



# Strategic Defence Packages

*Draft report of the Auditor-General*

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## CHAPTER 10

### **COST TO STATE AND FINANCIAL AND FISCAL IMPLICATIONS OF THE SDPs**

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*Lionel Seabrook  
Sone geobor.  
22/10/2007*

## 10.1. EXECUTIVE SUMMARY

## 10.1.1. KEY FINDINGS

10.1.1.1. During the investigation the following key findings were identified which are fully dealt with in detail in paragraph . . . . . of this report.

10.1.1.2. The costs of the Strategic Defence Package presented to Cabinet on 18 November 1988 amounted to ~~£29~~ £29 773.13 million which excluded finance costs is amounting to 49% of the procurement costs.

10.1.1.3. Necessary findings as to the reasonability of the financial <sup>and economic</sup> model used were made by two <sup>independent</sup> ~~economic~~ independent economists (ref. . . . .)

## 10.1.2. Conclusions

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## CHAPTER 10

### COST TO STATE AND FINANCIAL AND FISCAL IMPLICATIONS OF THE SDPs

#### 10.1 ~~10.1~~ BACKGROUND

The specific brief in this regard was to determine the costs presented to Cabinet, on the basis of which Cabinet took a decision to approve the procurement, including any reports on the assessment of the impact of the procurement on the economy and its affordability.

#### 10.2

#### ~~10.2.1~~ Scope of the Investigation

The investigation into the cost to state of the procurement of the Strategic Defence Packages sought to establish the following:

#### 10.2.2

Whether the amounts calculated by the model used are reasonable and reliable, taking into account that this would form the basis for the decision to be taken by cabinet.

#### 10.2.3

The macro-economic and other assumptions and variables used.

#### 10.2.4

The completeness of the model used.

#### 10.2.5

The treatment of the finance charges.

#### 10.2.6

The full financial and fiscal implications of the SDPs.

#### 10.2.1

The cost presented to Cabinet including any reports on the assessment of the impact of the procurement on the economy and its affordability.

## 10.3 Procedures performed

10.3.1. The following procedures were performed with ~~regard~~ in order to address the scope of investigation:

10.3.1.1. The members of the AASB, AAC, COB, and the ministerial sub-committee were pursued ~~in order~~ to ascertain the cost as presented to it.

10.3.1.2. Interviews to Admins were pursued to ascertain the cost presented to it.

10.3.1.3. The affordability report was studied.

10.3.1.4. Numerous consultations were conducted with relevant roleplayers in order to <sup>get an</sup> understanding of the calculation cost of the procurement at various stages.

10.3.1.5. Two independent economists were appointed to assess the reasonability and appropriateness of the models used by the affordability team.

## **10.3/** ~~FACTS~~ EVIDENCE OBTAINED

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

SOFCOM was tasked with the consolidation of the evaluation results pertaining to the SDPs made in the presentation to the AASB on 8 July 1998. The costs presented, according to the minutes, included all applicable costs, and are based on quantities other than those eventually contracted for i.r.o some programmes. The AASB resolved not to make any pronouncement on the presentation, but that the Minister of Defence and AAC should be advised of the progress. The total costs presented to the AASB included the finance costs, which were in respect of all the bidders. The detail of the costs presented is dealt with in paragraph 10.3.2.

### **10.3.2** Presentation made to the AAC on 13 July 1998

The presentation made to the AASB on 8 July 1998 was also made to the AAC on 13 July 1998, with the latter presentation including an additional spreadsheet detailing the costs pertaining to the successful bidders. The total amount presented was \$ 10 761.10 million, which was made up of \$ 7 273.5 million in programme costs and \$ 3 487.6 million in finance costs. These costs are based on the selection of the Aermacchi MB339FD for the LIFT programme. If the BAe Hawk were to be selected, the total cost would be \$ 11 402.5 million, comprising \$ 7 652.3 million and \$ 3 750.2 million in programme costs and finance costs, respectively. No rand equivalent was mentioned in the presentation or the minutes.

During a meeting of the AAC on 16 July 1998, the chairman instructed that the negotiation should proceed without eliminating any of the contenders or exposing the results.

In a response received from government it was stated that this financial cost was a first level attempt to estimate the cost of financing ~~without~~ without any hedging or alternative repayment structures.

### 10.3/3 CoD meeting of 21 August 1998

At this meeting, Mr S. Shaik informed the CoD that the total package deal, excluding finance charges, amounted to R66 718 <sup>million</sup> billion. The basis for this amount could not be determined. This amount did not account for the elimination of the main battle tank (MBT) programme and the reduction of quantities on other programmes. The amount is based on cost of \$10761,10 million referred to in paragraph 10.3.2 above converted at R6,25 per US dollar.

### 10.3/4 Ministerial briefing on 31 August 1998

A special ministerial briefing was held on 31 August 1998, at which the cost of the SDP was presented. The cost presented was R27 406.3 million, based on the selection of MB339 as the LIFT, and R29 773.8 million, based on the selection of the Hawk as the LIFT. The rand/dollar exchange rate used in the presentation was \$ 1 = R6.25, which results in dollar amounts of \$ 4 385 million and \$ 4 763.81 million, respectively. These amounts are programme costs and are exclusive of finance costs. The difference between the amounts in paragraph 10.3.2 and those above is due to:

10.3/4.1 The inclusion of the amounts of the MBT on 13 July 1998 which amounts were excluded on 31 August 1998.

10.3/4.2 The inclusion of <sup>four</sup> ~~five~~ submarines on 13 July 1998 and only <sup>three</sup> ~~four~~ on 31 August 1998.

10.3/4.3 The probable difference in exchange rates between the two dates.

### 10.3/5 Presentation to Cabinet on 18 November 1998

10.3/5.1 A presentation was made to Cabinet on 18 November 1998 with the objective of obtaining approval for the recommendation of the preferred bidders and for the

DoD, DTI and DoF to enter into contract negotiations. The total programme cost of the SDP indicated in this presentation amounted to R29 773.13 million. This cost did not include the financing costs of the SDPs.

10.3.5.2 Cabinet resolved that the recommendations of the preferred bidders are accepted in the interim, and that the departments involved should proceed with further detailed negotiations with the preferred bidders to achieve affordable agreements.

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

10.3.6.1 An "*Affordability of the Defence Strategic Armaments Packages*" report was compiled and issued by the affordability team of the IONT on 31 August 1999. The report was on the assessment of the SDP economic, fiscal and financial impacts. The total cost of the procurement according to the report, comprises:

- (a) The contract price, which is the actual military equipment as procured from the suppliers.
- (b) Statutory costs, consisting of freight, insurance and taxes.
- (c) Project management costs incurred by the DoD and Armscor in managing the procurements.
- (d) Financing costs for deferring payments to suppliers.
- (e) ECA premiums which are payable on all ECA-backed loans.
- (f) Escalation on all of the above payments made in future years.

10.3.6.2 According to par 2.1.2 of the affordability report, the costs as presented to Cabinet in November 1998 did not take into account all the elements as described above

for each and every package. The report further states that "consequently the total full cost is substantially higher than that originally presented to Cabinet". The total cost indicated in the affordability report as at August 1999 at an estimated forward exchange rate, is:

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

10.6.3 According to the report, the amounts above include all known costs as outlined above.

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

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

10.6.7.1 The scenario of some R21.6 billion was selected as the baseline figure. It should be noted that it is not indicated from the minutes whether this figure includes finance cost or not. The amount, however, appears to include project management, ECA premium and statutory costs and is based on tranche 1 only. This conclusion is based on the comparability of the baseline figure with the tranche 1 figure.



10.3.7.2 The cost of the full package requirement of all three tranches was R29.9 billion, with the decision to cancel/acquire tranche 2 and 3 in 2003 and 2005, respectively to be communicated to the international markets. The above figure also excludes finance cost.

10.3.7.3 The negotiation team should further explore a minor reduction to the R21.6 billion option.

10.3.7.4 The legal position with respect to "option to acquire" vs "option to cancel" should be cleared with the Minister of Finance before the next Cabinet meeting on 15 September 1999.

10.3.7.5 The negotiating team should conclude the final set of agreements with the respective suppliers for contract signature.

10.3.7.6 The recommendation of the Ministers' Committee on the Strategic Defence Package should be tabled in Cabinet on 15 September 1999.

### 10.3.8 **Cabinet briefing on 15 September 1999**

10.3.8.1 On 15 September 1999, Mr J. Naidoo, the chief negotiator with the IONT, briefed Cabinet on the Strategic Defence Package affordability. According to the minutes, Cabinet approved that the total price for the equipment should amount to R29 992 million. This total amount consists of two options to cancel decisions to be taken by the government in 2002 and 2004.

10.3.8.2 According to the minutes, government was further committed to the respective suppliers for tranche one only at this stage at a cost of R21 330 million. ~~Cabinet further approved that the negotiation team should be mandated to find solutions~~

~~to the cash flow bubble effect experienced in year 2003 to 2006 and report back to the relevant Ministers' Committee.~~ The amount of R21 330 million does not include finance costs.

10.3.8.3 The above rand values are based on the conversion of all foreign currency cash flows according to the estimated forward exchange rate at the relevant period. The resulting nominal rands have then been discounted back to real 1999 rands to remove the effect of inflation.

### 10.3.9 Cabinet Memorandum No. 14 of 25 November 1999

46 In terms of the memorandum mentioned above, the cost of the equipment package was R22.2 billion over an eight-year period. This is based on the transfer of the leasing of the simulator equipment for the Hawk and Gripen from tranche 2 and 3 to a full purchase agreement in tranche 1. If the option to procure additional equipment <sup>in the tranche 2 and 3</sup> is exercised, the total equipment cost will rise to R30.3 billion over 12 years. The totals include statutory and programme management costs and ECA premium where applicable, but not the finance costs.

### 10.3.10 Cabinet decision on 1 December 1999

10.3.10.1 On 1 December 1999, Cabinet discussed Cabinet Memorandum No. 14 of 1999, dated 25 November 1999, of which the objective was to obtain Cabinet approval to formally contract the preferred bidders. Cabinet, according to the minutes, granted the permission required by the DoD to sign supplies, Non-Defence Industrial Participation, Defence Industrial Participation and umbrella agreements. Cabinet also noted the cost associated with the supply of the defence equipment, of which the costs are as follows:

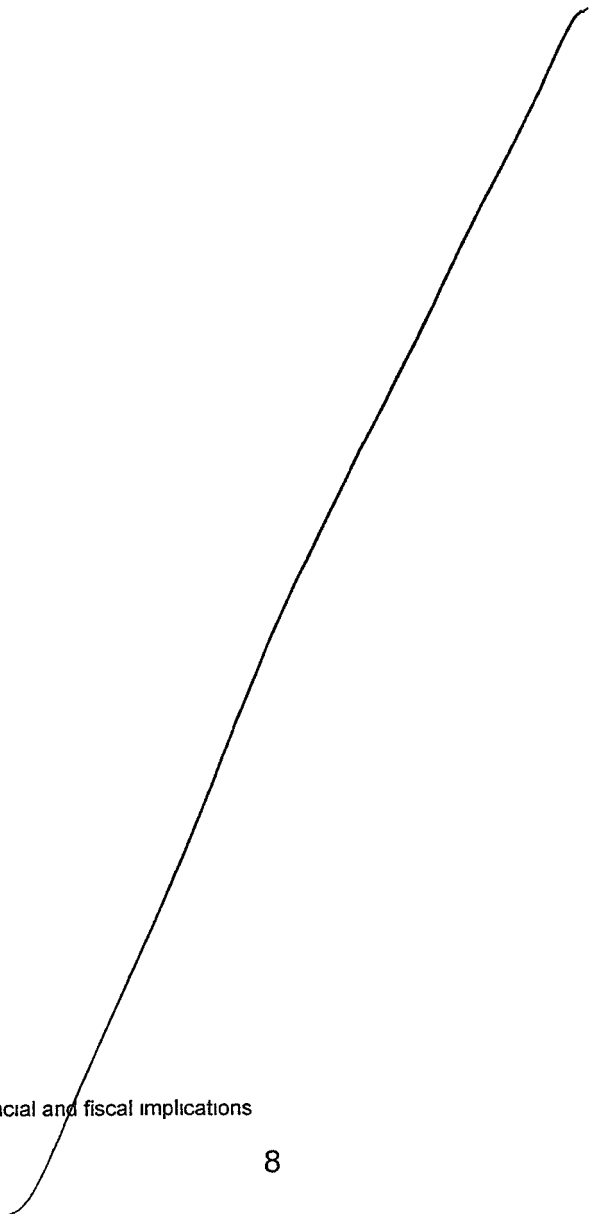
	24/11/99	15/09/99
	Rm	Rm

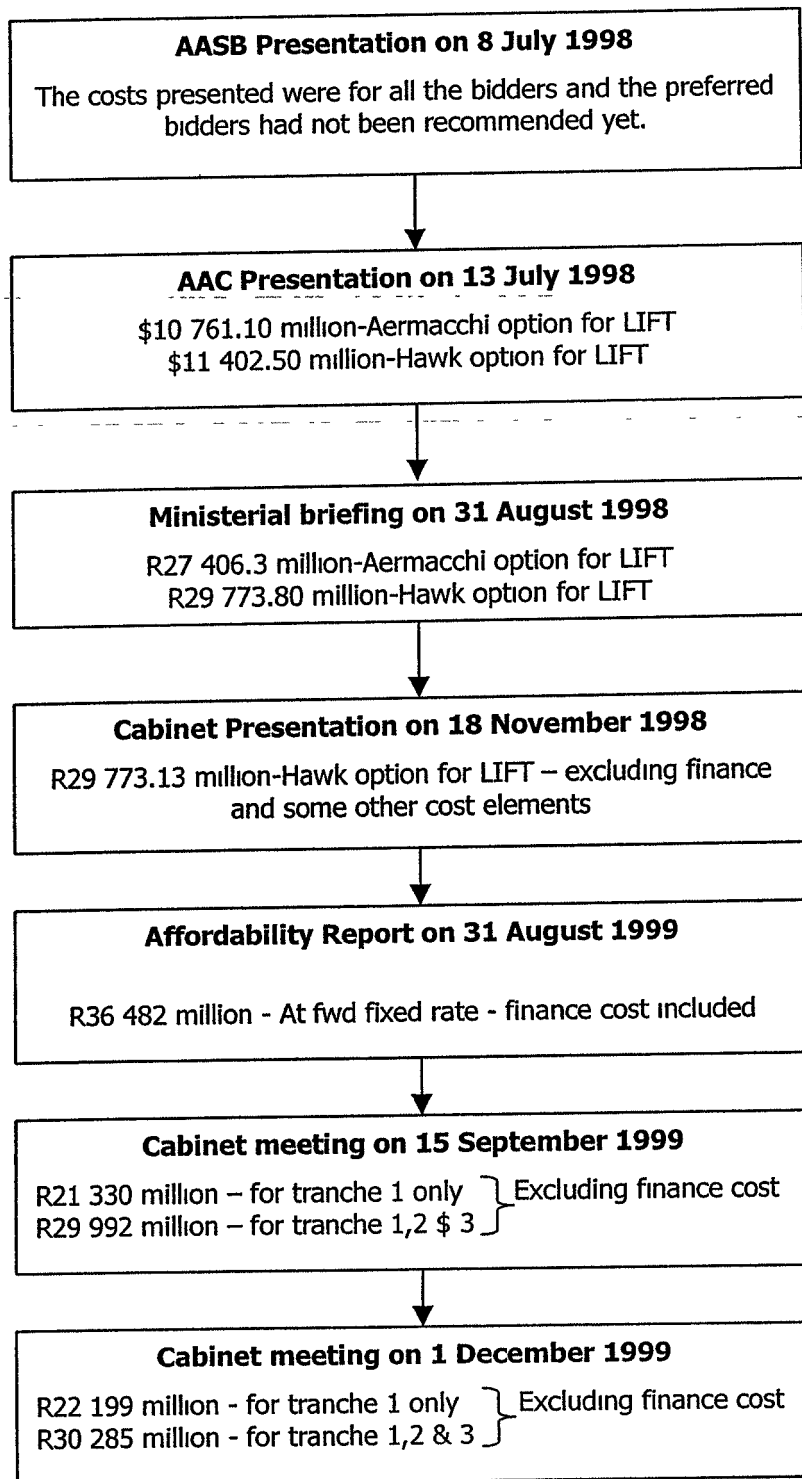
Total Tranche 1 Only	22,199	21,330
Total Tranche 1,2 & 3	30,285	29,992

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

**10.3.11 Graphical Representation of the Costs Presented**

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





### 10.3.12 Reasons for variations in amounts presented

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

	18/11/98 (R million)	31/08/99 (R million)	31/08/99 (R billion)	15/09/99 (R million)	25/11/99 (R billion)
Tranche 1 costs	-	25 364	-	21 330	22.2
Total costs	- 29 773.13	36 482	29.9	29.992	30.3

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

(a) Total costs

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

(b) Tranche 1 costs

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

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

The Affordability Team for submission to the Ministers' Committee on 31 August 1999 did a detailed report on the impact of the procurements. The affordability report was compiled using the economic models from IDC and the Bureau of Economic Research at the University of Stellenbosch. Inputs by Warburg Dillon Read, and Locker and Associates were also made. The assessment of this report with regard to the adequacy of the information and appropriateness of the financial and economic model used therein was performed by two economists.

## 10.4 FINDINGS

### 10.4.1 Costs presented to Cabinet

10.4.1.1 The costs of the Strategic Defence Packages presented to Cabinet on 18 November 1998 amounted to R29 773.13 million. These are programme costs and take into account statutory costs and programme management costs, but exclude the financing costs of the procurements, which amounted to \$3 750.2 million in terms of the AAC presentation on 13 July 1998. The finance costs account for about 49% of the programme costs. The fact that the costs presented in November did not account for all the elements is further substantiated in the affordability report.

10.4.1.2 This was also confirmed in a statement made by Mr R. White, one of the members of the affordability team.

### 10.4.2 Reasonability of the financial and economic model used

10.4.2.1 Two independent economists were appointed to assess the reasonability and appropriateness of the models used by the affordability team.

10.4.2.2 The key findings of the economists are as follows:

- (a) Certain fundamental errors, such as the accounting for the packages in the national and balance of payments accounts, crept into the assumptions used in the affordability scenarios.
- (b) Substantial impact on affordability that could in future materialise is the unsuccessful restructuring of the DoD budget and the effect on the DoD budget of underestimating the long-term full cost of ownership of the packages.

The implication of this is that no clear set of low to high risk scenarios incorporating as many as possible of the major risk factor was available for evaluation. This limits a clear understanding of the potential future costs and associated risks.

- (c) The affordability report was presented in a fragmented fashion. | *The procurement process.*
- (d) The general results of the affordability report also highlight the negative effect of unproductive expenditure on military equipment on the economy in general and its impact on government finance in particular.
- (e) The fact that the major elements of the affordability analysis were not available at an earlier stage of the negotiations limits the usefulness of the analysis.
- (f) The impact of the arms expenditure is generally negative in terms of growth, employment and the budget deficit.
- (g) The industrial participation packages have a potentially positive impact on Gross Domestic Product and employment creation. However, the extent of this is uncertain.
- (h) The model did not include all relevant costs, such as price escalations, cost of negative foreign exchange movements, etc.
- (i) The exchange rate projections by Warburg Dillon Read were found to be overly optimistic. *Notwithstanding the benefit of hindsight, no high risk scenarios relating to exchange rates were factored into the report.*
- (j) The projections did not include the maintenance costs linked to the SDPs and the medium-term public expenditure implications of the SDPs.
- (k) Very little attention seems to have been paid to the opportunity cost analysis of spending on SDPs.

## 10.5

### CONCLUSION



### 10.5.1 Treatment of the finance charges

The costs presented to Cabinet on 18 November 1998 did not take into account the financing costs of the procurements. These costs impact directly on the budget of the DoD and should thus have been taken into account.

*According to DoD the finance cost is not reflected in the Defence Star budget as this is a cost to state like any <sup>other</sup> IMF loans.*

### 10.5.2 The macroeconomic and other assumptions and variables used

The fact that the major elements of the affordability analysis were not available at an earlier stage of the negotiations limited the usefulness of the analysis.

### 10.5.3 The completeness of the model used

The model did not include all relevant costs, such as price escalations, cost of negative foreign exchange movements, etc.

The projections did not include the maintenance costs linked to the SDPs and the medium-term public expenditure implications of the SDPs. This could also have an impact on the budget of the DoD in the future.