SOUTH AFRICA

Background to Ferrostaal's activities in South Africa and involvement in the arms deal

In 1994 the post-apartheid South African government announced its decision to pursue a comprehensive program to modemize its navy and enter into an arms deal with various suppliers for military ships, aircraft and other hardware. The arms deal was concluded in 1999 after a round of bidding for the various contracts. The German Consortium of arms suppliers which received the contract is made up of two groups: the German Frigate Consortium (GFC) led by ThyssenKrupp and the German Submarine Consortium (GSC) led by Ferrostaal.

According to reports in the media, South Africa has already received four Valour Class MEKO A-200 anti-air frigates manufactured by Blohm + Voss in Germany which were bought for US$3,9 billion.[1] Ferrostaal, along with HDW and Nordseewerke Emden were to provide three submarines worth US$775 million (other reports say US$857 million) to the South African Navy in an agreement which would conclude at the end of 2007.[2]

The arms deal itself was structured to include the new economic development strategy of the South African government to negotiate for complementary investment from the arms suppliers. This complementary investment is divided into two parts: industrial participation agreements or the National Industrial Participation programme (NIP) and Direct Industrial Participation (DIP) in the actual defence industry. This is commonly known as the 'offset' programme. The offsets were valued at US$16,6 billion in total.[3]

The arms deal was not received favourably by some members of the South African parliament and has attracted much criticism from the press and opposition political leaders in South Africa. Part of this criticism is based on public expectation that the then newly elected ANC-led government would have focused on social and development investments rather than military investment. The government responded by emphasising the opportunity of industrial growth through the offset agreements. There was also a study reportedly presented to the South African cabinet assessing the arms deal as a highly risky proposition and one that would damage the defence parastatal, Denel, which was meant to benefit from the deal. Most of the criticism since, targeted at the German companies including Ferrostaal, has been around allegations of corruption and bribery which took place before and at the time of the award of the contract; and the failure of the offset agreements, which is explained in the next section of this report.

[1] *Defense News*, 17 April 2006.

[2] *Defense News*, 17 April 2006.

[3] *Mail & Guardian*, 29 July 2003. Other reports refer to amounts of ZAR104billion then ZAR110 billion and most recently ZAR140 billion in complementary investment.

Contractual obligation and the offset programme

South Africa's Department of Trade and Industry (DTI) under which administers the arms deal and the offset projects has limited public access to the contracts and information about the contracts in the context of accusations that it has failed to monitor the contracts and the offset agreements. This has made it extremely difficult for the status of the NIP to be assessed since there is no comprehensive list of projects initiated. Most information is based on source reports and leaked information in the media.

Well-placed sources in South Africa have confirmed that the contract price for the German Submarine Consortium (GSC) was ZAR4,289 million (approximately Euro660 million) and the Industrial participation (NIP) obligations alone for the consortium were ZAR19,680 million (approximately Euro3,028 million) when the contract was concluded in 1999. This is an implied 459% obligation to contract price proportion according to the source.

The South African Public Protector, the Auditor General and the Public Prosecutors Office conducted a joint investigation into the arms deal and published a Joint Investigating Team Report into the Strategic Defence Procurement Packages (JIT) in late 2002. The report compared the proportion of minimum industrial participation requirements in other countries including UAE, Greece, Australia, the Netherlands, the Philippines, Saudi Arabia, Denmark, Kuwait, Taiwan and Thailand; with the proportion required by the South African government. According to this report, the proportion of industrial participation offset to contract price varied from 30% to 100% and additionally pointed out that the proportion achieved in the arms deal was substantially higher than South Africa's own minimum requirement of 30% of exports.[4]

The Joint Report did not comment on the feasibility of the industrial participation undertaking by the contractual companies but sources believe that the undertakings were "onerous to the extent of being totally impractical". It is clear that the 'generosity' of the offset program was crucial to the success of the arms deal, partly because the South African government used this notion to justify the expense of the arms contract in the face of other priorities and partly because key members of the South African contracting team were enthusiastic about its potential to bring about broader industrialisation in South Africa. The DTI told the press that the

[4] According to press reports, under the NIP program, all government and parastatal purchases or lease contracts (goods, equipment or services) with an imported content equal to or exceeding $10m (or the equivalent thereof) are subject to an industrial participation obligation of normally 30% of the imported content of the contract. The seller/supplier will be required to participate in the South African economy as suggested by these guidelines and evaluation criteria. All such projects or business proposals must be based on the principles of mutual benefit and business sense.

arms deal and the offset projects were based on a strategy to attract operating partners with international experience and access to international markets not just foreign investment. The offset programmes were meant to have a long term commercial viability.[5] These projects would be aimed at benefiting previously disadvantaged communities and creating employment.

This enthusiasm was something the contracting German companies were not keen to discourage, in the opinion of the source. However the result is an impractical offset program which presents both the contracted suppliers and the South African government with a dilemma that is yet to be resolved.

According to sources, the offset conditions in the contract in themselves are problematic. The NIP and DIP programmes are based on the idea that the companies would gain credits in terms of the programme through an investment or project additional to what that company or another company for that matter, would have invested anyway. In the terminology of the contract, there has to be "direct causality" between the NIP and DIP programme and the investment. This begs the question of what constitutes an additional investment, for instance if a project is commercially justified, can it really be "additional"? And if it is not commercially justified, it would by definition fail (according to the sources). The relevance of this issue is that the judgement of whether a project should be an "additional" investment relies on the discretion of the DTI. Further, as in Ferrostaal's case, is a failed or problematic investment counted as a credit in terms of the programme and thus fulfilment of the offset obligation in the contract? Condition

These and other problems are likely to affect Ferrostaal in terms of its contractual obligation and possibly its reputation for the poor investment decisions within its own offset programme.

2.2.1 *Ferrostaal's offset obligations and projects*

check notes

Ferrostaal has a total NIP obligation of Euro2,85 billion. Thus far, projects worth Euro 1,718 billion have been approved divided between investments of Euro515,7 million and exports of Euro1,202 billion.[6] According to our sources, this is technically not a cash liability but a contractual liability. Ferrostaal is required to instigate investment or exports amounting to this figure and failure to do so will result in cash penalties of a lesser amount. However, the sources have said that given the high level of publicity around the arms deal, the South African government is under intense political pressure to ensure that at least the NIP and DIP commitments are honoured and in the opinion of well-placed sources, this could be described

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[5] *Moneyweb*, 6 April 2004.

[6] *Mail & Guardian*, 3 August 2002. Other reports put this amount at ZAR600 million in 11 projects with "total credits at ZAR817 million". (*Business Day*, 11 August 2006)

as an active contractual liability. This liability, according to some sources, amounts to roughly Euro1 billion.[7]

Ferrostaal's offset projects
The offset projects include: • bankrupted Magwa Tea Estate in the Eastern Cape (formerly Transkei); • Hosaf PET recycling plant, recycling plastic bottles to produce a granulated form of polyester; • a training centre in Atlantis; • a turbine –blade facility in Gauteng; • a joint venture to participate in engineering projects worldwide; • a frozen container plant worth ZAR640 million; • a Condom factory with German company Condomie (1993); • an aluminium smelter; • a steel precision strip plant worth ZAR800 million in Coega; • rig fabrication yard in Saldanha Bay and rig repair facility in Cape Town (March 2006).

Source: Various media database and web-based sources.[8]

2.2.2 *Reputational issues and consequences of failure to meet offset obligations*

Ferrostaal has been subject to public criticism several times because it was among the group of arms suppliers which had not met the deadlines for its local investment and purchase obligations as part of its agreement with the South African Department of Trade and Industry.

These deadlines were in 2003, 2005 and 2007 respectively. By 2003 Ferrostaal had a shortfall of ZAR4 billion and by 2005 Ferrostaal had achieved less than a third of its obligations. A few days after a report on the issue was published Ferrostaal announced the start of the two most recent projects (the stainless steel strips manufacturing unit and oil drilling rigs in Saldanha Bay).[9] Ferrostaal initially played down reports of the steel mill and did not confirm these reports

[7] Sources note that the actual contracts and offset projects have not been made clear publicly in South Africa.

[8] This includes mainly *Business Day*, 2 February 2005. Some of Ferrostaal's publicised joint venture local partners have included: DCD-Dorbyl, formerly Dorbyl Engineering and part of JSE listed Dorbyl Group (recently bought by Investec and BEE consortium Siyahamba); an unnamed Singaporean oil rig maker; KAP International's Hosaf Recycling for the recycling plant on the East Rand in Gauteng; Ferroman, Ferrostaal's local subsidiary, owns 30% of mineral processing engineering and project management specialist Metallurgical Design and Management (MDM) in Randburg, Johannesburg (the Black Economic Empowerment (BEE) component is provided by South 2 South); Condomie, a German company in the condom factory project to create a local company; technical partners on the Saldanha project are Grinaker LTA, DCD Dorbyl Heavy Engineering, DCD Dorbyl Marine and SA Five Engineering and Globe Engineering Works and Ferrostaal's local partner in the investment is Atlantis Marine Projects.

[9] *ISI Emerging Markets Africa wire*, 14 October 2005.

in the South African press but later made an official announcement of its investments worth ZAR1, 7 billion.

However sources report that trade and industry chief director, Sipho Zikode, briefing a parliamentary committee late last year, said that "hiccups" had occurred in Ferrostaal's plans to establish a ZAR1 billion (about US$160 million) oil and gas-rig manufacturing plant in Saldhana Bay. There were also reported 'delays' with the company's plan to invest in a precision strip stainless steel plant at the Eastern Cape development zone, Coega because of a disagreement with the Industrial Development Corporation on the rate of interest it would charge on its loan for the project.[10] However, press reports state that the building of the mill, which has been in the pipeline for many years, has been delayed due to the lack of financial disclosure by the investing company, Southern Cross Precision mill. The Coega Industrial Development Corporation had committed itself to funding part of the project, but Southern Cross was still raising the finance. After struggling to find investors for the ZAR1, 1 billion steel mill project, this delay has been used to criticise the offset strategy yet again.[11] It is unclear what Ferrostaal's position is with regard to this issue.

Two of Ferrostaal's other failed or problematic investments stand out: the first, the investment in the Magwa Tea Estate and the investment in the Atlantis Trust Deal. Both these deals as well as the other failed projects (which we do not currently have a comprehensive list of) are indications of poor investment decisions and poor planning on the part of Ferrostaal, according to well-placed sources. In fact, these sources claim that in comparison with other German companies involved in the offset programme, Ferrostaal has made poor investment choices of projects which have ended with various problems.

Magwa Tea Estate:

The country's biggest tea estate, the Magwa tea plantation, was in a bad condition and declared bankrupt but the resuscitation of the estate was one of the projects Ferrostaal attempted. However, the estate was handed over by the government to beneficiaries of a land claim without the knowledge of the management or Ferrostaal (funders).[12] Ferrostaal had spent ZAR16 million and planned to spend another ZAR7 million on the tea estate.

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[10] The Coega Industrial Development Zone (IDZ) was established to alleviate poverty and unemployment in one of South Africa's poorest provinces. A hundred jobs were said to be created during the construction phase and another sixty permanent positions at the plant itself. The Coega Development Corporation has been successful in attracting high levels of foreign investment. (*Business Day*, 1 February 2007)

[11] *Business Day*, 11 August 2006.

[12] Lusikisiki is one of South Africa's poorest towns and the Magwa tea estate is reported as the only significant employer (employing 2800 people). The tea estate comprises of 5200 ha of which 1200 ha are cultivated. (*Sunday Independent*, 19 November 2006)

There was also publicity about the partners which Ferrostaal introduced but which had exited the investment. First the Ugandan partner, Madhvani and then the Indian partner which the government brought in, and JV Gokal exited the deal after reports of the ZAR10 million in outstanding wages. This and other large financial needs make the deal seem an unfavourable choice likely to fail. The question is, why did Ferrostaal choose to invest in this type of project?

Trust Deal:

Ferrostaal lent ZAR25 million to the Atlantic Economic Development Trust as part of the offset programme. Danny Oilfant, former chairman of the Trust, resigned from the body in July 2006 allegedly because he feared legal prosecution by the German company after he and two colleagues were accused of defrauding the Trust of nearly ZAR3 million through their companies, Quantum Leap and Global Dinamix. It is also alleged that the Trust withheld tax of about ZAR1,2 million from the South African Revenue Service (SARS) and from the Unemployment Insurance Fund using the funds for other purposes. The matter has been opposed by the Trust.[13]

Ferrostaal applied for provisional liquidation of the education and training Trust after it claimed that the Trust was in breach of its loan agreement and that it could not pay its debts.

The company also gave ZAR2 million to the Trust to purchase premises but this was not used for that purpose as the Trust used a donated property. Olifant is also one of the 28 Members of Parliament in South Africa charged with fraud relating to the travel voucher scandal. By its own confession, this caused much embarrassment to Ferrostaal.

2.2.3 *Consequences of failure to meet offset obligations*

As mentioned above, there has been pressure on the South African government to enforce the offset investments since the results thus far have been poor. By September 2006, it was revealed to the South African Parliament that ZAR29 billion was spent on the arms deal for only 13,000 of the promised 65,000 jobs created and by 2005 only ZAR23 million had been generated from the offsets.

The South African government's own assessment of the program, according to sources, is that 150 projects had been approved and implemented in the first decade of its existence and it has generated investment of US$2,2 billion and export and local sales credits of US$4,5 billion. However, between 8% and 15% of the projects have failed or were in "intensive care" and

[13] *Business Day*, 11 August 2006.

although the South African government has not made specific comments about contracted parties, it is clear that there have been problems with Ferrostaal.

One possible solution of the problem of slow or failed delivery of offset obligations by the contracting German companies, including Ferrostaal, would be to impose the contractual penalties: the government could charge penalties of between 5% and 10% of the total value of a specific contract if any of the suppliers do not meet their offset agreements. According to the source, the Department of Trade and Industry (DTI) announced in 2006 that DTI Minister Mandisi Mpahlwa had written to both ThyssenKrupp and MAN Ferrostaal in 2005 warning them that unless they met their offset targets, penalties might be considered. Ferrostaal then announced further investment in the form of the Coega steel mill project and the rig fabrication facility in Saldhana.

At the last milestone evaluation in 2005 and until mid-2006 the following table represents Ferrostaal's and the GSC's status in the offset project (note that this has changed with two more investments since)

Contractor	Shortfall	Shortfall as a % of First Milestone Commitment	Estimated Penalty
Ferrostaal	R 4bn	69%	R136m
BAE/SAAB	R 845m	6%	R315m
Thales	R 263m	15%	R93m

Source: DA Report entitled 'R5 billion worth of broken promises'

A well-placed source stated that the specific public criticism of the German companies is a more recent phenomenon suggesting growing government anxiety and impatience with the state of the programme and this is partly a consequence of a change in portfolios of the personalities involved, following the departure of Minister Alex Erwin from the DTI in 2004.Erwin was one of the programme's most passionate advocates. Although Erwin is still somewhat involved in his current portfolio of Public Enterprise Minister, it does create the opportunity, in the opinion of the source, for the existing department to place the blame on the previous administration and this could lead to diminishing interest and commitment to the project balanced with the publicity and public expectation for the project.[14]

It is the opinion of our sources (although the DTI has given the contracted companies more time to fulfil their offset obligations) that the likely outcome of Ferrostaal and other companies' failure to meet these offset project goals, given the nature and history of the government's dealings with foreign investors, would be a financial settlement between the company and the South

[14] According to sources, there has been some attempt to 'downgrade' public expectation, for example, Erwin's original projection of the creation of 12,000 jobs from the project has been reduced to 8,000 by the DTI officials and more realistically only 2,000 – 3,000 jobs created.

African government either up to the full amount of the contractual penalty or in the form of a negotiated settlement which would see all parties coming away with some gain.

.3 Transparency, bribery and current investigations

:.3.1 *German and other investigations into the award of the arms deal contract*

The German official investigation into the German Consortium led by ThyssenKrupp and Ferrostaal has concentrated on the original deal in 1999. Thyssen is being investigated for the 30 million German Marks categorised as 'useful expenses' which appear in its accounts. This is said to be in relation to the sale of the four patrol corvettes to the South African government in a deal signed on 3 December 1999.

The German authorities are investigating incidents of bribery and tax evasion. The German authorities have not yet requested the National Prosecuting Authority (NPA) in South Africa to assist but the NPA has publicised its willingness to participate in any investigation.

This relates to the fact that some press articles report that the initial 700 million German Marks sale to the South African government was initially rejected in 1994 and President Thabo Mbeki, then Deputy President, reviewed the decision. British and Spanish suppliers were left after the German Consortium did not make the short list but four weeks later, Mbeki announced, during a visit by the German minister, that the Germans were in fact on the short list and it was still open. The Spanish company, Bazan which was negotiating for one of the contracts was selling the frigates for a lower price at ZAR2,5 billion. However, the claim that the German Consortium sold these arms to the South African government at a higher price without a legitimate reason has not been proven.[15]

Pounds

A former South African official, who had access to such information, informed us in confidence that Ferrostaal paid ZAR30 million (about £2 million) to current President Thabo Mbeki to gain the arms contract in the first place. When questioned by investigators in South Africa, Mbeki claimed that ZAR2 million was given to his former Deputy President Jacob Zuma and the rest went to the ANC. However it is unlikely that this information will be leaked in the near future because Mbeki maintains a tight reign on the National Prosecuting Authority where this matter would be dealt with. Further investigation into this issue is being pursued by by various sources.

Investigations into the arms deal are taking place in other countries too, according to one source, such as the UK, Sweden and France. This present a widespread reputational risk for

[15] One opposition leader accused the government of buying German frigates from Ferrostaal at an additional cost of ZAR75 million for each frigate. This appears to be misinformed.

Ferrostaal, although it is difficult to predict how far the German authorities are willing to pursue their case against Ferrostaal.

Controversial figures involved in the award of the arms contract to Ferrostaal

The "De Lille dossier" is an informal term used in the press to describe the file of information and evidence that opposition politician Patricia De Lille has gathered about the arms deal. This reportedly includes a memorandum drawn up by ANC (ruling party) intelligence operatives concerned with the issue of the arms deal and released to opposition politician, Patricia De Lille in September 1999.[16] According to a press article in a local South African newspaper, the individuals involved in the award of the South African arms contract to the German consortium are Tony Georgiadis, Shamin 'Chippy' Shaik, his brother Shabir Shaik, who has been sentenced to 15 years in prison for corruption connected to the arms deal, and a number of middle men and companies used to transfer the money.

Tony Georgiadis

Tony Georgiadis, a Greek shipping tycoon based in England, reportedly had the "ear of the President Thabo Mbeki" when lobbying for the Thyssen, leading partner of the German Frigate Consortium, and Ferrostaal, which led the German Submarine Consortium. This related to the statement of Mbeki to the German minister that the bid was still open even though the German Consortium did not make the short list. Georgiadis is named as the one who "supported" and "facilitated" the success of the German bid. [17]

The media article claims that sources in touch with the German investigators told them that Georgiadis is a focus of their investigation of at least US$22 million in commission payments gained in the deal.

According to the *Mail & Guardian* article *Der Spiegel* revealed that the German authorities were looking into payments made to several other people and this included a Monrovia-registered company, Mallar Incorporated, which received US$22 million by October 2001. This article claims that German investigators believe that Georgiadis is behind this company.

Georgiadis reportedly keeps a low profile but attracted some attention when his wife, Elita left him for the former South African president, FW De Klerk. Georgiadis has had a long history with the South African Apartheid government and was close to De Klerk. This relationship has continued with the post-apartheid ANC-ruled present government. He has been linked to former

[16] *Mail & Guardian*, 9 February 2007

[17] *Mail & Guardian*, 9 February 2007

Justice Minister Penuell Maduna, former NPA boss Bulelani Ngcuka and the publication claims that he is close to President Mbeki himself.

Shamin 'Chippy' Shaik and Merian Limited

Shamin 'Chippy' Shaik, the former chief of acquisitions for the South African Defence Department initially came under suspicion during the local investigations of the arms deal because of his brother, Shabir Shaik's involvement in the arms deal outlined in the next section. However, the recent South African press article has revealed that Chippy Shaik is one of the central figures in the controversy surrounding the arms deal and has been accused in the press of corruption.

Chippie Shaik allegedly met with executives of the German Frigate Consortium in July 1998 and demanded payment of US$3 million to ensure that the German Consortium won the bid. This was done through a middle-man and friend of Chippy Shaik, Ian Pierce. However, the article referred to quotes an article in Der Spiegel which states that later in 1998 a lobby agreement was signed with Merian Limited, a London based firm represented by Ian Pierce. The first payments to the GFC by the South African Government occurred in April 2000, the same month Merian received the US$3 million.

The South African publication, the *Mail & Guardian* in which the article appears claims that it has traced five payments made by Merian to a South African bank account held by Pierce which began in August 2000 until March 2001 totalling to about ZAR470,000.

Chippie Shaik has also been accused of influencing the investigation of the arms deal by being a member of a 'steering' committee which approved of the report on the investigation before it was released. More research would be required to determine whether this was a legitimate claim published by the South African press.

Shabir Shaik

There have been many controversies related to the arms deal not least the National Prosecuting Authority's (NPA) investigation into the arms deal headed by Bulelani Ngcuka which led to the conviction of Shabir Shaik for corruption and the trial of Deputy President Jacob Zuma. Ncguka has since resigned after intense criticism from Zuma's supporters and public scrutiny of his handling of the case. Some parties have commented that this criticism was a way of deflecting attention from the arms deal itself and the results of the investigation which implicated other members of government and even President Thabo Mbeki himself.

Another link to Ferrostaal is the fact that the German Consortium, of which it is a part, was given the order for the military vessels by African Defence Systems (ADS) which was headed by Shabir Shaik.

2.3.3 *Contribution to ANC election campaign*

Another significant scandal involved Ferrostaal's media advisor, Stephen Laufer. Media reports dated 2005 revealed that the ANC confirmed to the press that it had approached the Ferrostaal advisor in his personal capacity to source aide for its election campaign in 2004. Laufer subsequently brokered a deal with MAN Ferrostaal's sister company, MAN Truck & Bus of South Africa to supply ten trucks and two buses for the ANC campaign.

The ANC denied that it had not approached Laufer as representative of Ferrostaal but only in his personal capacity. However this occurred during a time when Ferrostaal was getting attention in the media for not meeting its offset targets and was about to be penalised by the government which could have been between 5% and 10% of the total worth of its contract. The South African government did not penalise Ferrostaal and there was much speculation that the two incidents were related.

This resulted in negative publicity for Ferrostaal and indicated that the company was not completely transparent about their activities and interactions with the ANC government.