significantly better for Schedule 2 entities that are more exposed to commercial discipline and stakeholder oversight than for Schedule 3b SOEs. Performance in general shows that SOEs need to become more effective, which calls for a more robust process in setting strategic direction and defining objectives. Customers and the private sector also indicated dissatisfaction with SOEs' worsening track record on service delivery, while levies and fees kept growing.

Regarding the State's transformational agenda, the Government has implemented various policies, strategies, and programs aimed at overcoming economic inequalities and underdevelopment but with mixed results. One of the policies is BEE, where SOEs are expected to provide capital for the attainment of BEE objectives. However, BEE programs have not worked optimally, and this has led to the enactment of the B-BBEE Act and the establishment of the B-BEE Advisory Council to provide leadership and direction for implementation. The PRC Review showed a high level of awareness on the expected role of SOEs in supporting the developmental agenda. Most SOEs perceive that they are achieving the optimal balance between social, economic and political imperatives of Government. Where this is not happening, the hindrances are seen to be financial or resource constraints.

The performance management system has encountered several issues and challenges. These include: (i) poorly defined KPIs and targets and lack of clear criteria to measure KPIs; (ii) outdated or very broad mandates that make assessment difficult; (iii) limited technical competence and capacity in oversight authorities to review and sign off on compacts (for example, the PRC Review of water boards under the Ministry of Water Affairs indicates that 10 percent of compacts were not signed off by the board and minister; 65 percent were signed by the board but not the minister; and only 25 percent were signed by both); (iv) greater focus on compliance than on the SOEs' strategic focus and performance, partly due to lack of capacity and to the relationship between oversight ministries and the SOEs which may not be conducive to engaging on those aspects of the developmental agenda for which SOEs would be held accountable; (v) lack of standard reporting templates; (vi) absence of performance assessment across the same value chain to assess service delivery and national developmental or sectoral outcomes; and (vii) absence of a central authority to set performance targets and monitor and evaluate performance across all SOEs.

The PRC Review made several recommendations for improving the performance management system and in turn the transparency and accountability of SOEs. A first recommendation is for Government to develop a performance management system that is aligned to the Developmental State goals and principles based on the mandates and objectives of SOEs, that is linked to the performance reporting systems of the oversight authorities, and that is based on standardized reporting guidelines. Second, mandates of SOEs should be subject to critical review every five years and updated as needed. Changes to mandates should be aligned with the SOEs' overarching strategy, approved in concurrence with the Council of Ministers, subjected to Parliamentary oversight, and formalized and easily measured. Third, the agreement and signing of strategic compacts and corporate performance plans should be made mandatory for every oversight authority and developed within a specified time line. There should be a dedicated training and development program for oversight agencies. Strong sanctions and accountability measures should be put in place to deal with non-compliance and ensure accountability and productivity. And fourth, oversight agencies need to undertake quarterly reviews of SOE performance, and upgrade their technical competencies and capacity to provide effective oversight.

Reform Implementation

Governance and other reforms are critical to improving SOE performance and competitiveness, increasing financial sustainability through access to new sources of capital, and achieving higher levels of transparency and accountability. There is full recognition in South Africa of the importance of SOE reforms. As discussed above, the key issues facing SOEs and the recommendations or solutions for improving SOE performance are analyzed in detail in the PRC Review and are widely accepted.

Going forward, the main challenge is one of implementation which requires buy-in and support from the highest levels of Government. SOE reforms are politically contentious and challenging to implement. Entrenched groups may oppose or find ways to resist reforms. Implementation entails fundamental changes in organization, incentives, and behavior that can be difficult to achieve. And reforms are ongoing processes that evolve and unfold over time. Managing these challenges will therefore require careful attention to the reform process, including the need for: (i) political leadership and commitment; (ii) a clearly defined strategy and action plan for phasing or sequencing of reforms based on the political and institutional feasibility of reform; (iii) identification of a strong institution with the clout and capacity to lead, manage, and sustain the reform process; (iv) building of public support to overcome stakeholder resistance; and (v) development of monitoring systems early in the process to evaluate impacts, ensure transparency and accountability, and provide a feedback loop to adjust course as needed.

In August 2016, the Government confirmed that the Inter-Ministerial Committee (IMC) chaired by the Deputy President is responsible for overseeing the stabilization and reform of SOCs, and the IMC in turn established a Presidential SOCs Coordinating Council to take the reform process forward and give effect to the PRC's recommendations. Chaired by the President of South Africa, the SOCs Coordinating Council was created to drive implementation and allow for better oversight and coordination of SOCs. This measure was part of a comprehensive overhaul of the shareholder model for SOCs being led by the IMC in line with the recommendations of the PRC to create an SOE Reform Committee.5 While the PRC recommended that such a Committee be comprised of representatives from the Presidency, SOEs, National Treasury, Economic Development, and Trade and Industry, there is no public information available on the composition and governance structure of the SOCs Coordinating Council, nor is there any information on its terms of reference.

As recommended by the PRC, one of the first tasks of the SOCs Coordinating Council is to develop a comprehensive master plan and budget for the SOE reform program. To ensure buy-in and success, SOE

[5] "Government on Reform of State Owned Entities", August 23, 2016, South Africa Government, www.gov.za

reforms should be sequenced over time, accounting for the realities on the ground. The PRC identified a series of detailed actions for the short, medium, and long term goals, identify relevant stakeholders and expected outcomes, and designate responsible parties to hold accountable for achievement of reform goals. The roles and responsibilities of the different parties will need to be defined and their capacity strengthened. The development of a comprehensive stakeholder management and communication plan was also recommended.

A special Committee or Task Force of selected individuals (between 5 and 10 people), representing key stakeholders from the Presidency, Treasury, ministries, academia, the private sector, and other key stakeholders could be formed to develop the strategy and action plan. The members should have clear objectives, time line, and expectations to contribute. While being inclusive and consultative, the process of convening the Task Force and designing the strategy and action plan will need to be led by a specific institution as the initiator, with substantial inputs and involvement of other members of the Task Force. The action plan should consolidate and organize the priority actions and designate sequencing and roles to institute effective reform in areas where this is feasible. Developing an action plan for SOE reform will be the priority of the Task Force based on agreement and consensus among the participants.

Suggested key components of the action plan are as follows:

Priority reforms and/or clarifications to existing policies, for example:

- Defining the state's ownership role: e.g. separation of functions; identification of key ownership functions; review of roles and responsibilities of different parties; steps to enhance coordination;
- Elaborate on ownership arrangements—whether to centralize ownership function within MOF or strengthen the current SEC as monitoring and compliance agency.
- Developing a framework to enabling SOEs to operate commercially: e.g. identification of non-commercial obligations; costing and financing of such functions; evaluation and disclosure of such functions;
- Identifying necessary changes to the legal framework: e.g.: development of state ownership framework; passage of new SEC act; improvements to Companies Code; possible corporate governance code;
- Charting approach and reform mechanisms: e.g. distinguish between updates and amendments to existing laws and elimination or complete replacement of legal documents.

Allowing appropriate action to be taken for unviable companies eg exit the market/liquidation.

Steps and processes for undertaking reforms:

Identifying stakeholders to be involved in the reforms: This includes but is not limited to the MOF, SEC, line ministries, Office of the President. There should be clear roles for the different players and members should be decision makers.

Identifying a realistic timeline for reform and strategy: How long will each step take? Many actions will be simultaneous, but involve different counterparts.

Classifying SOEs: By potential for divestiture or continued Government ownership, with clear categories and requirements and an associated timeline. For example, there may be some expectations of transparency attached to keeping SOEs under Government ownership.

Medium term (next 1- 2 years) - Implement the action plan and build capacity

In the medium term, the focus on governance reform should be on building institutional capacity while implementing the priority actions mapped out in the strategic action plan. Based on the short term actions, and under the leadership and guidance of MOF, the Task Force should communicate with other parties and ensure that priority reform activities are carried out.

Suggested activities for the medium-term are provided below:

Strengthen the capacity to exercise ownership within an improved State ownership framework. Refer to Task Force's strategic decision, as set out in the short term actions.

Option A: Centralized ownership within Ministry of Finance Public Investment Division

- Identify and collect all shares of SOEs to be kept at MOF;
- Develop policies and regulations on board nominations, remuneration, and evaluation;
- Build capacity of staff and systems to monitor performance of SOEs and compliance with corporate governance requirements;
- Maintain continuous dialogue and coordination with SEC;
- Elevate SOE governance to a higher point on the Government agenda.

Option B: Agency model: Enhanced State Enterprises Commission

- Implement necessary institutional changes: consider merging SEC functions with MOF to have one single ownership entity.
- Establish a professional board of directors.
- Identify capacity gaps and build capacity of staff to carry out effective performance evaluations.
- Develop systems to manage SOE accounts information and make them publicly available online.
- Establish jointly with MOF a directors pools of certified candidates for board positions.

Strengthen capacity of SOEs

- Company level corporate governance assessments and improvements: Carry out corporate governance assessments of selected SOEs and develop improvement programs to upgrade their status and provide tangible improvements and benefits that could create momentum for more widespread implementation across SOEs.
- Transparency: Strengthening of SOEs' capacity and ability to account for their operational and financial activities.
- Boards: Mandatory board trainings to ensure that boards understand and are effective in carrying out their roles and responsibilities
- Financial and commercial viability: Identification of public service obligations with separate costing, accounting and financing.
- Listing of SOEs on the stock exchange: Based on corporate governance improvements and the other above items, select candidates for listing on the Ghana Stock Exchange.
- For SOEs that cannot demonstrate improved governance practices within 2 years, it may be recommended to fully divest in order to protect Government assets and reduce liabilities.

Longer term (2-5 years) - Improving the legal and institutional framework

Some of the necessary reforms require more fundamental changes in legal and institutional arrangements. Most of the fundamental legal updates must be made with the Attorney General and sector ministries endorsement, with Cabinet approval.

Among the main activities are:

- State ownership framework: It is recommended for Ghana's SOEs to be governed by an ownership policy or corporate governance code which spells out specific procedures and requirements in areas where SOEs differ from other companies. The policy should set out the nominations processes, remuneration and composition and of boards and requirements of SOE management, the role of MOF and other ministries, transparency and accountability requirements and other general areas that fall outside of the scope of other regulation.
- Companies Code: Collaborate closely with Ministry of Trade and Industry and other stakeholders as needed to update the act.
- Change in Government ownership: Divest SOEs that have not performed according to requirements, or provided up to date and current financial and operational information.
- Creation of an effective Institute of Directors: A corporate governance entity, like an institute of directors, would contribute to improving accountability of SOEs. A dedicated institute with corporate governance specialists with strong connections to accountants, the legal profession and academia and with resources could represent a source of pressure on SOEs to improve by building awareness, training directors, and disseminating information. All board members should be required to take classes and be certified as fit to be members of the board. The institute could build on existing programs in GIMPA. It would be important for the institute to stay informed of developments in the Ghana SOE sector as well as international best practices, in order to develop a relevant and practical curriculum that will help SOEs achieve their objectives.