The Role of State-Owned Companies (SOCs) in Industrial Development

DG: TRADE AND INDUSTRY

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the dti
Department:
Trade and Industry
REPUBLIC OF SOUTH AFRICA

Economic Context

- Commodity prices have plunged – when SA grew by >5% in 2006-08 it was mainly on the back of the 'commodity super-cycle'.
- The NDP notes the risk to sustainable, inclusive economic growth if we do not purposively diversify the SA economy.
- The global economic recovery remains uncertain with all commodity exporting countries struggling and China slowing.
- Whilst there has been an increase in investment over past five years, we need to scale up significantly if we are to deal with the legacy of decades of underinvestment
- The 9-Point Plan is Government's response to the global and domestic challenges being experienced.

1. Problem statement

- The 9PP identifies the role of SOC's as fundamental to the SA economic recovery:
  - Direct impact on growth e.g. Energy and Broadband constraints are potentially costing the economy 1% each,
  - Transport incl. port infrastructure is constraining value-added exports,
  - Not localising will worsen the current account deficit and become a brake on economic growth,
  - Resolving the infrastructure constraints <u>and</u> localising infrastructure inputs could add as much as 2.4% – 3.2% to our GDP.
- Global experience suggests that SOCs are in a unique position to drive industrialisation through investments in infrastructure and direct investment and support for building domestic industrial capabilities.

Problem statement

- The problem in South Africa is that the SOCs have not been doing what they are responsible for.
- Consequently the binding constraints to industrialisation include:
  - decades of under-investment in economic infrastructure;
  - rising administered costs such as high port and freight charges with port charges amongst the highest in the world; and
  - electricity supply challenges and rapidly rising cost amongst others.
- The resolution of all these depends on how the SOCs carry out their mandate.

Problem statement Cont'

- SoEs need to invest in infrastructure, transport infrastructure, broadband rollout and the electricity build programme.
- Another critical lever for industrial development is localisation, when these SOEs invest on this infrastructure they must ensure they use locally manufactured products.
- Government has committed to localisation in terms of requiring 75% local content on all state procurement.
- This industrialisation programme therefore is not a narrow departmental objective but a national one that need to be committed to by all state agencies
- SoEs must be the drivers of our industrialization programme and and there are several policy levers that empower them to do that.
- We appeal to this portfolio committee to play a greater role in ensuring that SOEs do play this role

Policy Instruments/Levers

- The DTI has a range of policy instruments which must be used in close consultation with and support of The Department of Public Enterprises and State Owned Companies.
- These are:
  - **Localisation in Public Procurement** – especially large fleet procurements such as the rail procurement. In addition to strong co-operation with respect to the Competitive Supplier Development Programme (CSDP), Designations for local procurement are applied when the CSDP is not applied. There is room for improvement where neither the CSDP or Designations apply to secure localisation across all SOC to strengthen localisation and supplier development in support of domestic manufacturing.
  - **The National Industrial Participation Programme (NIPP)** which obliges all state procurement above US$10 million to investment in South Africa in an 'offset' programme. NIPP allows for direct NIP (investment in the sector in which the procurement took place) and indirect NIP (investment in other sectors where the state wishes to build industrial capacity and raise competitiveness.)

Policy Instruments/Levers

- It is also critical that SOC work closely not only with the DTI but also with Department of Science and Technology and Council for Scientific and Industrial Research (CSIR. For example the CSIR '**Technology Localisation Programme**' supports supply companies in the rail procurement to raise the competitiveness required of supply companies in the OEM supply chains.

Procurement

- **Government purchasing power** through public procurement contributes between 15% and 25% to GDP (value that is extracted from large scale procurements)
- **National Industrial Participation Programme (NIPP): Imported Content => US$10 million**
- **Defence Industrial Participation:** managed by Armscor and applicable to all defence procurement. **Imported Content => US$2 million**
- **Competitive Supplier Development Programme (CSDP):** managed by DPE in conjunction with State Owned Companies (SOCs) .
- **Designation & Local Production**
- **The Renewable Energy Independent Power Producer Procurement Programme (REIPPPP)**
- **The Local Procurement Accord**

PPPFA and Local Content

- Preferential Procurement Policy Framework Act (PPPFA) was enacted in 2000, and its Regulations promulgated in 2001
- The Regulations were amended in 2011 and new regulations came into effect on 7 December 2011.
- Section 9: Local Production and Content
- Paragraph 9 (1) of the Regulations empowers the dti to designate specific industries where tenders should prescribe that only locally manufactured products with a prescribed minimum threshold for local production and content will be considered
- To give effect to government decisions on public procurement; sectors/products were and are being designated for local production

Reg. 9.3 (PPPFA Regulations)

- **Regulation 9 (3) prescribes that** "...where there is no designated sector, an organ of state may include, as a specific tendering condition, that only locally produced services, works or goods or locally manufactured goods with a stipulated minimum threshold for local production and content, will be considered, on condition that such prescript and threshold(s) are in ***accordance with the specific directives issued for this purpose by the National Treasury in consultation with the dti".***

Consideration:

- Constitutional and legal compliance
- Economic and fiscal considerations
- Long term public procurement plan and expenditure
- Alignment with policy objectives, in particular the creation and retention of decent jobs
- Promotion of SMME's, geographic spread, technological capabilities
- Local manufacturing capacity and security of supply

The Competitive Supplier Development Programme:

The Department of Public Enterprises working closely with the Department of Trade and Industry introduced the Competitive Supplier Development Programme (CSDP) in 2008 to create a platform for the development of suppliers.

The objective of the intervention is to promote investment and the development of internationally competitive capabilities in supplier sectors to the SOC's capital and relevant operational spend, with the aim of:

- Building industrial capabilities in key, 'big ticket' industrial sectors such as rail and achieving transformation in the manufacturing sector
- Reducing costs through increasing efficiencies.
- Reducing dependency on imports and foreign exchange exposure.
- Developing niche export areas eg; SA as rail production hub for Africa.

Designations and NIP

- The Minister of Trade and Industry Designates sectors, subsectors or products for local procurement in terms of the Regulations of the Preferential Public Procurement Finance Act (PPPFA)
- All state entities are obliged to procure locally where a designation has been promulgated by the Minister. The National Treasury issues Instruction Notes to all state institutions.
- Designations apply where the CSDP is not in place. The Minister has Designated 16 sectors/products including many which are important to the procurement programmes of SOC. These include transformers; electricity pylons, buses etc,.
- There is significant room for improvement to secure compliance across all government departments inclusive of SOC beyond rail and electricity procurement to include for example oil and gas.
- **The National Industrial Participation Programme (NIPP)** projects arising from purchases by SOC's include purchases of aircraft components by Boeing and Airbus (SAA purchases), investment in ICT (SITA purchases), investment in ship building (PetroSA purchases) and automotive components (car purchases)

A higher impact industrial effort: Example infrastructure and operations for auto's sector.

Much greater co-ordination and higher impact of service provision is required to support industrial sectors.

Example: Infrastructure provision is presently not adequately supporting the competitiveness of the automotive industry:

- Reliability of service extremely problematic to some OEMs e.g. 63% capacity delivered versus contract in 2012 has now dropped even further to 52% capacity delivered.
- Turnaround times of specialised wagons extremely slow – 4 days on some corridors.
- Tariff increases of 13% in 2013, significantly above inflation.
- Rail market share around 30%.
- Significant shortage of specialised wagons – average age around 25 years – although new wagons are being built but insufficient and costly.
- Empty return legs for specialised wagons forcing cost up.

Relatively complex logistics processes but small share of TFR revenue. It is critical that infrastructure backlogs, operational constraints and pricing structure of Transnet and TNPA supports the development of critical IPAP manufacturing sectors.

The SOC-Automotive Competitiveness Forum has been established to improve service delivery to the automotive Industry.

The Forum is aimed at:

- fostering a responsive culture between the Shareholder, SOC and Industry around building a competitive economy.
- demonstrating leadership and creating a channel for dialogue and accountability.
- building a partnership between SOC and customer to unlock operational and capacity constraints.

Probable initiatives of the Forum include:

- Regular meetings between industry and Transnet to see how efficiencies can be enhanced.
- A KPI dashboard of TFR performance maintained by industry and presented to the shareholder on a quarterly basis (with explanations for “exceptions”).
- Require industry to collaborate so that inward and outward volumes can be optimised.

Example Two: Although South Africa has significant potential to grow the ship repair sector, the absence of relevant infrastructure is severely limiting growth. This matter was subject of attention in Marine Phakisa.

	Description of SA advantage	Current Situation
High traffic location	▪ South Africa is ideally positioned to service – **East-West cargo traffic** that is too large for the Suez canal – 30,000 ships – **African offshore oil and gas** vessels/rigs	• South Africa ship repair only has a market share of 5% of potential ships. • Existing specialised ship repair infrastructure is in an appalling state significantly hindering development of industry. • Saldanha Bay ideally positioned for oil and gas but being used for manganese. • TNPA not investing in new specialised infrastructure severely limiting sector growth
Low cost	▪ Total repair costs are driven by labour costs (~60%) and South Africa competes favourably when compared to EU counterparts	
Service sophis-tication	▪ South Africa can undertake a wide range of repairs e.g.,, ship repairers in Durban can undertake an extensive range of repairs on vessels in excess of 300m and are supported by specialised local firms	

There is contradiction between Transnet's enterprise and the imperatives of the national industrial effort. Marine Phakisa has sought to address this problem.

Causes of Situation

- While the marine engineering sector creates significant jobs and exports for service providers, investments in relevant infrastructure gives the Transnet Group relatively low returns ie. There is a contradiction between national and enterprise interest.
- In the context of the Market Demand Strategy, investments in existing and new marine engineering infrastructure has been deprioritized by Transnet for more profitable infrastructure.
- The Regulatory dispensation does not incentivize TNPA to use or maintain existing marine engineering infrastructure properly – they are able to recoup costs and get a return through their revenue allowance regardless of of well the infrastructure is used.

Solution

- Following the Phakisa process, Transnet has agreed to:
  - invest R5 billion in the maintenance and refurbishment of existing dysfunctional infrastructure.
  - Enter into PPPs to raise a further R10 billion of investment
- Both the above processes have commenced with a great deal of urgency from Transnet.
- The Regulator is reviewing the dispensation to incentivise efficient use of the infrastructure

Example: Port Tariffs to support the national industrial effort

- SA port tariffs and inefficiencies are a major barrier to a national industrialisation effort:

- Port tariffs for value-added manufactured products, according to the World Bank, are amongst the highest in the world.
- The export of primary commodities and the import of value added products are priced lower than the export of value added-products.
- The Port Regulator is not responsible for regulation of certain Transnet National Ports Authority (TNPA) charges. For example the Port Regulator does not regulate Transnet Port Terminals (TPT) charges which in the recent past have been raised at significantly above inflation costs.

- It is imperative that Transnet and TNPA supports the export effort, particularly the African export effort.

Rail fleet procurement

•PRASA's committed to a rolling stock programme, which aims to procure 7,224 new coaches at a projected cost of R123 billion over 20 years.

•This contract has been awarded to Alstom and the initial phase is estimated to create over 8000 direct jobs.

•In October 2013 PRASA and Gibela Rail Transportation signed a R51 billion contract to supply some of these trains.

•This contract will supply the state agency with 600 commuter trains (3,600 coaches) over the next ten years.

Rail fleet procurement cont.

Rolling Stock Fleet Renewal Programme

Modern Fleet

- PRASA wants to migrate from 1950's technology to a **modern** fleet which is up to **world standards**

Programme Requirements

- New Fleet requirement **~7224** procurement at ~360 coaches per year for two x 10 year contracts
- Total **~R123.5bn** over **20 year** period

Job Creation

- Creating **~65 000** direct and indirect jobs

Industrialization

- Focus on industrialisation through long term procurement aiming for **above 65%** of the value of a coach to be **produced locally**

Rail fleet procurement cont. :

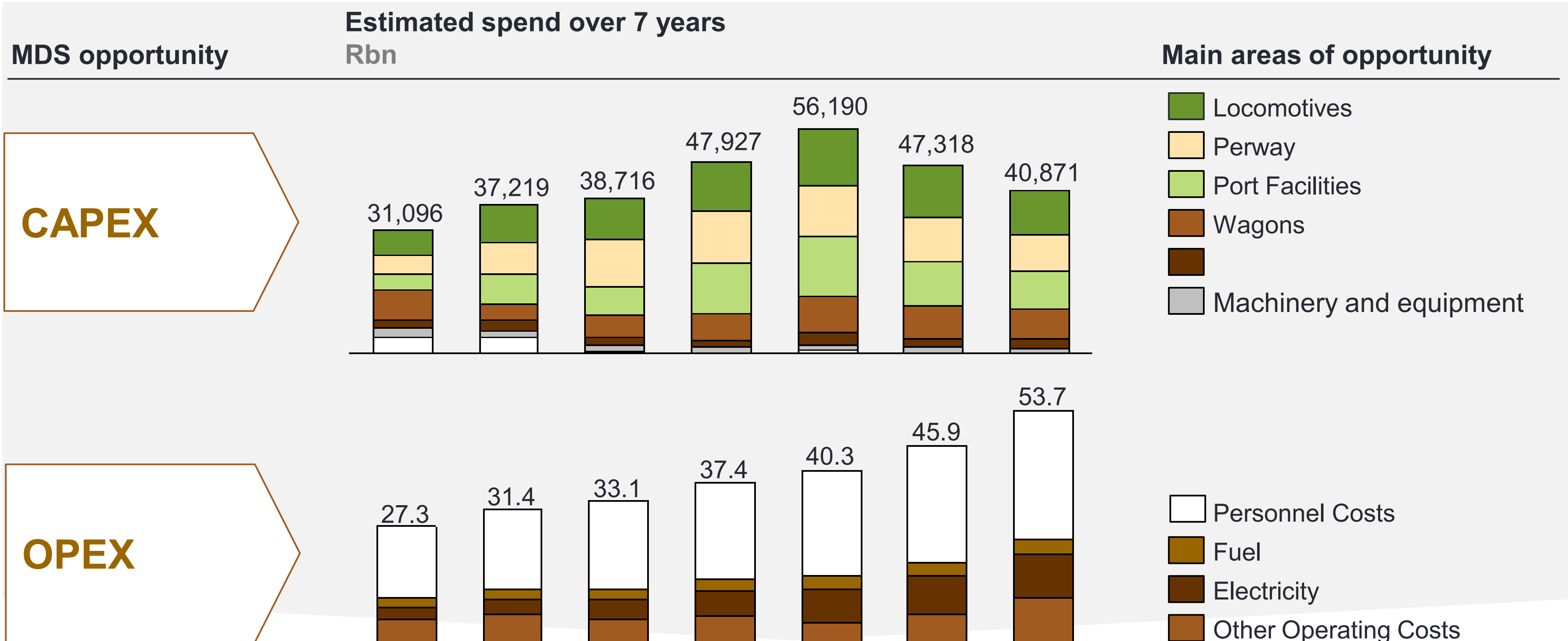
The Transnet locomotive fleet procurement can result in the establishment of a world class locomotive manufacturing cluster and position SA as a global rail production hub, particularly with respect to the African continent.

- Transnet finalised the procurement of 599 electric and 465 diesel locomotives in 2014 – this large order created a unique demand foundation for localisation to take place.
- The local content requirements for the procurement were 55% for diesels (from around 20%) and 60% for electrical locomotives (from around 27%)
- Four suppliers were selected, namely China South Rail and Bombadier for the electrical and China North Rail and GE for the diesel locomotives.
- Significant progress has been made by GE and Bombadier in developing local industry:
  - Suppliers have gone through rigorous accreditation processes which involve significant technology transfers to improve supplier productivity and capability.
  - Certain very complex components (such as traction motors) have been localised for the first time in South Africa's history.
  - These developments will improve the supply chain for the energy and mining industry as well.
- There is room for improvement to ensure that across all OEM's localisation and supplier development is secured and reported upon.

- **The dti** is working closely with Transnet and suppliers to maximise support, including the possibility of a supplier park for all suppliers.

Rail Procurement conti…

For example, Transnet identified a range of opportunities to leverage its spend to support the development of suppliers.



- While MDS Capex spend is set to peak in 2016, Operating expenses will continue to rise as increased volumes are moved
- Capex spend of R300m over 7 years whilst Opex spend will be R328 million
- Significant opportunity to extract SD through both Capex and Opex plans

Progress to date on Transnet National Ports Authority (TNPA)

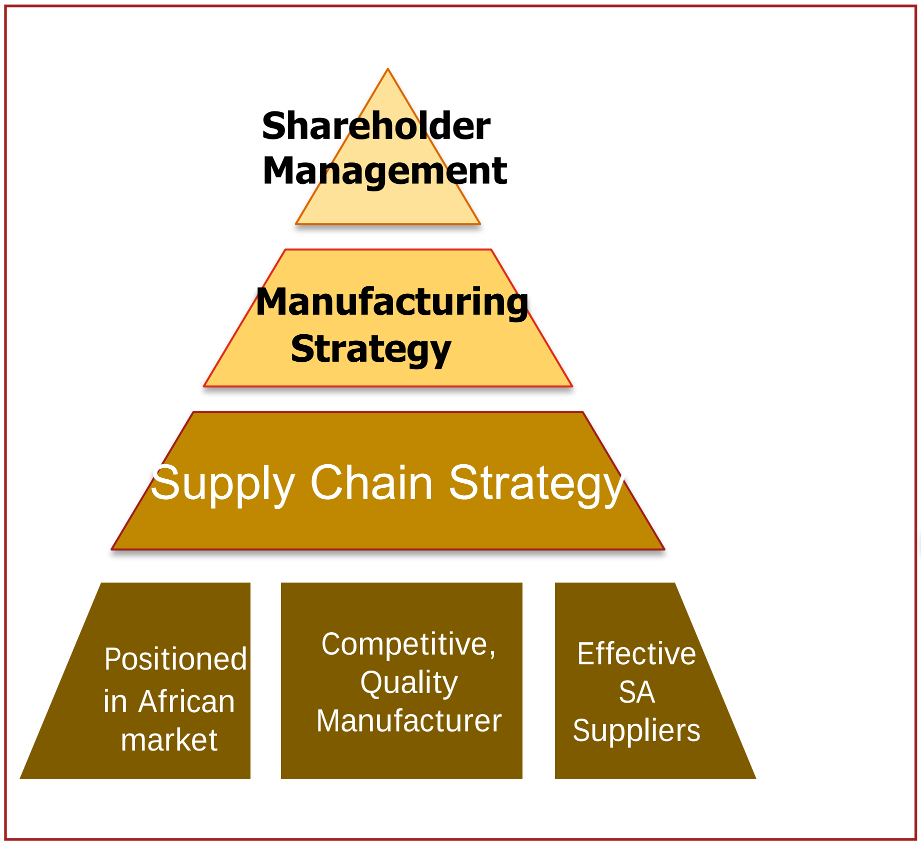
- Transnet National Ports Authority (TNPA) and Transnet SOC Limited have adopted a Public- Private -Partnership (PPP) model to finance new Operation Phakisa infrastructure.
  - TNPA has committed R7 billion for public sector investment in domestic ports to support industrial opportunities in the ports.
- Establishment of Saldanha Bay as an oil and gas hub:
  - Total scope of initiative amounts to R9.2 billion investment (public and private).
  - 3 projects:
    1. Offshore Supply Base – work has commenced.
    2. Berth 205 (rig repair facility)
    3. Mossgas Jetty (extension)

Progress to date on TNPA

- Ports of Port Richards Bay, Durban, East London, Port Elizabeth, Mossel Bay, Cape Town:
  - TNPA has appointed transactional advisors for refurbishment and maintenance of port facilities. Scope and maintenance refurbishment requirements completed.
- **the dti** designated working vessels for local procurement (60% local content). National Treasury issued Instruction Note.
  - A R1.4bn tender by TNPA for the procurement of tug boats was awarded to a South African company in support of local procurement
- **the dti** is in the process of developing a **strategic marketing campaign and value proposition for investors** into the MTM sector.
- Entails **marketing related content** to be deployed to market the country and investment opportunities in the Blue/Ocean Economy.
- DOT released Draft Maritime Transport Policy which includes work on cabotage on coastal, regional and continental waters.

SOC such as Denel or Transnet Engineering can make direct investments in industrial capability – but the trick is to act as an anchor for the development of a broader cluster.

Strategic Pyramid



Strategic Objectives

A ***Shareholder Management*** – Provide guidance to SOC in respect of strategic mandate, roles, responsibilities, high level objectives and KPIs

B ***Manufacturing and Design Strategy*** – Define a seven year vision and high level strategy for the SOC to drive enhancing national manufacturing and design / engineering capabilities – e.g. aerostructures.

C ***Supply Chain Transformation Strategy*** – Formulate a strategy which demonstrates over a five to seven year period what will be manufactured internally, what will be outsourced nationally, what will be imported and what will be localised internally and in the supply chain and how this links with a transformation process..

Illustrative Areas of focus for SOC

- ***Strategic Market Positioning and Investment Strategy*** – Positioned as an exporter to Africa
- ***Performance Management and Cost Containment*** – Define detailed competitiveness plan.
- ***SA Supply Chain Development and Accreditation***– Plans for interventions to develop and accredit sustainable SA suppliers

For example, Denel is playing a leadership role in the development of a small African regional aircraft that will catalyse development in the whole sector.

TIER 1 & TIER 2 SUPPLIERS

Design, integration, assembly, & manufacture of major and minor sub-systems

- Denel SOC Ltd Aviation, Aerostructures, Dynamics, OTR
- Paramount Group
- Aerosud Aviation
- TurboAfrica (Pty) Ltd

TIER 3 SUPPLIERS

Design, manufacture and integration of components

- Cliff's Way Engineering (Pty) Ltd
- Micromax (Pty) Ltd
- Daliff Precision Engineering (Pty) Ltd
- African NDT Centre (Pty) Ltd
- SAAB
- Tellumat
- AIRBUS DEFENCE & SPACE

RESEARCH & DEVELOPMENT

Service provision

- Council For Science & Industry Research
- National Aerospace Centre
- AISI
- Universities

The Small African Regional Aircraft Program involves developing a 24 seat passenger / freight pressurised African air taxi.

This can act as a base-load of demand for the sustaining and building of an entire cluster.

CONCLUSIONS

- SOCs have a particularly important role to play in the economy:
  - Through providing 'network' infrastructure, and
  - Investing where or when the private sector does not.
- Insufficient investment in economic infrastructure – as we have seen in energy – will create binding constraints to economic growth.
- Government's infrastructure build programme – one of the largest in the world – provides powerful levers to re-industrialise and deepen industrialisation in the SA economy.
- SOCs must be at the forefront of the industrialisation process – failure to play this role will lead to import leakages and missed opportunities for local value-addition, jobs and tax revenue.
- SOCs have a variety of levers available within the PPPFA - Section 9 (3), Competitive Supplier Development Programmes, and designations.