CHAIRPERSON: Good morning everybody. Advocate Mphaga.

ADV MPHAGA: Thanks Chairperson, Commissioner Musi. Ms Ramagaga will be leading the evidence of Mr Donaldson today and (indistinct) previously we have indicated that Ms Maria Ramos and Mr Kganyago will be here today, but after having considered the affidavit of Mr Donaldson we (indistinct) dealt with an issue that covers Ms Ramos and Mr Kganyago's evidence before this Commission. They appeared this morning in attendance and we request that they be excused provisionally in the event that anything arises during (indistinct) that requires their attention we will indicate to them, but if (indistinct). Thank you.

CHAIRPERSON: And what will be the impact of the subpoena that we have served on them?

ADV MPHAGA: Chair, if it can just be set aside until (indistinct) or extended until ... (Indistinct).

CHAIRPERSON: I would rather prefer to (indistinct) them all together, if at all there is a need to call them, because from what I understand from you now there is no need for you to call them (indistinct) because you say that (indistinct) that they are going to call will cover issues that (indistinct) Mr Kganyago should come that witness is going to probably come. If at all at a later stage you believe that there are issues that that witness cannot cover I think only then can we consider subpoenaing Ms Ramos and Mr Kganyago.

ADV MPHAGA: That will be in order Mr Chairperson.

CHAIRPERSON: That will be in order. Thanks. Ms Ramos and Mr Kganyago you are now excused because as you can hear from the evidence leader the evidence that they thought that they might want to, they might want you to give evidence on, the witness that they have in mind, they think that he might be in a position to cover that and if it turns out at a later stage that the witness did not cover all the evidence or all the areas that they thought he will be in a position to cover, we will come back to you, but then at the moment you are not provisionally excused, you are excused altogether unless a (indistinct) served on you. Ms Ramagaga.

MS RAMAGAGA: Thank you Chair. The witness that we intend calling now is Mr Andrew Donaldson and he has taken the stand. I request that he be sworn in.

(Witness is sworn in.)

MS RAMAGAGA: Thank you.

WITNESS (ARMSCOR) : MR ANDREW ROBERT DONALDSON (Hereinafter referred to as "MR DONALDSON"), GIVES EVIDENCE UNDER OATH

EXAMINATION IN CHIEF:

MS RAMAGAGA: Mr Donaldson, you are the Deputy Director-General for National Treasury and you were appointed in January 2011.

MR DONALDSON: That's correct.

MS RAMAGAGA: 2010 I beg your, 2001, I beg your pardon Chair. 2001.

MR DONALDSON: 2001, that's correct Chairperson.

CHAIRPERSON: I'm sorry Ms Ramagaga, maybe before we proceed, we were given this document, I've received mine on Friday or so and it was not signed. I see now there is a signed one. I just wanted to find out whether any difference between the one that was given last one and the signed one.

MS RAMAGAGA: Thank you Chair. May I firstly apologise for omitting to clarify that. The statement is still the same, the only change that there is, is the signature that has been appended to the statements, so in actual fact what should have happened would be just to substitute the last page.

CHAIRPERSON: Thank you. I was just asking that because I've made several notes, I just wanted to find out whether you know my notes are still valid, whether the witness is still going to stick to the statement that we were given last week. Judge Musi says that he also had the same difficulty. Thank you.

MS RAMAGAGA: And may I also Chair just indicate that the page numbers that we will be using is the ones that appear on the top right hand side of the document because you will see that in respect of some documents the page numbers do also appear at the bottom, but those are just the independent page numbering. Thank you. May I then proceed Chair? Thanks. Mr Donaldson, prior to being appointed as the deputy director-general you served as the Chief Director Financial Planning in the Budget Office Division of the Department of Finance and the National Treasury?

MR DONALDSON: That's correct.

MS RAMAGAGA: Now from January 2001, that is after you were appointed as the director-general, as deputy director-general you were head of Budget Office in the National Treasury and Acting Head of the Public Finance Division.

MR DONALDSON: That's correct.

MS RAMAGAGA: From 2004 until October 2013 you served as the Head of the Public Finance Division.

MR DONALDSON: Yes, that's right.

MS RAMAGAGA: You have made a written statement on behalf of the National Treasury and that statement appears in pages 3 to 55 of the paginated bundle.

MR DONALDSON: That's correct, yes.

MS RAMAGAGA: Now I'd like you to turn to page 55. Are you there? Okay, there is a signature on this page, just on top of the name "Andrew Donaldson", is it your signature?

MR DONALDSON: Yes, that's my signature.

MS RAMAGAGA: And you signed the statement on the date that appears on the statement?

MR DONALDSON: I signed the statement at a later date, so that date is probably, it should be corrected. What date do you have on that?

MS RAMAGAGA: The date that appears on the statement is the 1st day of April 2014.

MR DONALDSON: No, the signature was the 8th, it should be corrected Chairperson, we should apologise for that, and that date should be reflected as the 8th.

MS RAMAGAGA: With your permission Chair I request that the date then be reflected as the 8th instead of the 1st of April. Thank you. Will you then turn to page 3 of the statement? Page 3 of the bundle Sir. Now in the first paragraph you mentioned that the statement covers the activities of the former Department of Finance and State Expenditure as well as that of the National Treasury since 2000 in relation to the Strategic Defence Procurement Package.

MR DONALDSON: That's correct. At the time I worked in the Department of Finance and the Department of Finance was formed of a merger of the Finance Department and the State Expenditure Department in 2000.

MS RAMAGAGA: Now will you please proceed to deal with paragraphs 2 and 3 of your statement on the same page?

MR DONALDSON: As is indicated here Chairperson the Minister of Finance head the National Treasury which comprises the Department or initially the Departments of Finance and State Expenditure and in paragraph 3 I do indicate that although the Arms Procurement was undertaken at the time that the (indistinct) Act was enforced, the relevant provisions of the (indistinct), Act in effect as I understand it, are deemed to carry and remain valid under the Public Finance Management Act in terms of which the Finance Department has exercised oversight over this procurement and its financing since the Public Finance Management Act was passed.

MS RAMAGAGA: Thank you. Will you then deal with paragraph 4 of the statement.

MR DONALDSON: Thank you Chairperson. Paragraph 4 just summarises the responsibilities of the National Treasury in the form of Finance and State Expenditure Departments, coordination of fiscal policy and macroeconomic policy and in relation to the Arms Procurement which was a very substantial expenditure with possible macroeconomic and fiscal implications, we therefore had a role and concerns to address with intergovernmental, fiscal and financial relations and management of the budget process and much of my work has involved the budgetary implications of this procurement programme.

MS RAMAGAGA: Now on page 4 of the statement or of the bundle I'd like to focus your attention to paragraph 6 and please explain to the Commission as to what the statement seeks to address.

MR DONALDSON: Chairperson, I set out in this statement the various roles played by officials of the former Finance and State Expenditure Departments and National Treasury and in some the role played in relation to providing for the expenditure in the appropriations of the Defence vote as they are presented to Parliament annually, importantly also the role of the Finance Department in financing the parts of the programme which was supported by international loan facilities and these loan facilities, the financing aspects of the procurement were managed by the National Treasury and Finance Department at the time and I also explain in the statements our cost estimates and there is some complexity to that because this was a large procurement of several items of equipment and the procurement was undertaken over a long time period and procurements over a long time period have to take into account exchange rate movements that affect those costs and inflation adjustments that affect those costs and so the statement does seek to try to give clarity to cost estimates which are varied depending on how they are calculated and perhaps have caused some confusion in the public information.

MS RAMAGAGA: Now turning to page 5 of the bundle it is actually common knowledge that the Department of Finance or National Treasury did not actually make decisions pertaining to the acquisition of the armaments. Can you just explain as to what you mean when you say that the, neither the National Treasury nor the Department of Defence was the contracting party to the contracts that were concluded, and may I just indicate as to why I ask this, I ask this in the light of the fact that the National Treasury is actually party to the contract that relates to financing and it is cited as the borrower in the contract.

MR DONALDSON: Yes. Chairperson, these were procurements undertaken by the Department of Defence and the Department of Defence's procurement arm, ARMSCOR, partly because they were so, such substantial investments in equipment they were accompanied with financing proposals, they were accompanied with loan offers by the governments and banks associated with those governments involved in the bids and so the Finance Department was involved in assessing those financing proposals but the procurement responsibilities and the contracting for procurement of the equipment remained the responsibility of the Defence Department, the responsibility of the Finance Department under the Treasury was the financing agreements and so the overall Arms Procurement Programme can be thought of as two sets of agreements, the set of procurement agreements which were the responsibility of the Defence Department and of loan agreements which were the responsibility and remained the responsibility of the National Treasury.

MS RAMAGAGA: So in this paragraph when you talk about not being a contracting party you are referring to procurement in particular?

MR DONALDSON: That's correct Chairperson.

MS RAMAGAGA: Now will you then inform the Commission as to what your involvement with the SDPP entailed?

MR DONALDSON: Chairperson in paragraph 8 I'm summarising the roles that I played, much of my work related to the Arms Procurement was advice on its budgetary implications and that was internal advice to the director-general and the Minister of Finance in part to support his responsibilities on the Minister's Committee and in Cabinet. We also were asked as the department to be represented on the Management Committee, sometimes referred to as SOFCOM for the evaluation of the international offers and officials of both the Finance and State Expenditure Department attended those meetings.

MS RAMAGAGA: May I just come in here Sir in respect of the participation of the Department of Finance in the SOFCOM. Is it correct that you were appointed to be a member of the, of SOFCOM as the representative of the Department of Finance?

MR DONALDSON: Yes Commissioners, that's correct.

MS RAMAGAGA: Right, then you may proceed.

MR DONALDSON: Subsequent to that initial work of the SOFCOM, the Management Committee, the Finance Department undertook an assessment of the affordability of the procurements, in fact I should perhaps clarify that there were several stages in that work, so from the very early stage when following the Defence Review initial proposals were under discussion between the Department of Defence and the Finance Department for procurement of equipment. Right at that stage we did preliminary estimates of likely cost implications and how they might be accommodated in the Defence Department, but there was a very substantial review of affordability undertaken in 1999 on behalf of the Ministers Committee which was overseeing the completion of the procurement at that stage. I did not have direct responsibility for that work but I would have participated in several of the discussions of it in the Finance Department at the time.

And then the last point I make is that once the procurement was underway its budgetary implication had to be accommodated on the annual appropriation every year and as is set out in more detail later in the statement the estimates of costs associated with these procurements because they involved substantial imports changed from year to year as affected particularly by the depreciation and other movements in the value of the Rand relative to other currencies and so we had in agreement with, in consultation with ARMSCOR and the Defence Department officials we had an annual process of revising the cost estimates and including those in budget documentation so that Parliament and the public would be informed of the costs and expenditure associated with the programme. So, these are not all the issues that are covered clearly in the overall procurement but these were the main responsibilities that fell under me.

MS RAMAGAGA: Right, thank you. Shall you then proceed to deal with the role of the National Treasury in respect of the SDPP's as indicated in paragraph 9 of your statement.

MR DONALDSON: Thank you. Commissioners, the, I've summarised the various roles that the National Treasury did play in paragraph 9, our responsibilities included, as I've indicated monitoring and assessing the budgetary implications of the procurement and participating in the deliberations of the Committee that was established in 1998 to oversee evaluation of bids once these had been received following the Defence Department's publication of a request for proposals, for Request for Offers, and then secondly as a specific subcomponent of that evaluation of bids a team was formed to evaluate the financing proposals that accompanied the bids. This is, this needs to be recognised as an unusual feature of this procurement because it was so large bidders were invited to submit financing proposals and those offers of financing were assessed.

Perhaps I can take this opportunity to indicate that from the perspective of the Department of Finance there was no presumption that we would necessarily use these financing offers at a later stage in our, in the process, we assessed very carefully the merits of the financing proposals and compared them with the other sources of finance available to Government and it was only because they were cost-effective financing offers that we took advantage of them.

So there was a role, now that's a separate issue, the assessment of the financing and decisions about them from the initial evaluation of those financing offers as part of the Bid Evaluation Process. The Bid Evaluation Process comprised three elements, an assessment of the Military Value of the offers, an assessment of the Industrial Participation Offers and an assessment of the Financing Offers and the Finance Department played a role in that third part of the evaluation process.

Then thirdly we played a role in the Finance Negotiation Workgroup. Once Cabinet had taken its preliminary decision on the procurement and negotiations proceeded with the companies that had been identified as preferred bidders and with the banks and associated export credit agencies which had made financing offers we served in the work of the International Offers Team that assessed the financing proposals and negotiated financial aspects of the procurements to ensure best value for money in the financing agreements.

MS RAMAGAGA: Now Mr Donaldson before you proceed to the next paragraph I'd like to take you back to 9.2 where you were dealing with this Financing Evaluation Committee. Mr

Hoffman who was an employee of ARMSCOR has already testified about this Financing Evaluation Committee. Now his evidence is that the Committee with the participation of members from the Department of Finance also developed the Financing Evaluation Model. Do you confirm that?

MR DONALDSON: Yes Chairperson, I understand that that committee develops a framework, a set of criteria for assessing the financing proposals that was submitted.

MS RAMAGAGA: And he has also testified that Ms, is it Bristowe and Mr Kganyago were members of this Committee, do you confirm that?

MR DONALDSON: Yes Chairperson, Mrs Bristowe and Mr Kganyago were participated in the work of this Committee and Mr Roland White was involved. There would have been other officials in Treasury consulted as part of the development of the criteria but my understanding of the process that was followed is that ARMSCOR developed a set of criteria that was submitted, the main roles that we played in the Finance Department was to score the offers that, the financing offers that had come from various bidders and complete the templates, the forms that had been provided by ARMSCOR. I think the process of developing that evaluation, that set of evaluation templates included consultation with a team from ABSA Bank and that's the sense that I make of the documentation we've seen on this.

MS RAMAGAGA: Yes. He has in fact stated that the members or the team was constituted of ABSA or of experts from ABSA as well as from the Department of Defence and ARMSCOR and Department of Finance. Will you then proceed to deal with paragraph 9.4 of your statement?

MR DONALDSON: Thank you Commissioners. Under the, once Cabinet had taken a preliminary decision a committee of ministers was formed to oversee the negotiations before final decisions were taken and during the time that these negotiations were proceeding we also undertook a very substantial assessment of affordability which looked at the various fiscal and macroeconomic and employment implications of the procurement in order to assist the Ministers Committee and Cabinet in reaching final decisions, and so paragraph 9.4 I indicate that Finance, the Department of Finance and State Expenditure were involved in preparing initial costing and risk assessments and several documents relating to that are included in the annexures to this statement and then were involved in preparing a more comprehensive Affordability Report which was presented to the Ministers Committee in August 1999.

MS RAMAGAGA: Right, thank you. I just want to ...

COMMISSIONER MUSI: Can I just get clarity here before we go any further. This Management Committee, how does it feature, is it the same as SOFCOM?

MR DONALDSON: Commissioner, my understanding yes, when I referred to the Management Committee that is the same Committee that is referred to in much of the documentation as SOFCOM, and my understanding is that its work was complete by this stage that we're talking about now. Its work involved overseeing the assessment of bids once Cabinet had reached decisions on preferred suppliers and entered into a process of negotiation with those suppliers the process was overseen by a Ministers Committee supported by the International Offers Negotiating Team.

COMMISSIONER MUSI: Thank you.

MS RAMAGAGA: Right, thank you Commissioners. I'd like to take you to 9.4, the first bullet where reference is made to Annexures "AD1" and "AD2". Now Annexure "AD1" is found in pages 55 to 67 of the bundle and Annexure "AD2" is found in pages 68 to 130 of the bundle. Now "AD1" is the Affordability Assessment of the Defence Special Packages Programmes drawn in November 1998. Now I'd like to take, to draw your attention specifically to page 56 of the bundle. Now the introduction is in the first paragraph of this document and this outlines the purpose of this document. Will you just read that into the record please?

MR DONALDSON: Yes. Chairperson, the opening paragraph of this document which was prepared at an early stage of the process, this was an initial submission to the Minister of

Finance and indicates that:

> *"The Department of Defence was engaged in a procurement process to acquire a number of strategic military equipment packages involving government-to-government contracts and that in order to assist Cabinet decision making in these procurements the Department of Finance undertook an assessment of the affordability of the proposed packages with a view to establishing the physical consequences of the packages and the overall budgetary parameters within which the procurements could take place".*

And I should emphasise Commissioners that this report which is fairly brief and has a very simple model of the Defence Budget and its projection over a 20-year period was a very early assessment and nowhere near as comprehensive as the later Affordability Report that was prepared the following year.

MS RAMAGAGA: Yes. This document sought to assist at the initial stages with the assessment of the affordability of the proposed packages and while the document is not dated it would appear that it was drawn just before the 18th of November 1998 announcement, am I correct with that?

MR DONALDSON: That's correct Chairperson.

MS RAMAGAGA: Now in paragraph 4 of this document there is mention regarding some armaments that was left out due to specified reasons, will you please read that into the record, paragraph 4 on page 56?

MR DONALDSON: Chairperson, paragraph 4 indicates that:

> *"Preferred suppliers had been tentatively identified through a tender process, but at this stage the results of that had not been announced, remain confidential. A seventh product category for which tenders was sought, namely main battle tanks for the Army has since been temporary shelved by the Department of Defence because it was extremely costly under the lower priority relative to the other six product categories which involved ships, submarines, Maritime Helicopters at this stage was still included in the programme, Light Utility Helicopters and Fighter Aircraft".*

MS RAMAGAGA: Thank you. Still on that document I'd like you to turn over to page 57. Now page, in page 57 paragraph 6 has two bullet points. Now it deals with what this memorandum focuses on as well as the subject matter of this document, will you please explain this to the Commission, these two sub-bullets?

MR DONALDSON: Thank you. Commissioners, the first bullet point in paragraph 6 indicates that:

> *"This memorandum is only concerned with the affordability or budgetary issues, not with the*

> *Military or other benefits of the proposed procurement".*

So our responsibility was to assess the cost implications and how they would fit into the overall fiscal framework and budget, and it also notes that it states that it's not possible to translate the potential economic benefits associated with the countertrade or Industrial Participation components of the packages into robust assumptions insofar as their impact on the fiscus is concerned, and I think that it is interesting in retrospect to find here that in our very early assessments within the Finance Department we were aware that although the Industrial Participation proposals under consideration promised considerable benefits in principle these were hard to assess and would be difficult to evaluate for budgetary and fiscal planning purposes, and I think I can say on the strength of international experience here that that is broadly in line with international experience, that Industrial Participation and countertrade proposals, whatever their merits, and often they do have, bring considerable benefits, are difficult to evaluate. And then the second bullet point notes that:

> *"The equipment purchases of course were not the only issues of concern within Finance and State Expenditure in Defence spending".*

Indeed there is reference later in my statement to a review of Defence expenditure which was undertaken at around this time and that other aspects of the Defence Budget were being dealt with through other processes.

MS RAMAGAGA: Right, thank you. In paragraph 7, 8 and 10 you are dealing with the assumptions that were taken when you were to do the analysis and give advice. Now what I'd like you to do first is to explain to the Commission two concepts, in paragraph 7 you are talking about "The Base Case", the assumption that related to a scenario called "The Base Case" and the, in the eighth item you talk about the optimistic case. Will you please just simplify that for the Commission?

MR DONALDSON: Thank you Chairperson. This is a document which sets out a 20-year projection of possible affordability of a procurement programme within the Defence Budget, so it's a very long-term projection. At this stage in 1998 we were in the first years of implementing our three year budgeting system and so Chairperson you will appreciate that a 20-year projection is considerably longer than the budget framework within which our more detailed budgets were prepared and what is indicated here is that the assumptions made for purposes of these projections were very cautious, these assumptions begin with a zero real growth expenditure envelope for the Defence Budget, so no assumption of any growth in resources available for Defence spending associated with expansion of the economy or shifts in priorities.

And in paragraph 8 a suggestion of an optimistic case in which there is a 1% per annum real growth in the Defence Budget, perhaps that should really read less pessimistic, but you will see Chairperson that our preliminary projections were based on very cautious assumptions about resources available for Defence. And although this is not reflected in the statement itself I think it is perhaps pertinent to note that this was of course at a time, 1997/1998/1999 of two important underlying factors in our thinking in the Department of Finance at the time, one was the financial crisis in developing countries and particularly the Asian markets at the time, so considerable concern about the growth implications and financial implications associated with financial uncertainty at the time, reason for caution in projections, and secondly that this was a stage when implementation of the reconstruction and development programme with its priorities on education and health and housing and broadening social spending was certainly, those priorities were certainly dominant in budget planning and so we were necessarily cautious about expenditure commitments in other areas.

MS RAMAGAGA: Right, thank you. I notice in page 58 just overleaf you have, there is a table "Macroeconomic Assumptions" table which has actually summarised this, the assumptions that are dealt with in the preceding paragraphs. Can you please just take the Commission through this table for a better understanding because I notice on the first line you are dealing with "The Base Case", the second line you are dealing with ..., or the report, I beg your pardon, is dealing with "The Optimistic Case" and the figures seem to be identical but for one under 2001, 2002. Will you please explain the table to the Commission?

MR DONALDSON: Thank you Chairperson. This is the table which summarises the assumptions that go into the projections that are set out in table 2 on the following page where projections are made for 20 years and so the base case here has the initial budget numbers which were in the medium term expenditure framework at the time for the next three years and then for 2002, 2003 onwards, in other words for the remainder of the 20 year period a growth projection of 4% per annum in the Defence Budget or in the, what is called the optimistic case 5% a year in the Defence Budget, associated with GDP growth of around 3% a year projected in this, for the purposes of this exercise inflation and where borrowing costs were taken into account and assumed the cost of borrowing of 12% a year. There is also a projection of the exchange rate and so we were already beginning to think about the possible consequences of depreciation of the Rand on affordability of these procurements and I would simply say in summarising these projections that these were very cautious projections, and that's reflected, the context within which we were planning at the time that I referred to earlier.

MS RAMAGAGA: And in paragraph 12 you are dealing with the additional borrowings that might be made with regard to the Government bonds, can you speak to that paragraph please?

MR DONALDSON: Thank you Chairperson. We recognised that there might be additional borrowing associated with the substantial procurement and so had to make assumptions about the cost of that borrowing and what I point out here, and would suggest is worth noting for the Commission's purpose is that at this stage the Finance Department was not presuming that we would necessarily make use of the financing offers that accompanied the bids that were under consideration in the Department of Defence, and so our modelling of financing costs simply takes this point of departure, our projections of the cost of finance through ordinary conventional bonds or other borrowing instruments of the Department of Finance.

MS RAMAGAGA: Now you mentioned that at the time when this report was made a presumption was not taken that the Government would go the long way through the suppliers, but that maybe it would just be ordinary loans that are raised. Is it not a fact that this report was drawn after the FET Committee, that is the Financial Evaluation Committee, had already submitted the evaluated financing proposals that had been submitted by bidders?

MR DONALDSON: Yes Chairperson that would be correct, but I think it's probably also important to note that there was a small team within the Finance Department that had assisted with the evaluation, that evaluation had not yet been released and so those drafting advice on budgets within the Finance Department would not have had access to the information available to the two or three officials responsible for that assistance with that financing evaluation.

MS RAMAGAGA: Now shall you proceed to deal with paragraph 13 of this same report, you mentioned that it has been assumed that the interest costs will be met from within the existing budget. Can you just explain especially this portion?

MR DONALDSON: Thank you Chairperson. What is indicated here is that at this time the Finance Department was already thinking about the possible risks and modelling of risks associated with and therefore modelling of the possible consequences of borrowing over and above the budget commitments at the time and so the possibility of borrowing excessive relative to affordability of the fiscus was under consideration and it's indicated that the intention was to ensure that interest costs and borrowing costs should be, should remain within an affordable expenditure and financing envelope, in other words that the loans to be taken out to finance the arms procurement should be part of our financing strategy and not over and above the intended financial commitments of government because as it's indicated here governments get themselves into difficulties when they start borrowing to repay interest and that debt builds up into an unsustainable or debt trap scenario.

MS RAMAGAGA: Now in paragraph 14 of this report you are dealing with the split of the budget over the three, that is the personnel, the operating expenses as well as the capital expenditure. I think this part of evidence has already been dealt with adequately by witnesses from the Department of Defence. As a result I'll then draw your attention to the following paragraph, paragraph 14 which makes mention of the price escalation on the Dollar denominated contract. Can you just explain that to the Commission?

MR DONALDSON: Chairperson in paragraph 14 we are indicating here, and I'm sure Defence Department officials would have briefed you on this but that Finance Department was very aware that capital spending, expenditure on equipment within defence had fallen to a very low level and that there were therefore good reasons for considering and reequipping or an expansion in equipment spending on the Defence Budget and the ratio between personnel spending, operating spending and equipment spending or capital spending which is often taken as a broad indication of the balance of spending within Defence had fallen to a ratio of 58 to 33 to 9, in other words rather too much spending on operating and personnel costs, not enough spending on equipment, and so working with Defence at the time, and I referred earlier to the review of defence expenditure which was undertaken, the broad intent was to ensure over time movement to a better balance between personnel spending and operating costs and capital spending, but our concern was in part that we shouldn't simply be adding capital or equipment spending within, we should rather work within an affordable, sustainable, overall envelope and so there is some emphasis in the Department of Defence's recommendations and documentation at the time to containing personnel spending in particular and reducing the burden of that on the overall Defence Budget.

MS RAMAGAGA: Now basing still on that same paragraph, basing the escalation on the Dollar denomination, was it a decision that had been informed by anything in particular or is it a decision that was made on the assumption that the loans would be financed through the Dollar currency? I'm asking this question because we now know that subsequently the Government entered into an agreement whereby different currencies were also used as a base for payment and the US Dollar is one of the currencies but it's not the only currency.

MR DONALDSON: Yes Chairperson, I'm referring to paragraph 15 which indicates that we recognised that in looking at the foreign currency denominated costs of the equipment purchases we have to be concerned with two things, one is the depreciation of the Rand, so contracts denominated in Dollars or in the case of some of these items in British Sterling would be affected by the depreciation of the Rand but that as with the Rand-based parts of the procurement there would also be price escalation associated with inflation, so we had to make an assumption about that price escalation and the assumption made in the base scenario of price escalation equal to the US inflation rate of 1% per annum. It's really a little conservative assumption in practice price escalation on contracts of this kind tends to run a bit faster than conventional inflation and that is indicated in the paragraph, the details of those price escalation clauses were still under discussion.

MS RAMAGAGA: Right, now in paragraph16 and 17, I think those paragraphs are self-explanatory, you are dealing with the assumptions regarding normal "Capital Expenditure" as well as in 17 the "Scheduling of Payments for the Special Packages" I'd like to, you to turn to page 59 of the report. Now there are two tables that have been drawn to address the issue of affordability of potential procurements, they appear in pages 59 and pages 60 respectively. Can you please do a comparative narration of the two tables to the Commission for a better understanding of these tables.

MR DONALDSON: Chairperson, what we're indicating in table 2 based on projections of personnel costs, of operating costs and of the equipment expenditure of defence, other than the new procurements, we're indicating an envelope available for package costs and that's what's indicated in the fourth row of table 2 and it indicates over a 20-year period a gradually rising share of the Defence Budget which would be available for, or could be available for additional equipment and in the final column of the table that envelope of, headed "Package CAPEX" is summarised in nett present value terms, in other words the future expenditure is discounted to 1998, 1999 prices and represents a value of R6.7bn.

And then in table 3 there is a comparison of that available envelope with what is really a very early estimate of the possible costs of the procurement programme and so it indicates a shortfall. So this was our initial estimate within the Defence Department of the possible funding shortfall associated with the big procurement programme, but as I indicated at the, in, and it is reflected in the early paragraphs of this document the projections of what is available to Defence were based on very cautious assumptions, very limited real growth, and so it's an indication of gaps that would have to be addressed through the scheduling and timing and details of the contracts and possibly through enhancement of the Defence Budget.

MS RAMAGAGA: Will you then turn to page 60 of the statement and deal with paragraph 22 of this report.

MR DONALDSON: Chairperson, paragraph 22 indicates that if there is a gap between procurements, expenditure programme and available funds, then that has to be addressed, there are broadly three ways of doing that, either within a fixed budget constraint, a reduction in the amount to be spent on the procurements that can be sought, or secondly the budget constraint can be relaxed but within a given envelope of resources available to Government resources can be reprioritised between functions and so what's indicated in subparagraph 2 is the possibility of a shift of resources between different areas of Government spending or thirdly, an increase in the Defence Budget without reducing allocations to other departments in which case the overall fiscal envelope would need to be raised with the increment financed through borrowing.

Perhaps to be more complete paragraph 3 should have said "or through higher taxes", but we were at that stage wanting to (indistinct) higher taxes.

MS RAMAGAGA: Okay. Will you please just in detail, in detail explain these options that were open to the Government.

MR DONALDSON: Chairperson, these are of course the options that are available to the Government under any circumstances faced with higher expenditure on any area of new priority and I think what is important to note is that this was a very preliminary 20-year projection giving an indication of the need to focus attention on the possible budgetary implications of a large procurement and treasuries all over the world, and certainly this is a big part of our work here, always are considering, are having to think about the longer term implications of spending commitments and adjust those to annual budgetary realities. Sometimes we find ourselves in the position when growth is higher than expected or revenue improves and so the resource envelope widens, and indeed as is dealt with later in these documents you will see that as things turned out our economy grew very strongly from 2000 onwards until about 2008, also and during that period of higher growth the resource envelope widened and the defence procurement was easily accommodated within a moderate level of spending.

In reality as it turned out there was no need to shift resources from other functions to Defence in order to accommodate the spending but that would of course not have been known at the time and so at the time as is the nature of treasuries in considering future budget implications, cautious assumptions were made about future resources.

MS RAMAGAGA: So, what you are saying is that what ultimately happened is that it never became necessary to shift the resources or to shift the budget?

MR DONALDSON: Yes Chairperson, I think that's in ... I'm speaking there in hindsight of course, we didn't know in 1998 or 1999 what the growth outlook was going to be. What you will find Chairperson if you look at successive budget reviews is that over most of these years we were able to add additional resources to many areas of spending and so the resource constraint signalled here turned out to be less severe than it indicated in these projections, but of course in putting the budget together in preparing recommendations to go to Cabinet in 1999 and in 2000 the full costs of the new procurement had to be accommodated and had to be accommodated within an envelope that did not overly burden the fiscus through excess of borrowing.

MS RAMAGAGA: Just to close on this item Chair, I notice that it's now 11h00 but I just want to close off on this one where after I'll ask for an adjournment, this question about the shift in Government policy I've asked because I'm looking at page 61 of this report and in particular paragraph 26. In that paragraph it is said that:

> *"Even the optimistic scenario does not make the Special Packages much more affordable. Furthermore it would entail a shift in Government policy regarding the real levels of spending on defence. Substantial parts in the procurement would still be required in order to remain within the Defence Budget".*

Would you like to comment on that?

MR DONALDSON: Yes Chairperson. So what paragraph 26 indicates is that the optimistic scenario here, and as I've indicated, it was just a 1% real growth projection, so by no means an aggressive expansion in resources but within that envelope there would still be a shortfall between the likely costs of the procurement and what is indicated as the available resources and so on these projections, on these cautious projections there would be a need to shift, reprioritise spending in order to remain within the available resource envelope.

MS RAMAGAGA: Thank you. I request for an adjournment for a tea break Chair.

CHAIRPERSON: Thank you. I think we'll adjourn until 11:30. Thank you.

(Commission adjourns.)

(Commission reopens.)

CHAIRPERSON: Can the witness confirm that he is still under oath?

MR DONALDSON: I do.

MS RAMAGAGA: Thank you Chair, may I proceed? Now we are still on that report Sir. Now will you take the Commission through paragraph 29 that appears on page 62 which deals with the restructuring, "The Scenario of Restructuring the National Budget".

MR DONALDSON: Chairperson, in these paragraphs this submission elaborates on the three options which are summarised in paragraph 22 and so in paragraph 29 it's indicated that, and again I would emphasise based on these very cautious projections of the resources available to Defence, indicates that substantial reprioritisation within the budget would need to be made in order to accommodate the spending in the absence of higher growth or an increase in borrowing.

MS RAMAGAGA: Right, now please turn over to page 63 of the same report. I'd like to draw your attention to table 6 that is headed "Nett Present Values of Cash Flows". Now before you deal with that table will you please explain to the Commission as to what is meant by the nett present value?

MR DONALDSON: Thank you. Commissioners, when a procurement is undertaken that extends over a long period of time, when a bridge is being built or in this case equipment is being purchased on an order in 1999 for delivery in 2002 and 2005 and 2010 we have to take into account that the cash payment in 2005 will be higher than the price that's quoted in 1999 because of the effects of inflation and these procurement contracts all include contract price escalation clauses which link the future payments to a contract price in 1999 prices or in the bid prices in 1998 prices to an escalation factor which takes into account inflation. Those escalation factors are sometimes linked directly to CBI, which is a general measure inflation but more generally they are linked to specific indices of the price of steel or the price, the price of contracts, or the price of labour in the construction industry.

So, in assessing the future cash requirements one needs to, and in order to compare them with 1999 prices you've got to take out the inflation again and so all that the nett present value calculation does, it takes the future cash budget estimates and adjusts it down to 1999 prices, so that's the long way of saying nett present value means that these numbers are all in 1990, in this case 1998 prices and that makes them comparable with the contract prices which were under consideration at the time.

MS RAMAGAGA: Now in paragraph 34 on the same page there is mention of the additional public debt because of a rollover. Now will you explain to the Commission the meaning of the rollover in the context of international agreements.

MR DONALDSON: Thank you Chairperson. On the overall budget we do occasionally find ourselves in surplus and so able to pay back debt but in most years there is a deficit that has to be financed and so Government debt increases over time in total when we talk about gross Government debt or sometimes nett loan debt, that's the total outstanding liability, debt liability of Government. That doesn't mean that individual loans or individual bonds which is the instrument through which Government borrows lasts forever, bonds are repaid after 10 years or after five years or after 20 years, depending on the terms of the specific security, but they are then typically rolled over, they are replaced with other debts, so when we talk about rolling over of debt the assumption is that the new debt issued, this is, remember an explanation of option 3 which is that the additional spending should be financed through loans or higher borrowing, that higher borrowing escalates over time because of the assumption that Government doesn't reach the position of repaying debt, it has to provide not just for the increase in debt but also for the increase in interest payments associated with that.

MS RAMAGAGA: Now in the following paragraph you are dealing with the "Off-Budget Funding Approach" as one of the approaches that were available, that would be available to the Government. Can you expand on that please?

MR DONALDSON: Commissioners, this is just two paragraphs and it's dealt with very quickly because it's an option that was very firmly rejected by the fiscus, but it's perhaps worth highlighting because it is sometimes thought that there's a budget available and then there are off=budget financing options and those represent in some sense money that is extra, and of course finance departments don't think like that, they recognise that if you have a loan or an off-budget option or a private financing structure that is not in your books, that doesn't mean you don't still owe it and if you are buying military equipment nobody else is going to pay for it on your behalf and so off-budget funding approaches are rejected by finance departments everywhere in the world for equipment of this kind precisely because they are almost always attempts to deceive. They represent the pretence of additional money when there isn't in fact additional money, so in our view the equipment is being purchased by Government, the debt associated with it is part of Government debt, there is no mystery about that off-budget funding approaches or not available to us.

MS RAMAGAGA: Now in paragraph 37 you are dealing with the fiscal and economic risks. Now you indicate that, or rather the report indicates that:

> *"It has not yet been possible for the Department of Finance to assess the risks in any detail".*

Now there are particular risks that the report indicates on this, on pages 64, on page 64 of the report. Will you please highlight that to the Commission?

MR DONALDSON: Thank you Commissioners. These are all issues that are dealt with in much more detail in the later Affordability Report but this is a summarised version that perhaps is an easier way of appreciating the way that risks are taken into account in long term budget planning. So it's recognised in paragraph (a) that when you have long-term procurements and they are subject to the contract price escalation associated with inflation that I talked about a moment ago, that escalation is unknown, you don't know what future inflation is going to be and so there's a risk that it might be higher than expected, and indeed in several of these instances there were price escalations associated with the prices of steel or the prices of inputs that exceeded normal inflation.

And then secondly there's a rather different risk or factor that we were concerned about, particularly at this time in 1998 when the Defence Budget was under pressure because of high personnel spending and the Defence Department at this stage employed close a 100 000 people it had plans to reduce to its personnel numbers over time but we had to alert ministers to the concern that personnel reduction is never an easy thing to do and so there's a risk identified here that the proposed personnel reductions would not be achieved in which case the Defence Budget would come under pressure from that source.

Paragraph (c) refers to "Interest Rate Risk" and this is a recognition that at the time 1998/1999 with the financial crisis internationally future interest rate movements were very hard to predict. As it's turned out things ended up more favourable than we projected at this time because interest rates did come down and stayed down in the course of the subsequent years, but we pointed out that if interest rates rise and you are borrowing more, that's an additional source of additional expense that may get the budget into difficulties.

Paragraph (d) refers to "Foreign Exchange Risk" and I've indicated already that "these procurements very largely foreign currency denominated" meant that movements in the Rand, the weakening of the Rand would mean higher costs and although banks and financial institutions may offer hedging options for dealing with foreign exchange risk the hedging of options come with a cost. You can't really as Government when you are doing very large procurements escape the possible cost consequences of foreign exchange movements or of Rand devaluation.

And it's recognised in paragraph (e) that when you are buying equipment there are other costs associated, particularly with its use that are difficult to project and may bring further pressures, so it's recognised that when you are thinking about buying equipment you really need to consider also the operating costs, what we sometimes call the full lifecycle costs of equipment and those are often hard to assess and tend to be, and there is a risk of their being ignored.

Paragraph (f) refers to the uncertainty associated with the economic benefits of Industrial Participation and of compliance with those obligations, there's also implicit in that the risk that when you are imposing a heavy Industrial Participation obligation on a supplier that may contribute to raising the costs and you may not really see that increase in costs but it's, but it is a concern you need to take note of.

And then the last paragraph, the subparagraph (g) recognises that although the Defence Department had a projection of its preferred envelope of spending over time the suppliers in most cases would have preferred more rapid delivery schedules and so the time, the timing of payments was also a concern, there are ways of raising finance to meet the timing mismatches but there are costs associated with that as well and so we point out in this submission to the Minister that the affordability difficulties were likely to be more severe in the earlier years than the later years of the procurement programme.

MS RAMAGAGA: And in paragraph 5 you are highlighting the risks of the DIPs and NIPs, can you just ... Paragraph (f) you make ... Sorry. Paragraph (f) you make reference to the risks of the DIPs and NIPs. Could you just touch on that?

MR DONALDSON: Yes, thank you Commissioners. Benefits in the defence and non-Defence Industrial Participation projects, these are hard to evaluate and so there's reference here to the difficulty of quantifying these benefits but also of tying down IP components and so although Industrial Participation obligations take the form of intention to invest in particular businesses or promote exports in practice economic circumstances change, markets shift, opportunities may, that looked favourable at one time may turn out to be less favourable and indeed if one were to go into the detail of the

Industrial Participation obligations as the Commission did in discussion with the Department of Trade and Industry you will find there's a lot less certainty attached to these commitments than to the main procurements themselves.

MS RAMAGAGA: Thank you. Will you then turn over to page 65 on "Conclusions". Before you deal with paragraphs 38(a) and 38(b) respectively I would like to invite you to address the Commission about this apparent belief that at the time when the decision was made to procure through the SDPP there was no budget and as you explained in the context of the finance environment also be mindful of the statement that appears on these two subparagraphs 38(a) and 38(b). Will you please expand on this issue of whether there was a budget or not?

MR DONALDSON: Thank you Chairperson. I think the impression has sometimes been created that there was no funding available on the Defence Budget for this equipment and therefore loans had to be, had to acquired and that somehow brought money that otherwise would not have been available and so one of the main purposes of this submission at an early stage of the process within the Finance Department was to clarify our own thinking and to advise the Minister that you can't avoid the costs of equipment that you purchase, it is expenditure, it gets accounted for as expenditure and so if there are loans associated with it those loans form part of the overall Government debt or borrowing that is undertaken to finance the budget as a whole, and so in our accounting for the arms procurement, and there's further documentation in the submission that elaborates on this in more detail, the expenditure incurred as equipment is delivered is fully expensed as expenditure on the Defence vote, some of that spending, the imported parts were financed by loans, those loans were dealt with by Finance but they in no way reduced the costs of the spending that actually incurred and written-up as expenditure on the Defence Budget and so that's the point that the first subparagraph is making, there's a substantial difference between the total costs of the projected packages and the funds available in what we call the baseline budget, and so it was recognised and we were advising the Minister that these procurements would necessitate an increase in the baseline budget or an increase of allocations to Defence over and above its baseline allocation and that although the paragraph does elaborate that some cost reductions might be realised through the negotiations the Defence Budget as projected at the time would not be sufficient to meet these costs and indeed in practice a year later and in subsequent years as the arms procurement proceeded we added a supplementary allocation to the Defence vote in order to assist in meeting this gap.

And then the subsequent paragraphs elaborate on the options available. Clearly as I've indicated already the

Finance Department at the time advising the Minister being cautious about projections and indicating that there are substantial additional costs, that the ships, the funds associated with those that might be necessary in the absence of a growth in the resource envelope would be considerable and that there might be macroeconomic or fiscal effects that would be difficult to deal with.

MS RAMAGAGA: But at pages 56 to 67 you are dealing or the report is dealing with the five basic options open to the Government as recommended then prior to the announcement of the 18th day of November 1998. Will you please take the Commission through paragraph 41(a) to (e) that deals with the options available.

MR DONALDSON: Chairperson, the Finance Department here is advising the Minister of options that could be considered in Cabinet consideration of the procurement. Option A as indicated would be to approve the bids and authorise commencement of negotiations, so that would represent a substantial commitment to expenditure which the submission indicates might raise difficulties and so that option is not, is not recommended in this submission, the submission in effect is alerting Cabinet to a concern about the size of the procurement.

The second option that the procurement should proceed only on the basis of what is affordable within this very limited no-real growth or 1% real growth envelope would entail Defence cutting back substantially on the strategic packages and ensuring that it enters into negotiations only for a more limited package that would be affordable and that paragraph describes the two options, a 0% and a 1% real growth option.

The third option Government could authorise the preferred bidders for certain contracts and withhold permission on others temporarily or indefinitely, a suggestion that there might be an opportunity to defer decisions on some of the procurements but it's recognised in the paragraph that that as it puts it, would put some tenderers in a holding position which they would probably find untenable and will generate some controversy and in general that is an issue that Government often finds itself faced with in large procurements, you might prefer to wait a little while until there's greater certainty on resource availability but it's, you get into difficulties with bidders if you are continuously keeping them on hold and that's not good for the contracting reputation of Government.

The fourth option again a suggestion that there could be a delay in the decision on the preferred bidders until a more comprehensive review of the Defence Budget and Defence capabilities was undertaken and a caution about such a delay. In practice there's a sense in which that's the option that Government took, it decided to recognise, to make a preliminary decision on procurements but then undertook a substantial review during the course of 1999 before finalising the procurements.

Option (e), to cancel the entire process and revert to purchasing military hardware on an *ad hoc* basis and the submission recommends against that in view of the considerable work that had already gone into the procurement process.

MS RAMAGAGA: Alright, thank you. I'd like to take you back to page 6 of the bundle. Now we have to an extent necessary thus far dealt with "AD1". Now there are also certain portions of "AD2" that I would like to highlight through you. Now "AD2" Mr Chair and Commissioner Musi appear at pages 68 to 130 of the bundle. Now that document is the Defence Strategic Packages, an assessment of the potential fiscal impact and it's a document of March 1999. It was produced by the Finance Negotiation Workgroup of the Department of Finance. Now in particular I'd like to draw your attention to ... It is actually common cause that at the time when this document was produced the Government had already made a statement or a commitment on the 18th day of November 1998 and this appears to be the first document on affordability assessment that was produced by the Department of Finance since that announcement. Is it correct to proceed on that understanding that this is the first product after that announcement?

MR DONALDSON: Chairperson this is certainly the first substantial review of affordability and fiscal impact considerations. It's probably not true that it's the only thing that had been produced between November and March, there had no doubt been some working documents developed in preparing this, but it is perhaps pertinent to note then that "AD1" which was prepared in October, November 1998 was the sort of first fairly preliminary, very rough set of long term projections and a very cautious projection of the resource envelope.

Cabinet then takes a decision in November 1998 in principle to approve to proceed to negotiations and then more intensive work on affordability and fiscal implications is undertaken first for this report, "AD2" which was an internal Finance Department working document and then in the more elaborate, much more extensive Affordability Report completed later in the year for the Minister's Committee. So there is, I think it's fair to say, a considerable amount of repetition in these three documents, they cover similar issues but in increasing debt and in increasing detail.

MS RAMAGAGA: Right, thank you. After the decision was made on the 18th day of November 1998 the Cabinet Ministerial Committee was formed and at the meeting of January 1999 some of the terms of mandate that were given by the Committee was to assess the affordability of the procurement including measures to increase affordability and to formulate proposals for the National, for the Negotiating Team and Ministerial Committee on this subject. Mr Chairperson and Commissioner Musi, this appears on page 70 of the paginated bundle and what I have just said is actually captured in paragraph 1.1.2(i), just to give an introduction about how this document came about to be in existence. May I then proceed. Are you on that page? Thank you.

Now I'd like you Sir to look at paragraph 1.3 which deals with the points of departure with regards to this document. In particular I'll request you to enlighten the Commission about paragraphs contained in 1.3.1 as well as 1.3.4. Before he does that Commissioners it would appear that there are other pages that are missing pages of this document and I will seek for clarity later as to whether this was done deliberately or not because it could be for confidential purposes that that was done and if it is so we will take the opportunity to furnish the concerned document to the Commissioners later in due course. Thank you. You may then proceed Mr Donaldson.

MR DONALDSON: Thank you Chairperson. As point of departure in this document the, in paragraph 1.3.1 the basic issue identified in the earlier work in 1998 that there was a gap between the-then available funds on the budget's medium term expenditure projections and the costs of the procurement is noted and so it's a recognition that the costs of the packages are high and that work will need to be done to ensure that a procurement programme is affordable. That is the point of departure, that's the essential task that this document seeks to contribute to.

And in paragraph 1.3.4 I think a very important point is made which is that affordability is not so much about a quantum of money in absolute terms as the relative priority of spending in this case on defence equipment given the other claims on the fiscus and so paragraph 1.3.4 indicates that what constitutes an affordable level of expenditure on the packages is ultimately a relative matter which has to be resolved, can be resolved only at the political level in order to ensure the coherence of the national budget, to provide a mandate for successful negotiations a budget constraint needs to be set at a political level because that's where the trade-offs between relative priorities of Government, education, health, spending on defence and other activities needs to be resolved.

MS RAMAGAGA: In conclusion on that paragraph the report says:

> *"This document aims to supply ministers with sufficient material to make an appropriate political decision in this area".*

That is the area of financing.

MR DONALDSON: That's correct Chairperson.

MS RAMAGAGA: Now I'd like to then request ... Maybe before I request, are you able to deal with the question as to whether the omission of other subparagraphs of paragraph 1.3 was deliberate or not, or is it something that you can address during the adjournment and then we can be able to give the Commissioners a clear indication?

MR DONALDSON: Chairperson this is the only version of this document that I've seen, so it is a bit unclear what, whether there is a missing subparagraph, it seems to be complete in the sense that there's page 1, page 2 followed by page 3, I don't know the answer as to whether this was just an incorrect numbering or whether there was sections that were amiss that had been in earlier versions of the document.

MS RAMAGAGA: Right, thank you. Chair, we will try to clear that with National Treasury during the adjournment. Now I'd like you to please turn to page 72 of this document and in particular I'd like to draw your attention to paragraph 2.1.3 which deals with "The History of Defence Expenditure". Will you please elaborate on that?

MR DONALDSON: Chairperson, Commissioner, what is illustrated in Figure 1 is the defence expenditure (indistinct) in real terms. Between 1998, 1999 ..., 1989, 1990, 1991 which is the period in question, 1997, 1998, 1999, during that period the Defence Budget fell in real terms very substantially, so the upper line which is declining is real expenditure, this is the purchasing power of the Defence Budget. In nominal terms it was flat for much that period but in real terms was declining and indeed in the review of defence expenditure that we undertook, we have slightly different numbers, but we also show a substantial decline in defence expenditure here in paragraph 2.1.2, the numbers are given as a decline from 4.6% of gross domestic product, 4.6% of the economy to around 1.6% or about 1.5% of GDP by this time. So that's an important background to this large procurement programme that it occurred at a time when defence had had to adjust to very considerable reductions in its available resources.

The subsequent paragraph deals with personnel spending. Personnel numbers are a little misleading, so you'd have a growth in staff numbers up to about a 100 000 in 1995, 1996 with the incorporation of non-statutory forces into the Defence Force but of course personnel spending by Defence had fallen very considerably because of the phasing out of national service under the former Defence regime.

MS RAMAGAGA: Right, thank you. Please turn over to page 73. Now in paragraph 2.2 it deals with the Defence Fiscal Policy context in relation to the acquisition. Now mention is made of the fact that the costing was not actually taken into consideration or there was no comprehensive review undertaken regarding the costing or the cost involved in the acquisition. Can you please talk to that?

MR DONALDSON: Chairperson what is indicated here in this Section 2.2 is the work on a Defence Review following the White Paper on National Defence which had been undertaken in the 1990's and it's noted that although substantial proposals for reequipping Defence, the diagram at the top of the page indicates how capital spending or equipment spending had fallen over the previous decade as a share of defence spending and so there was a need to reequip the Defence forces, the Navy and Air Force in particular. These had not been fully costed and again attention is drawn to the importance of accommodating future equipment spending plans within an affordable budget.

MS RAMAGAGA: Yes, in actual fact I beg your pardon because I referred to 2.2.1, the relevant portion that I'd like to refer to is 2.2.3 which makes mention of the fact that:

> *"On the whole the review was conducted without detailed attention to its fiscal viability".*

Can you please just elaborate on that particular paragraph?

MR DONALDSON: Yes Chairperson, we're drawing attention here to the Defence Review whose primary purpose was to elaborate proposals for the role of Defence Force and set out its equipment requirements for the future, but unavoidably that needs to be accommodated within budgetary and fiscal constraints and so that's all that this is referring to is that the work needed to be done to accommodate a defence equipment programme over a realistic timeframe within a realistic fiscal envelope and still needed to be completed.

MS RAMAGAGA: Right then, I'd now like to take you to page 76 of the bundle and will you please elaborate on this table 1 "MTEF Allocations to Defence", 1998 to 2002.

MR DONALDSON: Chairperson, 1998 was the first year of a three year budgeting system, so in the course of 1997 we developed a framework for budgeting on a three year basis. Until then South Africa's budgets had always been prepared on a one-year basis, so here we are reproducing the expenditure on Defence for 1998, 1999 referred to as a preliminary outcome of R10.3bn. The actual budgets which would have been tabled in the appropriation in 1999 for the 1999/2000 year of R10.6bn and in the medium term expenditure framework estimates tabled and in Parliament at the beginning of that year the 2000/2001 and 2001/2002 estimates were R10.899bn and R11.329bn. These we sometimes refer to as forward estimates, so these are the indications published in 1999 of the projected available budget for defence in 2000 and 2001.

And as the table indicates Chairperson the increase is very moderate, a 2.5% and the 3.9% increase well below inflation at the time and so the context was one in which the approved medium term expenditure framework provided for very little growth in defence spending. Then again as I indicated earlier this of course was a period in which substantial RDP commitments were still being prioritised in the budget and so defence was under considerable constraints as a consequence of that.

MS RAMAGAGA: Right, then will you please turn over to page 81, turn to page 81. Now page 81 paragraph 4 deals with the affordability of the procurement. Without necessarily reading through the paragraph can you just explain to the Commission about the costs of procurement and the advice given in this respect?

MR DONALDSON: Thank you Chairperson. This section begins with just an acknowledgement that when major equipment is being purchased in this way over a long period of time with loans associated with those procurements then there will be financing costs to consider, the costs for the financing which in due course became the responsibility of the Finance Department and the Treasury. There is secondly the escalation of tender prices, in other words the inflation relation increases in costs, contract price escalation that is a consequence of the passage of time, and that's the second bullet point, and then some other costs which are not so obvious at the first stage of pricing of equipment, premiums charged by the export credit agencies, so under consideration was the use of export credit facilities. Well, that financing comes with commitment fees or agency fees of one kind of another and so those are costs to consider, statutory costs, taxes, import duties, the costs of freight and insurance and customs duties and project management costs.

So these might not be a high percentage of the overall costs but they also need to be budgeted for and provided for and so as we move from the assessment of tenders in 1998 to the negotiation with suppliers in 1999 we needed to ensure that the full costs were brought under consideration. And the balance of the section then just describes some of the work that's in progress on estimating financing costs, the introduction of expert advice from Warburg Dillon Read in assessing financing options, work on scheduling of both the procurements and loan repayments under consideration with the relative merits or short term or longer term loan facilities, how to make projections and take into account the exchange rate movements and inflation adjustments and how to ensure that management costs and other statutory costs were all fully taken on board. Thank you.

MS RAMAGAGA: Right. I'd like to draw your attention specifically to paragraph 4.1.6 and 4.1.7 on page 82, 4.1.6 deals with certain, actually states that:

> *"Certain costs which are intrinsic to these purchases and the financial packages were excluded from the figures presented on 18th November 1999".*

I think 1999 is just a type error, it must be 1998 because this is a report of March 1999, is that correct?

MR DONALDSON: Yes.

MS RAMAGAGA: Yes. May I request that the relevant amendment be done to read 1998? Commissioner Musi that appears at 4.1.6. Okay thank you, will you deal with that please.

MR DONALDSON: Yes, thank you Commissioners. So in this report we're drawing attention to information that had emerged from the more detailed examination of the offers and in particular to the fact that the costs of export credit facilities were dealt with differently in different packages and so paragraph 4.1.6 points out that the export credit agency costs were built into the tender price for the fighter aircraft, but that was not the case for the other packages and so adjustments needed to be made to the cost estimates to take that into account and then 4.1.7 also just explains some differences between the way in which price escalation was dealt with in different packages.

In the case of the helicopters the price escalation was not explicitly stated but was built into the price that was quoted and again you know for comparability an exercise was undertaken to present the costs in a similar way for each of the packages. The point of these paragraphs for the purpose of the Commission is to indicate that at this stage of the work more detailed work was done to ensure that we were looking at full costs, that there would be no surprises in the implementation of the package.

MS RAMAGAGA: Right, thank you. Shall you then revert to page 6 of the bundle, to your statement. Right. And will you then proceed to present your evidence in respect of bullet 9 ..., no, no, item 9.4, the second bullet onward, that is dealing with the role played by the National Treasury in this respect.

MR DONALDSON: Thank you Chairperson. So we're still here at the (indistinct) roles that the Treasury and the Finance Department played and as we've seen already the work that was done within the Finance Department on budgeting and affordability went through several phases, the first very preliminary, very rough set of projections in October, November 1998, a more detailed assessment of fiscal impact in March or thereabouts of 1999 and then in the second bullet we referred to the much more detailed Affordability Report which was undertaken under the leadership of the Finance Department but with considerable external support and so the Affordability Report which is contained at "AD3" in the documentation was drawn up with assistance from the Bureau from Economic Research with assistance from external experts, economists and advisors and was undertaken also in consultation with the other departments and officials represented in the International Offers Negotiating Team in order to introduce estimates of the impact of the Industrial Participation for example into the assessments, so the

Affordability Report is a much more comprehensive and much more detailed review but really a review of broadly the same issues that are covered in these earlier documents. Thank you.

MS RAMAGAGA: Thank you. Chairperson, this "AD3" appears in pages 131 to 341 of the bundle. That is the Affordability Report and it will be referred to in detail to an extent necessary later in the evidence. You may then proceed to present your evidence in respect of Item number 9.5 onwards.

MR DONALDSON: Thank you Chairperson. 9.5 refers to the role that the Department of Finance and Treasury has played in managing the financing agreements, so as we've indicated already the Arms Procurement Programme divides into a set of agreements of ..., a set of procurement agreements which were the responsibility of the Department of Defence and ARMSCOR and a set of financing agreements which, once they were signed were administered by the Department of Finance and so, and were administered as part of the overall borrowing requirements and debt of Government and the debt and the interest costs on these loans were therefore recorded in the Department of Finance's accounting of government debt and not recorded in the budget of the Department of Defence, so the appropriation accounts of the Department of Defence do not include these loans or the repayment of these loans, they are recorded along with other Government debt instruments and obligations in the debt accounts that are managed by the Asset and Liability Division of the National Treasury. And then sixthly in 9.6 I indicate that:

> *"In consultation with the Department of Defence and ARMSCOR each year adjustments were made to our projections of costs and so the budgetary implications of the expenditure were provided for".*

And what's referred to in 9.6 is the actual expenditure and payments made to suppliers by Defence, either directly in the case of costs that were directly incurred on the Defence, from the Defence accounts, or indirectly through loans, so when a payment is made through an export credit agency to a supplier where there is a loan involved in the financing of the imports that expenditure is nonetheless recorded as expenditure in the books of the Defence Department and so the Defence accounts fully reflect the actual expenditure on the equipment over the course of the procurement programme but that had to be accommodated in the budget, the three year estimates that have taken to Parliament every year of the, of the expenditure projections of the National Government include those estimates and as is set out in more detail later in the statement there were changes to those estimates every year taking into account exchange rate movements, taking into account up to date information about the scheduling of payments and the escalation of costs.

MS RAMAGAGA: Right, thank you. In paragraph 10 you are dealing with activities that the National Treasury was not involved in. Will you please just go through that paragraph mentioning those activities?

MR DONALDSON: That's correct Chairperson. So in paragraph10 we do indicate that assessment of the Military Value of the equipment to be purchased or of the Industrial Participation or Defence Industrial Participation proposals was not the responsibility of the Treasury or the Finance Department, the Supply Terms of the procurement agreements themselves as opposed to the loan agreements was not dealt with by the Finance Department and the prices and the costs of the equipment itself were also not the responsibility of the Finance Department but were dealt with by Defence and ARMSCOR. And then similarly as the programme was implemented ensuring that supply agreements were adhered to certifying the delivery of equipment and therefore the payments that should be made for that equipment and certifying the Industrial Participation agreements and compliance with them were undertaken by the Department of Defence and of Trade and Industry respectively.

MS RAMAGAGA: Right. Thank you. Shall we then turn to the information in detail regarding the National Treasury's involvement in the SDPP's acquisitions. Now that appears from page 8 of the bundle, paragraph 12 just mentions that, it just gives the background leading to the acquisition, it makes reference to the White Paper and then paragraph 13 also continues to deal with the White Paper and also mentions the Defence Review that were prepared in the context of a substantial decline in the relative share of defence in South Africa's public expenditure. Will you please take the Commission through from paragraph 12 of the statement?

MR DONALDSON: Thank you Chairperson. The rest of this statement does deal in more detail with the six roles that have just been described and so there is a reminder here that the planning for the Defence Procurement Programme goes back several years before 1998 and 1999 and ... Yes Chairperson?

CHAIRPERSON: I'm sorry Ms Ramagaga, if you don't mind I think there is enough evidence about the Defence White Paper (indistinct) dealt with those two issues in detail. Maybe if you don't mind just skip that information.

MS RAMAGAGA: No, thank you Chair. I will then omit that portion of the evidence. It is true that the witnesses from the Department of Defence have actually dealt with the information, all what I will do is to zoom in, in respect of particular aspects that I would like to highlight in the presentation of the evidence. Now in paragraph ... May I proceed Chair? Thank you. Now in paragraph 13 of your statement you make reference to "AD4" which is the 1987 budget policy ..., 1997 Budget Policy Statement. Do you see that?

MR DONALDSON: Yes Commissioner, yes. Yes Chairperson, what is indicated here is that in 1997, so even before the assessment of offers that occurred during 1998 there was an indication of the structure of spending on defence and recognition that particularly capital spending on defence had fallen considerably. In the earlier document we referred to the 1989/90 defence spending of about 4.6% of GDP, here is a number for 1990/91 where it was 4% of GDP and had fallen to about 1.7% in 1997/98. So, the background has been a considerable decline in defence spending over the decade preceding the procurement.

MS RAMAGAGA: Right, thank you. "AD4" appears in pages 345, 345 to 351 of the bundle. Now I would like to draw the attention of the Commission to page 345, I will not burden the Commission with other information that has already been placed on record. I would like to draw your attention particularly to page 345 starting with bullet, the second bullet on that page from top, do you see that Sir? Now may I just indicate to the Commissioners that the purpose for which I highlight this part of information is just to address the issues relating to the priorities of the Government at the time then with regard to budget allocation to specific departments that were seen as being departments that ought to have been prioritised as compared to the Department of Defence. You may then proceed to read into the record Sir bullet 2 to the last one. Thank you.

MR DONALDSON: Thank you Chairperson. So this was the published Medium Term Budget Policy Statement of 1997, this was the first Medium Term Budget Policy Statement which the Government published and introduced then for the first time a three year framework to be set out in more detail the following year in the 1998 budget and it notes the reduction in defence expenditure, as I've indicated from 4% to 1.7% of GDP between 1991 and 1997 and 1998, whereas spending on social services, health, education, welfare, housing, land reform had increased as a share of the total from 12% to 14.4%, in 1997/1998 an increase in education spending as a share of GDP from 6.1% to 6.5%, an increase in spending on social security and welfare from 2% to 3% of GDP, so these were shifts in relative priorities on the budget effected by the new Government after 1994 largely in giving effect to the reconstruction and development programme commitments at the time.

If I may Chairperson I'd like to draw attention also to the interest payments line at the bottom of Table 4.1 because this is an illustration of why the debt and interest costs concerns which were dealt with in the Department of Finance's submissions to the Minister during the course of 1998 and 1999 were prominent and you can see there how interest costs had increased with the increase in Government debt over the previous decade from 4.3% of GDP in 1991 to

6.2% of GDP in 1997 and 1998 and so the Finance Department at the time was concerned to avoid commitments that might worsen the debt position of Government.

MS RAMAGAGA: Right, thank you. Paragraph 14 or the contents of paragraph 14 have already been dealt with adequately by other witnesses, I'd like to then focus your attention now to paragraph 15 which appears on page 9 of the bundle.

MR DONALDSON: Chairperson in 1997 six reviews of expenditure were conducted by the Department of Finance in consultation with other departments and these included reviews of education and health amongst others and of defence, so a focused review of defence spending was undertaken and it made various recommendations. The two most important recommendations it made were that there should be a rebalancing between personnel spending, operating expenditure and equipment, so that refers to the ratio changes which we looked at earlier and the recognition that capital spending, equipment spending was too low, but that operating and personnel spending would need to be reduced in order to create room for higher equipment spending and then secondly makes this very broad recommendation of an overall defence expenditure level of around 1.5% of GDP and this was the context in which Defence, very mindful of the decline in defence spending in real terms that had occurred over the previous decade was anxious to receive some assurance that it would not be completely neglected in budgeting and so the Defence Review of 1997 which was not a firm budget decision but was a recommendation to ministers suggested that 1.5% of GDP might be a reasonable benchmark to set for future defence spending levels.

MS RAMAGAGA: Right, thank you. The MTEF that you are making reference to in paragraph 15 appears in pages 352 to 359 of the bundle. Now in particular to confirm what you were saying about the recommendation of the reduction of personnel in order to can balance the (indistinct) I'd just like to refer you to paragraph 5 on page 352 of the summary of Sectoral Team Report. Now that paragraph reads as follows:

> *"The force design described in the Defence Review would necessitate a considerable expansion in the Defence Budget. Alternatively applying the same design to a reduced budget would require a market reduction in personnel".*

So, in actual fact in terms of this statement there were options either to go the option of reducing the personnel or to go the option of increasing the budget markedly. Is that correct?

MR DONALDSON: That's correct Mr Chairperson.

MS RAMAGAGA: Now in page 353 of the bundle we have that table, "The Historic and projected trends of the Defence Budget (1989/90 to 2000/01)". Will you please just take the

Commission through that table for a better understanding of what has been said prior to us now dealing with the table.

MR DONALDSON: Thank you Chairperson. What this table does is set out year-by-year the breakdown between personnel spending, operating expenditure and capital spending on the Defence Budget and it illustrates how personnel spending had increased very substantially as a share from about 20% of the budget in the first years to 50% in 1997/98 whereas capital spending or spending on equipment decreased from 44% of defence spending in 1998/90 and 1990/91 to just 11% and 12% in 1996/97 and 1997/98.

MS RAMAGAGA: So in terms of this table the main concern of the Department of Finance in relation to the SDPP would be the line dealing with the capital expenditure, am I correct?

MR DONALDSON: Yes Chairperson, a concern with the capital spending but also of the pressure on the Defence Budget of the increase in personnel spending and so much of this review was a recognition that in order to accommodate more equipment spending a rationalisation of personnel numbers would be needed.

MS RAMAGAGA: Right, now I'd like to turn your attention to page 354 in paragraph 12 in particular, will you please read that into the record?

MR DONALDSON: Thank you Chairperson, so paragraph 12 which reads:

> *"The size of the allocation to Defence ...".*

The amount of money made available to Defence:

> *"... therefore depends on the probability and covariance of the above responsibilities, and their relative importance in relation to other claims on Government resources".*

So that's a bit wordy but it refers to the previous paragraph in which the roles of the Defence Force are summarised, protection of the sovereignty and territorial integrity of the Republic, service in respect of international obligations, these could include peacekeeping operations or specific interventions in the preservation of life, health or property and then some maintenance and essential services and in some circumstances support for the South African Police Service in its responsibilities. So, in very broad terms what paragraph 12 indicates is that the roles and responsibilities, the mandates of Defence need to be taken into account in assessing budget allocations but not in themselves, there is also the need to assess these obligations relative to other claims on Government resources, relative to education, health welfare and other responsibilities of the State.

MS RAMAGAGA: Right, now I'd like to take you through to page 356 of the bundle. On that page there is a preliminary allocation and desired spending ratios table. Will you please take the Commission through that table?

MR DONALDSON: Thank you Chairperson. So, one of the things that this Defence Review undertook to do was to explore options for shifting the balance of spending within Defence over a medium term, over, in this case a three year framework, and it's worth remembering that this was written at this time of the first Medium Term Expenditure Review, so this was for the first time the Defence Department in its budget process looking at three year numbers. Now I say, and I mention that partly because of course when we come to the procurement programme we're looking at a 15 year programme and not just three years, but you can see here how the Defence Department in its budget request to the Finance Department and the Department of State Expenditure in 1997 for the 1998 year requested R13 million in total comprising R5.2bn for personnel spending and R3.9bn for, of, for operating and capital spending. So, there was a very high level request submitted that gave effect to a 40%, 30%, 30% ratio, but if we recall that the spending on equipment at the time was about 11% or 12% and the spending on personnel was 50% these requests were already quite considerable shifts in allocation and in practice it takes time to give effect to shifts of this kind.

And then you can also see the preliminary recommendations made by the Finance and State Expenditure Departments to probably ministers at the time through the Medium Term Expenditure Committee for somewhat different ratios but in, with the intent of recommending a more realistic expansion in capital spending and the more limited overall budget allocation. And what's illustrated here is a small version of what happens in every area of spending every year, Departments submit requests that are always larger than can be accommodated and there's a process of engagement between the committees in the Finance Department or now the National Treasury and other departments in order to reach recommendations that can be accommodated within the resources available to Government.

MS RAMAGAGA: Right, will you then explain to the Commission as to what the implications of proposed long-term allocation would be as indicated in the report?

MR DONALDSON: Chairperson this section of the report which takes as it points of departure the Defence Review and the Defence Review's indicated 30 000 personnel reduction to a Defence Force of approximately 70 000 members, takes that as point of departure but recognises that a personnel reduction of that kind takes some time to implement and so there's some discussion in the following paragraph of the practical issues that would have to be addressed, possibly the closure of headquarters or of infantry battalions and in effect this as an outcome of a discussion between Finance and State Expenditure officials and Defence Department officials with an exploration of what in practice would need to be done in order to achieve this changed ratio of personnel to other spending, and paragraph 29 makes some specific suggestions in respect of changes in the size of particular components of the Air Force, and paragraph 30 of the Navy. I think it's important to stress that this is a very high level discussion of issues that of course would be dealt with in much more detail in the Department of Defence's own planning ahead, but as is done in the budget process every year Finance and Treasury officials try to understand the transitions that are underway, tries to understand the implications of the reorganisation in this case of defence that was being proposed.

MS RAMAGAGA: Will you then please turn to page 358 and deal with the conclusions, record the conclusions from this expenditure reviews.

MR DONALDSON: Thank you Chairperson. So, the conclusion of this review, and this is just a summary of the larger report is, the conclusion is a suggestion that maintaining defence spending at just under 1.5% of GDP will after an initial period of adjustment provide defence with a stable and rising level of spending, and over time this will facilitate the rebuilding of sufficient defensive capabilities to deal with emerging military contingencies, so a suggestion that that would be an appropriate benchmark for the level of defence spending, and then a recommendation that, or an indication that Defence would need to work perhaps with the support of the Department of Public Service Administration to achieve a personnel reduction to about 70 000 and thirdly a broad recommendation that consideration should be given to improving the specifics of Defence budgeting, making more transparent the purposes of defence spending and the intended application of resources and it's indicated that there would be some scope for achieving savings that might contribute to affording equipment purchases in future years through better financial management.

MS RAMAGAGA: Thank you. Will you then revert to page 9 of the bundle. Now evidence has already been led that subsequent to the announcement of the 19th day of November 1998 the Finance and Evaluation Team was formed and the evidence that has been presented by Mr Hoffman is actually in line with what you have alluded to in your statement and for that reason I will not then invite you to rehash what has already been said, however, what I wold now like to draw the attention of the Commission to is paragraph 18 which appears on page 10 of the statement. In paragraph 18, the paragraph 18 reads:

> *"The Finance and Evaluation Team consisted of officials from the DoD, ARMSCOR and DoF (Department of Finance) with professional assistance from ABSA Bank. I attach marked 'AD6', a copy of the Terms of the Reference for the*

participation of Department of Finance officials in the Department of Defence Equipment Financing Evaluation Team".

Now the reason why I'm drawing this to your attention Commissioners is just to clarify the fact that the "AD6" which is referred to as the Terms of Reference is actually the Terms of Reference that were just for internal purpose in relation to the members that would be participating in the FET from the Department of Finance, so you should not read that to mean that is the Terms of Reference in relation to the FET. Now "AD6" is found in pages 360 to 361 of the bundle and you will notice from that document that the persons that were appointed to serve or to assist the Department of Defence and ARMSCOR were Mr Donaldson who was appointed to the Management Committee which is also interchangeably referred to as SOFCOM and there is also a Ms Bristowe as well as Mr Kganyago who were appointed to the FET and I have already said this part of evidence is actually consistent with what Mr Hoffman has already told the Commission. Now I would also like to draw the attention of the Commission to paragraph 19.1 which makes reference to the, to Annexure "AD7". Now Annexure "AD7" appears in pages 362 to 378 of the bundle and that annexure is actually a letter enclosing financial offers received from bidders, the instructions that were issued by Mr Hoffman as well as the evaluation sheet that were sent to members of the team for the purpose of evaluating the financing proposals and actually even 19.2 deals with the evidence of Mr Hoffman and it alludes to the report that was produced, it is a report that is dated the 30th day of June 1998, that is "AD8".

You will find it in pages 379 to 386 of the report. I would just like me, please grant me the leave to look at 379 and to 381 and see as to what it is that I would like to ... Now I'd like to draw the attention of the Commissioners to page 379 Mr Donaldson. Now this is actually "The Availability of Funding for Procurement of Defence Equipment" document, is it correct that this document was actually produced by the Department of Finance?

MR DONALDSON: That's correct Chairperson.

MS RAMAGAGA: Now in paragraph 1 of this, in fact you may just read an introduction that appears on page 379 of this document. Please go ahead.

MR DONALDSON: Thank you Chairperson. So, what is indicated in paragraph 19 of the main statement is that this Financing Evaluation Team that Treasury participated in did two things, it assisted in the assessment of the financing offers, but it also continued to work within Treasury, within the Finance Department on the overall affordability issues and so in some ways the document that appears as "AD8" needs to be read along with "AD1", they were produced about the same time in the first half of 1998 and comprise and overview of budgetary and fiscal considerations, in this case more specifically the implications for the budget but there is a considerable similarity between the projections over 20 years of available funds on the budget of Defence. In this document there's a considerable similarity with the projection of funds available over 20 years that we looked at when we looked at document "AD1", so these would have been documents produced around the same time in Treasury using the same model.

The intention to come to the counsel's question of this document is to alert the Minister of Finance but also this broader Financing Evaluation Team that was a joint team with Defence and so to ensure that Defence was aware of the issues that were being discussed in the Finance Department to, the intention of the document was to evaluate the proposed procurement against the context of their budget implications, so before the process could be finalised and any contracts signed the Department of Defence needs to be certain that any contract or combination of contracts will be affordable to it over the full funding period, so that's a statement of the intent to work towards an agreed, affordable funding level for the overall procurement, recognising that what was initially proposed would cost considerably more than was available in the indicative three year budget estimates that we've already looked at, published in the medium term budget policy statement from 1997.

MS RAMAGAGA: Right, thank you. Will you then turn to page 380 of the report, in particular I would like you to address paragraphs 8 and 9 of this report. Paragraph 8 deals, actually states that:

> *"At the meeting of the 11th day of June 1998 the team identified two questions that needed to be addressed at the time; ...".*

And that, the first concern:

> *"The financial structure and soundness of the various proposals and would require financial analysis. The second question related to the affordability of the different packages and this would require fiscal analysis".*

Now Mr Hoffman's evidence did not actually address this point, would you like to elaborate to an extent just necessary.

MR DONALDSON: Yes. Chairperson, so what it indicated here is that this Financing Evaluation Team, which was a joint team that involved Defence, ARMSCOR and the Finance Department and had to do the job of evaluating the financing offers that had accompanied the bid submissions but particularly the finance representatives on that committee were also concerned to ensure that the affordability of the packages should be addressed, it would not be a concern of ARMSCOR, so it's not a surprise that it doesn't feature as strongly in the ARMSCOR evidence or on the minutes of the meeting but what is indicated here is that the Finance Department representatives at that meeting were raising at the time questions of affordability and brought back to the Finance Department the need to develop a more systematic approach to the budgeting and affordability issues.

MS RAMAGAGA: Right. Paragraph 20 of your statement is also covered by the evidence of Mr Hoffman, I'd now like you to turn to page 12 of the bundle, the "Negotiation with the Preferred Bidders". Now this evidence also presented, it is actually common cause, everyone, almost everyone has spoken about the Cabinet announcement of the 18th day of November 1998, however, I would just like us to turn to page 387 where this, the copy of this announcement appears, page 387. Now without burdening the Commission with information that is already there I would just like to highlight the purpose of this statement and the implications that would flow from this statement. Now at paragraph 6 or Clause 6.1.3 it reads:

> *"The Minister informed the Cabinet that the objective of the briefing was to obtain approval for the recommendation of the preferred bidders and for the Department of Finance, Defence, Public Trade and Industry to enter into contract negotiations with the preferred bidders. The Cabinet discussed the*

matter and resolved that the recommendations on the preferred suppliers for the Strategic Defence Equipment be accepted as recommended as an interim step and that the Department of Defence and the rest of the Department should assist in achieving affordable agreements".

Now there is mention of the fact that the announcement would be made but as an interim step there would have to be negotiations. Are you able to inform the Commission about the implications of reference to an interim step would be and as well as the clear mandate that was given with regard to the affordability. Please elaborate.

MR DONALDSON: Thank you Commissioners. This is a direct reproduction of the Cabinet decision and we've seen fit to include this in the submission because the wording of the Cabinet decision is particularly important. This was the decision at which preferred bidders were announced or agreed to and subsequently announced and so in an important sense it represents the outcome of the procurement process, the evaluation of bids that had been undertaken during the course of the previous few months, but it also as is implicit in the wording of the Cabinet decision, is a decision not for a final procurement but to enter into a negotiations period recognising that there was still affordability and other considerations to finalise and so Cabinet in this decision was acknowledging that this was a substantial procurement which still needed to pass through the full affordability tests and hurdles and so a Ministers Committee was established in order to verse that process and over the subsequent months and the first half of 1999 work was done on the military side in refining the equipment procurement on the Industrial Participation side in tightening up the Industrial Participation agreements and in respect of financing in ensuring two things, one; that the procurement would be affordable overall and two; that the financing arrangements would be cost effective and sensible and so Government was in a position to proceed to announce the preferred bidders and indeed to indicate the indicative cost implications of the procurement, the R29.773bn estimate of costs but at the same time to indicate that these were not yet final contracts, they were still under negotiation.

MS RAMAGAGA: Right, thank you. In paragraph 22 it's actually indicated that:

> *"The Department of Defence did also make a presentation on the 18th day of November 1998".*

That is already part of the evidence that has been presented, however, just for completeness I'd like to point out to the Commission that "AD10" does appear on pages 388 to 403 of the bundle and paragraph 23 deals with, actually just mentions the preliminary cost estimate that was given at the time, that was given by the Department of Defence and that is, that appears on page 391 of the bundle and then the Acquisition Proposal Endorsement by the Cabinet which appears on page 13 of the bundle, that part of the evidence is already, has already been presented before the Commission and now I'd like to focus your attention on paragraph 25 which appears on page 13. Mr Chair, it has just been brought to my attention that it is now the lunch hour, I thus request that we adjourn for lunch.

CHAIRPERSON: We will take a lunch break until 13h45. Thank you.

MS RAMAGAGA: Thank you Chair.

(Commission adjourns.)

(Commission reopens.)

CHAIRPERSON: Can the witness confirm that he is still under oath?

MR DONALDSON: I do.

MS RAMAGAGA: Right, thank you Chair. When we adjourned we were just about to talk about paragraph 25 which appears on page 13 of the statement. Would you please proceed.

MR DONALDSON: Thank you Commissioners. There's a table, Table1 which summarises the cost estimates which were noted by Cabinet in November 1998 and in advising the Minister of Finance before that Cabinet meeting of the budget considerations a submission was prepared which we have already looked at, that's the submission at "AD1" which provided that very limited preliminary assessment of the envelope that would be available in the context of the budget position, fiscal position at the time. And it's against that background that the Cabinet decision was to proceed but to conduct further work on the affordability of the overall programme.

MS RAMAGAGA: It is already on record that the Ministers Committee was appointed by Cabinet to look at the affordability of the agreement and the committee was then, in fact the Minister's Committee then appointed an International Offers Negotiation Team which will be referred to as the IONT and in paragraph 28 which is on page 14, paragraph 28 indicate as to who were the members of this team, that is how this team was constituted. Now it is clear from paragraph 28 that from the Department of Finance the person that was appointed to represent the Department was Mr Ronald White. Now paragraph 29 deals with the workgroups that were constituted by the IONT.

It is already common cause that there were three groups that were established, those that were to deal with the technical aspect, those that were to deal with the NIPs and DIPs and those that were to deal with financing and the Terms of Reference of this IONT are contained in "AD11" that appears in pages 404 to 421. Now while that document is a document that deals with the entire IONT you will notice or the

Commission will notice from certain portions of that document that there are areas where the issues that are being addressed are issues that relate exclusively to the finance and I will thus refer the Commission to those portions just for the completeness of the record and Mr Jayendra Naidoo who was the chairperson of this team will be called later to come and present evidence. The Commission will notice even from the document that it is actually, there is provision catered for, for Mr Jayendra Naidoo as the chairperson to sign this document. Now I have already said "AD11" appears on pages 404 to 421, now I would like to take the attention of the Commission to page 409 of the bundle.

Maybe then before I do that Commissioners may I take you to page 405. I beg your pardon for taking you initially to 409. Mr Donaldson will you please look at paragraph 2.3 on that page, in particular please elaborate on bullet, the first and the second bullets under 2.3.

<u>MR DONALDSON</u>: Thank you Chairperson, in paragraph 2.3 it is indicated that the National Treasury had begun its work on the affordability issues in late 1998 as the Finance Department then and that this included developing the roles, tasks of the financing aspects of the negotiation process and the planning of the programme for it. Sorry I'm confused, this is a reference not just to the Finance Working Group, this is a reference to the structure objective roles of the negotiating team and that is

set out in this document and its appendices, and in the second bullet importantly establishing the kind of capacity supported by appropriate expertise to undertake negotiations and so in respect of the financing work this involved bringing in expertise in economic analysis and in, and in financing in preparation for the negotiations with banks and the export credit agencies.

MS RAMAGAGA: Thank you. Now I'd like to take you to ... Sorry, page, I think it's 14. Sorry about that Chair, page 406, the second bullet. Towards the end of that paragraph I'd like to highlight the portion that reads as follows:

> *"In respect of the financial area preliminary work has focused on the possibility of reducing total costs through reducing financing costs, building on the initial affordability analysis work conducted for Cabinet before the 18th day of November 1998, the budgetary implications of the purchases have also received further attention".*

Now this is actually confirmation of your earlier evidence that the subsequent reports that were drawn were actually also based on what had, the work that had already been done in development of other (indistinct), is that correct?

MR DONALDSON: That's correct Chairperson.

MS RAMAGAGA: Now further on, on the same page paragraphs 3, 3.1 the last bullet, it reads:

> *"The overall aim of the negotiating team is to*

> *conclude on behalf of the Government and within the mandate of the Ministers Committee a set of contracts for the purpose of procurement of military equipment as specified in paragraph 2.1 which contracts must ensure that ...".*

I'll read that into this just to make sense.

> *"... must ensure that the contracts are affordable and impose acceptable levels of risk on the fiscus".*

Is that actually what the paragraph is meant to portray?

MR DONALDSON: That's correct, yes.

MS RAMAGAGA: Now paragraph 3.2 on this page just deals with the different domains that would be addressed by the Negotiation Team in their negotiation, I don't think I need to belabour the point by reading that information onto the record as because that is already common knowledge. Now I'd like to draw your attention to page 411. Maybe before I do that Chair I should then invite you to deal with paragraph 30 because the pages that I would like to take you to also have reference to the establishment of the FNW or the work of the FNW. Please take us through that paragraph.

MR DONALDSON: Yes Chairperson, the Department of Finance then took responsibility for the Financing Workgroup and its work was led by Mr Roland White who was a senior manager in the Budget Office in the Department of Finance and he was responsible for reporting to the IONT who in turn took these matters to the ...

CHAIRPERSON: I'm sorry, we're not certain where the witness is now.

MS RAMAGAGA: My apologies Chair. The witness will be dealing with his statement and in particular page 14 paragraph 30. Sincere apologies.

MR DONALDSON: Chairperson, paragraph 30 indicates that the Financing Workgroup which was the subcomponent of the negotiating team comprise of Department of Finance personnel and was led by Mr Roland White.

MS RAMAGAGA: Thank you. Will you then proceed to indicate to the Commission the responsibilities of the FNW as appears on pages 14 to 15 of the bundle.

MR DONALDSON: Thank you. Chairperson we summarised the responsibilities of the Financing Workgroup here as in comprising five parts, the first involves assessment of the affordability of the procurement, so that's a continuation of the work that had already been done within the Finance Department on affordability, budget implications and more specifically to formulate proposals for the International Offers Negotiating Team and the Minister's Committee and secondly to assess budgetary implications and again for these to go to the Negotiating Team and the Minister's Committee and thirdly to define and recommend appropriate ways of financing the procurement of the strategic packages, so this is a reminder that the Finance Department did not assume that we would necessarily use the loan offers that had come with the packages, these were first assessed on their merits before deciding to proceed with them and indeed in several respects the Financing Workgroup undertook to negotiate improvements in the terms and conditions of those loan offers.

And then fourthly, and this relates to affordability, is the assessment of economic implications, the various aspects of the proposed procurements and make proposals and to undertake the actual negotiations with suppliers and supplier-related parties in respect of the financial aspect, so that refers to the banks and the export credit agencies that were in partnership with the banks in respect of the proposed loan offers.

<u>MS RAMAGAGA</u>: Commissioners, for the completeness of the record these responsibilities of the Committee appear on page 422 of the paginated bundle under "General Responsibilities":

"The FNW will have five areas of responsibility: ...".

And those are mentioned there. The, in paragraph 32 you indicate that:

"The Terms of Reference of the FNW are attached and marked 'AD12'".

Now "AD12" appears on pages 422 to 426 of the bundle and I have already highlighted what one believes should be highlighted in respect of these Terms of Reference . Is there anything else on the Terms of Reference that you would like to talk about Mr Donaldson?

MR DONALDSON: No Chairperson, I think that covers it.

MS RAMAGAGA: Thank you. Then let us proceed to the role of the Working Group in the SDPP negotiations. Will you please proceed to inform the Commission about that?

MR DONALDSON: Commissioners, the next few paragraphs deal in particular with the role that the Finance Working Group played in seeking the best possible financing terms and this involved quite extensive negotiations with five international banks and in part because there were five different financing offers there was an opportunity to compare interest rate offers, the duration of loans, the other fees attached to them that might contribute to costs, the, and most importantly to the Finance Team the scope within these loan agreements for adapting the terms to suit the capacity of the ..., to suit the needs of South Africa and the, and to fit the loans within our broader debt management strategy. So, for example in several of the loans there were specific opportunities negotiated to switch between fixed and variable interest rates to vary the terms of the loan over time and if, and at our discretion in some cases to repay the loans early or terminate them and indeed in one case that is what was done. So, there was a considerable effort put in to ensuring that these loan agreements were cost effective and sound, and they were judged to be good value for money as borrowing instruments and as I indicated earlier there had not been any presumption within the Finance Department or the Ministry of Finance that we would necessarily use dedicated loans to finance the Arms Deal, if it had turned out that the terms of the loans were less favourable than conventional borrowing terms then in all likelihood we would have recommended against them, or taken a more limited, made more limited use of these facilities, but it turns out that these export credit facilities which were backed or supported by the governments in question had guarantees attached to them and because Governments do put resources into guaranteeing and supporting the export credits associated with their major export industries there was advantage to the South African Government in taking up these loans.

So that's one important set of responsibilities but in the subsequent paragraphs, and I'm now on page 16 of the statement, the Financing Workgroup was also involved in preparation for the affordability study and that's dealt with at a later stage of this statement, so that, the five broad roles identified but this part deals with the loan agreements and the costs of financing and was undertaken while the ARMSCOR and Department of Defence Teams were busy with the technical negotiations around the procurements and the Trade and Industry Team was involved in the Industrial Participation and

National Industrial Participation negotiations.

MS RAMAGAGA: Now you have made reference or actually touched on the conventional borrowing terms as is against the loans approach. Will you please just explain to the Commission as to what benefits, if there are, would be received by the Government in the event of choosing the loans approach as it is the case in this case, as against going the conventional borrowing way?

MR DONALDSON: Chairperson the usual route that our Government takes in financing its deficit is to borrow money on the capital market and this is done through weekly and regular auctions of Government bonds and of Treasury bills, Treasury bills are short term borrowing instruments, 30 days or 60 days or 90 days and so some parts of the, of Government debt is in the form of short term obligations to the banks and institutions that have surplus cash and invest them in Treasury bills but the larger part of Government's debt is in the form of long term bonds and the investors in these bonds are pension funds, insurance companies, large corporations who are investing money for longer term purposes, those loans are subject to interest rates that are market determined and so there is an immediate and transparent cost of debt in the capital markets or in conventional borrowing instruments against which the Department of Finance was able to compare the terms of these loans, but the terms of dedicated loans such as these export credit facilities are a bit more complicated than conventional Treasury bills or bonds because they sometimes involve upfront fees, they sometimes involve early termination penalties and so careful examination of the terms of the specific loans associated with these procurements was necessary in order to ensure that they were good value for money. The advantage of conventional borrowing is that it's transparent, market determined and it's not tied to any particular spending programme, so most of what Government borrows is not tied in a way that these loans were tied to particular purchases, but when you're doing a very big, a very specific procurement that is contracted in foreign currency it may be advantageous to take export credit facilities and so that's what was done in this case, I think the important point to make is it's an unusual way of borrowing but it's for the South African Government because most of our debt is not held in this way, it's not tied to particular purchases but on assessment it was found to be worthwhile and the advantages in part are in the fact that these loans were in the currencies in which we were undertaking to spend money in the purchase of submarines or aircraft over the course of this procurement programme.

MS RAMAGAGA: Now taking into consideration that when the Cabinet announced on the 18th day of November 1998 this intended procurement it actually gave mandate for the negotiation of the contracts. Ordinarily in the conventional borrowing approach is there room for the negotiation of price?

MR DONALDSON: Chairperson there is very little negotiation of price in conventional borrowing. There were some negotiation sometimes where a bond perhaps is nearing the end of its term and we undertake to replace it or roll it over with new debts, sometimes there will be offers made to repurchase those bonds and there might be some negotiations involved in that but the usual, the key mechanism in conventional borrowing is really an auction mechanism, it's the fact that Government undertakes to borrow so much requests, submissions from the banks to be submitted by a certain date, it's like a tender process and there is a competitive auction through which the interest rates are determined on either Treasury bills or bonds, so it's a different process of securing funding from investors to meet Government's deficit requirements.

MS RAMAGAGA: Thank you. Then in paragraph 5 there is mention of the drawdowns by the banks and the actual effect that the suppliers, this formed part of the Supply Terms. Now did this person of the agreement fall within your terrain, that is specifically with reference to the drawdown of payment?

MR DONALDSON: Chairperson, the Arms Procurement comprises two sets of agreements and the supply agreements indicate projected drawdowns attached to specific delivery commitments and if those delivery commitments are not met then perhaps there's a penalty or a delay that comes into play. The financing agreements which are separate agreements make reference to those scheduled drawdowns in the supply agreements and so the Treasury and the Department of Finance before it have overseen a set of loan agreements that has schedules of drawdowns on loans that correspond with the scheduled delivery dates and payment dates that are specified in the supply agreements

MS RAMAGAGA: Now in the event of default from the suppliers, would that immediately come to your attention or is it something that falls within the terrain of the concerned department, in this case Department of Defence assisted by ARMSCOR?

MR DONALDSON: Commissioners, there was a formal agreement between the Department of Finance and the Treasury and ARMSCOR and the Department of Finance in terms of which instructions to draw on loans and to, and instructions to the banks to make payments to suppliers were only made once a confirmation had been received from the Department of Defence or ARMSCOR that those payments were due in terms of the suppliers having met the delivery schedules or commitments involved, so there was a very clear process of information flows from Defence and ARMSCOR to the Treasury and the Finance Department to ensure that the loan agreements were implemented in accordance with the Supply Agreement commitments.

MS RAMAGAGA: Thank you. Now let's focus on paragraph 36 which states that:

> *"The strategic finance negotiation strategy followed by the FNW was outlined in the report prepared by Warburg Dillon Read on behalf of the DoF ...".*

And that report is marked as Annexure "AD13", "AD13" appears on pages 427 to 437 of the bundle, is there anything that you would like to add or comment on in this respect?

MR DONALDSON: Chairperson, it is perhaps worth noting here that in order to support our negotiations with the banks we brought in a global leading advisory firm, Warburg Dillon Read, in order to assist with developing a negotiating strategy identifying the various ways in which we could perhaps improve on the terms of the loans and ensuring that we got the best possible deal and this is in part because loans of this kind are quite unusual for the South African Government. There are other governments in the world that do loans of this kind often because they don't have the advantage that we have of a deep and competitive capital market but we don't have that problem, we rely for the most part on a deed capital market, we understand that market very well, we don't need international advice in how to take advantage of it, but for these particular loans recognising that this was a kind of financing in which we had limited experience, we brought in international expert advice.

MS RAMAGAGA: Right, thank you. And let us then proceed to paragraph 37 which mentions that:

> *"The objectives achieved through the negotiations of the IONT and the FNW are summarised in paragraph 2.4 of the Executive Summary of the* Affordability Report *of August ...".*

Now the Affordability Report appears in pages 316 to 317. Are there any points in particular that you would like to highlight as appears on page, the following page 17? It's actually page 17 to 18, it's actually an extract of that report, am I correct? Then you can just read from the extract as appears on your statement.

MR DONALDSON: Yes Chairperson, I think this extract gives a bit of meat to what I've been talking about and so it gives some examples of the ways in which the terms of the loans were improved during the course of negotiations, so in some cases the ECA agreements, the Export Credit Agreements were increased in scope, the first bullet point refers to how they now account for the full imported content in the initial offers, it had been a, I think 90% or thereabouts of the imported content, and so that eliminated the need for commercial foreign exchange loans and that was an advantage to the fiscus, commercial foreign exchange loans would have been somewhat more expensive than these facilities.

There had been particularly attractive terms offered by the United Kingdom Export Credit Agency, which is a government department, the Export Credit and Guarantee Department ("ECDG") of the United Kingdom Government, and we were able to take those as reference costs, reference prices and achieve similar favourable costs in the other agreements as well. Chairperson, I don't think I need to go through all of these but there are several other kinds of benefits that were achieved in the negotiations that are illustrated here, longer terms of the loans, in some cases lower interest rates and in some cases an option to fix the rates or to vary them, depending on our perceptions of trends and international interest rates and the relative advantages of different borrowing instruments.

And the nett outcome of these negotiations in the end was a set of agreements in which the cost of borrowing was brought down to in the range of 5%, 6%, 7% as an all-in cost of finance, and I mentioned those numbers, they vary from case-to-case, so I don't want to be, try to be too precise about that, but Commissioners, if you recall in the earlier preliminary Finance Department reviews of the cost of finance and risks associated with borrowing we were concerned about borrowing costs at an interest rate of 10%, 11% and 12% and so one of the reasons the Arms Procurement has turned out to be affordable and to be managed within moderate overall budget envelope we've not faced the kinds of risks that were raised in those early reports is precisely because such favourable borrowing terms were negotiated.

MS RAMAGAGA: Right, thank you. Will you then ... Right, you have indicated that you would not like to really go through each paragraph by paragraph but for the benefit of the Commission I think it would help for you to actually highlight paragraph 2.4.2 of your statement as appears on page 18.

MR DONALDSON: Yes Chairperson, the concluding paragraph of this section of the Affordability Report indicates that the concessions that were reached in negotiations with the export credit agencies were largely unprecedented internationally, and I quote:

> *"The terms now achieved with the Export Credit Agencies and banks have substantially improved the financing in terms of cash flow, foreign exchange risks and have produced substantial savings for the borrower amounting to approximately US$1010.9 million (Over R600 million)".*

So that's our financing advisor's estimate of the savings achieved in negotiations with the banks and financing agencies.

MS RAMAGAGA: Right, then you can proceed to paragraph 38. Well, in 38 you are just mentioning that:

> *"A report prepared by Warburg Dillon Read further*

details the outcomes of the IONT's negotiations on loans to fund the armaments packages, and appears as Appendix "G" to the Affordability Report".

Is there anything that you would like to draw the Commission's attention to on this appendix?

MR DONALDSON: Chairperson, I would just indicate that the, that there is a summary table which is referred to as Appendix 1. I need to point out that there is a typing error in paragraph 39, the reference in the statement is Appendix "I", but in fact that should read Appendix 1 to Appendix "G". So, this is part of Appendix "G" and it's on page 288. And page 288 is the beginning of a table which details for each of the loan agreements a series of improvements in the terms of the loans that were achieved during the negotiations.

MS RAMAGAGA: Right, you can then refer the Commission to the particular section that you would like to refer it to from page 288. The Commissioners have found the page, am I right Chair? Yes.

MR DONALDSON: Chairperson, I'm happy to go through to, to go through this if the Commissioners would like to. If I may be so bold there's a lot of financing detail here in which, in which there are other people who will be better placed to advise than I am and so I merely would like to point to the fact that this is an externally provided assessment of the improvements that were achieved in the negotiations and it's set out in some detail on those pages.

MS RAMAGAGA: Right, then that concludes 38 and 39. Now on page 19, page 19, "The Affordability Report" is the heading now that you will be dealing with. If you look at paragraph 40, I believe this we dealt with earlier on when we were referring to the March 1999 report, unless there is anything else that you would like to add? Okay, I see you are shaking your head which means that you are fine with it. Then I will proceed to paragraph 41 and now even paragraph 41 just mentions as to what is it that was ..., and then paragraph 42:

> *"The Affordability Team presented its Affordability Report to the Ministers Committee in August 1999".*

Now were you, are you, is there anything that you would like to talk about in relation to this presentation that was made to the ministers in August 1999?

MR DONALDSON: Chairperson, the Affordability Report is very lengthy and has lots of annexures, it deals in a lot more detail than the earlier reviews of affordability and budget issues and it takes into account that during the negotiations with the aircraft suppliers the possibility of three tranches of aircraft supply was raised and so there is a costing of the aircraft supply is broken up into three tranches, the first tranche comprising 12 Lead-In Trainer Aircraft and nine of the Alpha Advanced Fighters, the second tranche of Lead-In Fighters Trainer Aircraft and a third tranche comprising the remaining 19 Advanced Fighter Aircraft, so in some of the costing and in some of the modelling and indeed in the later work that we were responsible for in budgeting for the arms procurement there are models that break down the cost between these three tranches of aircraft. That was one of the ways in which, during the negotiation phase the possibility of a lower cost overall procurement was provided for and in presenting the affordability estimates and cost projections there were three scenarios that were sketched, the higher and the medium and the lower cost procurement scenario, they were tested using an economic model and a set of projections and some calculated indications of the impacts of the programme on the economy and on the budget to allow ministers to reach a conclusion based on a consideration of different possible scales of the overall procurement.

MS RAMAGAGA: Right. In the following paragraph you talk about the "Revised Cost Estimation". When would the cost estimation have been revised?

MR DONALDSON: Thank you Chairperson. In the, we referred earlier to the work that was done early in 1999 to complete, provide a more comprehensive set of estimates of costs to take into account, project management costs, statutory costs *et cetera*, and so those updated and more complete sets of costs were then set out to provide a new set of cost estimates for the purposes of the affordability study, but there is a bit more complexity to the costs than that, so that's one thing to bear in mind that by comparison with the 1998 costs that went to Cabinet in November 1998 and the 1999 costs there's more completeness in the 1999 costs. There was also a raising of costs to 1999 prices by comparison with 1998, and I need to also point to the R36bn cost estimates which is set out by comparison with the 1998 and earlier 1999 cost estimates, which is based on quite a different costing methodologies, so there's a bit of complexity in this, but in order to allow ministers to take into account very specifically the risks associated with the exchange rate depreciation a set of costs, a cost estimate was prepared and that's the R36bn, R36.482bn cost estimate which takes into account forward exchange rates, so I need to step back a little here and say that when we look at procurements that involve future obligations in foreign currencies it's possible to get quotes from the banks, you can even get those quotes from newspapers of what a bank would charge you for Dollars or British Sterling or Euros in one year's time or two years' time or three years' time, those are called forward estimates of the foreign exchange costs, and so what is done for this R46.4bn estimate of costs is that the forward commitments in Dollar or Euro terms were costed in Rand, not at the exchange rate of 1999 but at the forward estimate of the exchange rates, forward estimate quotes provided by the banks, and so therefore a much higher Rand cost for those foreign exchange obligations. So that's a bit of a mouthful I'm afraid, but it's essentially the difference between the R30bn estimate or R29-something estimate in 1998 prices or in 1999 prices and that R36bn estimate which takes into account the potential depreciation of the Rand associated with the, as quoted by banks in their forward exchange estimates.

MS RAMAGAGA: Now generally when I talk about just general comments about the prices and the costs there is a suggestion that the price shot from R29bn to R36bn at some point and I have heard you trying to explain as factoring in the forward exchange rate and so forth, but can you put it in simpler terms to indicate as to whether in fact there was in fact any increase in the price or is it simply because of these other factors that you have mentioned that the R26bn, ..., the R29bn in November 1998 then translate into R36bn in or around March 1999?

MR DONALDSON: Yes thank you Chairperson, that's a very important point. There were some changes in, there is greater detail in these more recent estimates used for the purposes of the August report and we've referred to some of those management costs, statutory costs, in fact in some cases those cost estimates came down as the negotiations with suppliers proceeded, but they do not, those are minor changes, they improve the reliability of the cost estimates but the difference between the R30bn and the R36bn number is not that, that

R30bn to R36bn number is a change in methodology, it's a change in the way in which the estimates are done to take account of these forward foreign exchange costs and so it's a representation of the price based on a different calculation, it's not a consequence of increases in costs in the sense of adding another roof to your house or finding that the invoice is larger than was expected.

Yes, perhaps with your permission Chairperson the table that sets out these different estimates, the estimates that went to Cabinet in November 1998, the estimates used by the Finance Department in its March 1999 report and the estimates of costs used for the August 1999 Affordability Report and Report of the Negotiating Team to Cabinet, the comparison of those costs is set out in Table 3 on page 152 of the Affordability Report and the accompanying paragraphs explain the various changes that are made.

MS RAMAGAGA: Which page is it, is it of the paginated pages, because I think the Affordability Report starts with page ... Okay, 151. You say what page is that, 151?

MR DONALDSON: 152.

MS RAMAGAGA: 152. Right, would you like to summarise or touch on particular items that can help us to understand better this problem of the increased cost and non-increased cost from this table, please go ahead.

MR DONALDSON: Yes, thank you Chairperson. The key explanation is the paragraph at the bottom of that page which says, and I quote:

> *"The most significant source of the difference in prices between the last two columns is that the actual Rand depreciation rate (6% to 8%) is expected to exceed the inflation differential between South Africa and the US, EU, and so the real cost of the procurement is higher than it would be if it was simply calculated at a rate of R6.25 to the Dollar".*

So, here we were in 1999 with the Rand at an exchange rate of R6.25 to the Dollar, but we had to recognise that that exchange rate was not necessarily a reliable predictor of where we would be in 2002 or 2003 and indeed the Rand depreciated very sharply in 2001, 2002, thereabouts, and so the costs to the South African taxpayers of the procurement rose as a consequence of that and this final column is a projection of the possible real cost of the procurement taking into account the likelihood of exchange rate depreciation, real exchange rate depreciation over the period ahead. I should emphasise that it's just an estimate, so all it is, is finance officials using a model, taking into account forward exchange rates as quoted by banks and indicating that if the exchange rate depreciates in the way the forward rates signal, it might ... , then the overall procurement costs in real terms would be substantially higher than the R30bn estimate and it's a way of indicating to ministers that when you are doing a big procurement like this in foreign currency it might end up costing more than it looks because you are subjected to, you are subject to exchange rate risk. Thank you.

MS RAMAGAGA: Right, please turn to page 20. Now in page 20 the table, Table 3 that you have referred to, I think that is dealt with in paragraph 45 of the statement. Now in this page you are dealing with the cost estimates that were made by the Affordability Team and also you indicate as to why the team made higher estimates than those that appear in 44.1 and 44.2. Would you like to elaborate on that?

MR DONALDSON: Mr Chairperson as paragraph 46 indicates there are several reasons for the higher costs, one is the, that the August 1999 estimates are based on contract prices in 1999 prices, not 1998 prices, so that raises the cost estimate somewhat, although that's just an adjustment for the inflation. And then there're a range of factors identified in paragraph 46.2 that we now had actual costs that were the outcome of negotiations and so there were some changes as a consequence of technical specifications and so on, again these were not particularly, not major changes, but statutory costs were fully taken into account including the freight insurance and relevant taxes, project management costs. Some provision for what is referred to in the fourth bullet as financing costs associated with deferred payments, so these were proposals that were tabled for cash payments to suppliers perhaps a little later than delivery dates, in which case there's a borrowing that has to happen to meet that time lag, so that's financing within the procurement process itself which might raise costs a bit, in fact very little use was made of that facility as I understand it but there were some estimates made of possible costs there. The Export Credit Agency premiums were taken into account and these were negotiated in the finance negotiating process, and then most importantly cost increases associated with the projected depreciation of the Rand against other contract currencies. And 46.3 summarises the point that I was making a moment ago that it is that projected depreciation of the Rand, projected real depreciation of the Rand that is the main reason for the higher cost estimate of a possible cost of R36.4bn in 1999 prices.

MS RAMAGAGA: Now in simpler terms what does the concept "constant price cost" mean?

MR DONALDSON: Chairperson, the constant price means prices in today's prices, so 1999 prices and this is where this estimate of costs taking forward exchange rate into account is a little complicated because the exchange rates are not today's prices, they are the future prices but they have been brought into the equation and then adjusted to represent prices in 1999 terms. I wish it was simpler than it is but that's the way it is, and so ... And the intention is to give an indication in Rand terms, the R36bn number of what might need to be set aside in 1999 terms, that's one way of thinking of constant price values, what would need to be set aside and invested in the bank or invested in Dollars or Euros in 1999 to ensure that the full costs could be met over the duration of the programme invested in a way that earns interest which would then cover the escalation in costs associated with inflation. So, in layman's terms what we're trying to look at in looking at constant price estimates is what it would cost today if you paid it all off at once.

MS RAMAGAGA: Now in paragraph 46.4 you say that:

> *"While the March 1999 estimates included the ECA premiums, these costs were stripped out of the August 1999 prices ...".*

Can you explain as to why this approach of stripping it and what impact did it have on the costs that are cited as costs for the SDPP.

MR DONALDSON: Thank you, yes. The paragraph is perhaps a bit misleading, so it's important to explain that what is referred to here is that there was an agreement that at this stage it was clear that the financing costs were going to be dealt with by the Finance Department as part of our overall financing costs and it was agreed that the Export Credit Agency fees should be treated as financing costs, and it was really just a way of clarifying exactly which cost were going to fall where, so the Defence vote carries the equipment costs, all the costs associated with raising loans from the banks, including the Export Credit Agency fees were then treated as financing costs and charged against the Treasury's accounts for debt service costs and associated fees. So it's not that we saved the money, it's just that it was dealt with by Finance and not on the Defence vote.

MS RAMAGAGA: So, it actually did not have any impact on the price or on the cost, it's only that there was some splitting that it would be put in a certain envelope?

MR DONALDSON: That's correct.

MS RAMAGAGA: Right, thank you. Then shall we then proceed to paragraph 46.5? Well, it states that the profile of cash flows changed considerably between March 1999 and August 1999 and with the effect of reducing the projected interest costs. Is there anything that you want to add on that or is the statement self-explanatory?

MR DONALDSON: Just that Chairperson, this reflects the joint work of the Finance Working Group and the Defence team within the Negotiation Team in improving the profile of costs over time to avoid too much bunching of costs in any one year and that assisted in managing the, in keeping the overall programme affordable.

MS RAMAGAGA: Right, then in paragraph 47 you state that:

"By August 1999, the underlying contract prices of the armaments had generally decreased".

Can you just elaborate on that Sir?

MR DONALDSON: Yes Chairperson, this is really detail that would be part of Defence's evidence if you wanted to pursue it in more detail, but it's in the specifics of negotiations there was a tightening up of the specifications that contributed to lower costs and in some cases reductions in specifications where arms had come with various options and these had to be considered and decisions taken, adjustments of delivery times, so a range of ways in which the overall affordability of the procurement was improved during the course of negotiations.

MS RAMAGAGA: Thank you. Then let's proceed to the next paragraph which deals ..., it's actually the next paragraph which deal with the analysis of the risks and impacts. Will you proceed to lead evidence on that?

MR DONALDSON: So Chairperson, costs is one thing but then there are the risks and uncertainties. Now as we've discussed in a slightly complicated way risks associated with exchange rate depreciation were built into that R36bn cost estimate, so that's the main way in which the Affordability Report dealt with the perceived risks associated with foreign exchange rate movements and the depreciation of the Rand, but the report also deals in a lot of detail with several other risks. Much of this is an elaboration on the risks and concerns identified in the earlier affordability submissions that had been prepared within the Finance Department. As I've indicated the Affordability Report explores three different levels of spending, a R21bn, a R16bn and a R25bn option in present value terms and this is again a different way of setting out the numbers in present value terms, so this does not take into account that addition in costs associated with the exchange rate but the main point to make is that as is set out in subsequent paragraphs and in particular in paragraph 50 of this statement there were a range of macroeconomic risks that were explored in considerable detail in the report, risks associated with interest rate movements, the possibility of higher interest rates, meaning the debt costs would be higher, risks associated with the uncertainty of the Non-Defence Industrial Participation and the Defence Industrial Participation projects where we had made assumptions about the possible economic benefits of these commitments and the Affordability Report distinguishes between contract risk, the risk that suppliers might have already built their costs of non-compliance into their project costs and market risk which is a risk that even if an industrial participation obligation is implemented it might not have the intended economic benefits, it might fail as a business, it might not generate the exports intended and so you have to take a view on, for modelling purposes on these projections.

So, for economic modelling purposes there had to be assumptions made about these benefits. The Affordability Report deals with exchange rate issues and also deals with risks associated with the restructuring of Defence spending, that's a balance between personnel spending and operating and capital costs that we talked about earlier and risks associated with lower growth of the economy, so there's a wide range of things that had to be explored in order to ensure that ministers had a full picture in deciding on this procurement programme.

MS RAMAGAGA: Now paragraph 51 on page 24 makes mention of the fact that the Affordability Report drew attention repeatedly to the risk of the adverse Rand. Will you please just deal with that paragraph or that topic in particular.

MR DONALDSON: Thank you Chairperson. So, the first way in which exchange rate movements was dealt with we've talked about which is the costing that took into account a real depreciation of the Rand and then there are, there is a section of the Affordability Report and I can perhaps draw the Commission's attention to paragraphs 44.3.1, so that's at page 192 of the Affordability Report and of the statements and its annexures where there is a section headed "Adverse Rand Depreciation" and it points out that about ¾ of the spending on the arms procurement would be in foreign currencies and that we were therefore fully exposed to exchange rate risks, in some cases this was risk well into the future and so we were having to make, take a view on the position of the economy at some stage in the future and then in Table 8 there's again an economic exercise undertaken to try to estimate the costs of adverse Rand depreciation and so in Table 8 on the top of page 193 we calculate the estimated cost of a 10% exchange rate, a 10% depreciation of the Rand would have what impact on the cost. Well, in the case of the arms expenditure itself, the procurement itself a R1.6bn cost but an impact also on financing costs and debt repayments that were estimated in the subsequent columns of this table.

So, there are three ways in which Rand depreciation is estimated for risk management purposes here, the possible consequence of a 10% depreciation in the year 2000, the possible consequence of a 1% a year real depreciation or a higher depreciation of the Rand by about 1% a year and then a third estimate of costs associated with the continuing 2% real depreciation of the Rand per year and the numbers are set out in that table. So, I want to stress that these are simply speculative projections undertaken in order to illustrate the possible magnitude of shifts in the costs associated with Rand depreciation, these are not predictions, their intention was to alert ministers to the scale of the uncertainty associated with the Procurement Programme.

MS RAMAGAGA: Right, thank you. I think even in that statement that was made on the 18th of November 1998 the Cabinet made it clear that even the R29bn was just an estimate, so throughout it is our understanding that whatever is brought, especially in terms of projections those would be estimates based on the formula that you would be relying on to develop what you would have developed. Now on page 25 paragraph 52 deals with "Other financial and fiscal risks and impacts identified in the Affordability Report". Now will you please take the Commission through that.

MR DONALDSON: Thank you Chairperson. First specific risk listed here is that of the, of unsuccessful budget restructuring, that refers to the balance of spending in the Defence Budget and the restructuring of personnel costs that was needed and the Affordability Report points out the importance of that reform for the longer term affordability of the procurement. 52.2 refers to the risk of lower underlying economic growth and you know, this is if you like a sort of disaster scenario, if there really is no economic growth and you just can't afford the procurement then there are, there would typically be cancellation costs that would kick in and the Commission will have noted already that the inclusion of those second and third tranches for the aircraft options, although the costing of those tranches was not a favourable costing, it was never an attractive option to cancel the second and third tranches, they did provide an option to reduce spending without cancellation costs and so that risk of a disastrous outcome in which growth is very, very weak, and here I suppose one has to say in 1999 in the context of a financial (indistinct) crisis and before the commodity price boom which raised the prices of platinum and gold and our export so much that the economy did well and grew strongly, we had to be a bit concerned about the possibility that the economic growth would not meet the requirements of an expanding level of defence spending. And so fortunately that is not a risk that materialised but it was certainly discussed in the Affordability Report.

And then thirdly impacts of the procurement packages on other spending, again in the context of slow growth and weak fiscal resources it was recognised that the defence procurement or increase in defence spending might have some consequences for the levels of spending possible on other functions of Government, and again that's a risk identified in the report here, a risk of a reprioritisation against priority areas like education and health that did not materialise in practice, in practice economic growth and rising revenue made it possible to expand spending on those activities in addition to accommodating the Procurement Programme but the Affordability Report did not know that at the time and could not assume that at the time and so sets out some cautious, some cautions in that regard.

And then fourthly the point is made that the loans associated with the Arms Deal would raise the foreign debt content of our debt portfolio and there is, one has to be cautious about the extent of debt that is held in foreign currencies, South Africa prides itself on not having a higher level of foreign currency denominated debt, indeed the day our foreign currency denominated debt is quite low by international comparison but these were loans that would have been incurred in foreign currencies and so at the time would have raised somewhat the share of our debt held in foreign currencies, so those are some of the affordability risks dealt with in the report.

Perhaps Chairperson if I can just refer to paragraph 53 as well, which offers the main conclusions of the report, it highlights four characteristics of the programme, that this was a large procurement programme and so therefore the risks associated with that, that it entailed fixed contractual commitments over a long period of time and that cancelling contracts of this kind is expensive and so there is some reduction in discretion, reduction in the capacity of Government to adjust its budget from one year to the next associated with that, thirdly that the Procurement Programme was highly import-based and so would represent an accumulation of foreign spending that had to be financed on our balance of payments and fourthly that the economic impact and the performance of the Industrial Participation commitments was uncertain and difficult to quantify.

MS RAMAGAGA: Right, thank you. We are now on page 27 of the bundle. The next paragraph that I would like you to deal with is paragraph 54 which highlights as to what it is that the report stressed. Please proceed.

MR DONALDSON: Thank you Chairperson. 54.1 against the background of a wide range of risks that had been extensively canvassed in the report indicates that there are several things that can be done to mitigate and manage those risks and those activities, careful negotiations with the banks ensuring supply agreements were scheduled in a sensible way, making sure that costs were carefully assessed and so on, and ensuring that we could get best value from the Industrial Participation, those are all risk mitigation and management measures but they don't make a difference to the fact that when you are spending R30bn you are spending R30bn, and so for budgetary purposes the procurement remains very large and so the Affordability Report explicitly indicates to ministers that a lower level of spending would represent lower risks and that Cabinet needed to give consideration to that.

And that's elaborated in paragraph 54.2, this is a quote then from the Affordability Report and it's a caution that if conditions developed adversely Government will be confronted by mounting difficulties and as the expenditure level rises, so the scale of risk increases and the concluding paragraph there is that the decision about how much to spend on the arms packages really is a decision about Government's assessment of the risks, the ability to manage these risks adequately and its assessment of the needs and benefits driving from the procurement decision.

MS RAMAGAGA: Right, and then in paragraph 55 you state that:

> *"In sum, the Affordability Report provided the Ministers' Committee with a comprehensive overview of the costs of the envisaged arms procurement programme, with a strong emphasis on risks associated with the adverse economic circumstances".*

Now you then highlight as to what it is that should be noted pertinently, can you take the Commission through that?

MR DONALDSON: Yes Chairperson, in paragraph 55 essentially here we're looking back now at the end of the procurement programme which had been successfully completed and afforded and financed within our budget envelope. It is important to note that this was a report that sounded a cautionary tone in Cabinet and in the Ministers' Committee at a time of considerable economic and financial uncertainties. So, the Affordability Report has to be read as a report written at a time of considerable uncertainty and so it emphasises risks, it emphasises risks very strongly.

Secondly it's not a report that deals with the Military Value, it doesn't try to say whether we need ships or aircraft, it is concerned with affording them, so it recognises in effect that there has been a Defence Review and intention to proceed with procurement and it asks the questions about affordability that is always the job of the Treasury and the Finance Ministry to ask in the context of Government decision-making.

And then thirdly it points out that although substantial benefits were negotiated in terms of the Industrial Participation proposals these were not assumed to contribute to budget revenue and they were not relied on for the purposes of financing or revenue associated with the programme.

MS RAMAGAGA: Thank you. Mr Chairperson before proceeding to the next paragraphs I would like to ask for a short, short adjournment, even if it were to be just a 10 minute adjournment.

CHAIRPERSON: Okay, let's adjourn for 10 minutes.

MS RAMAGAGA: Thank you Chair.

(Commission adjourns.)

(Commission reopens.)

MS RAMAGAGA: Thank you Mr Chair. We had hoped that what we wanted to attend to could be resolved and finalised in 10 minutes but we couldn't, and in actual fact the problem that we have relates to the documents that have been used during the presentation of evidence today, in particular documents "AD1" and "AD2", we are informed that they have not yet been declassified. We have actually discussed with the Treasury, the National Treasury, and the view expressed is that the documents or the contents of the documents are already in the public domain because evidence has been led from the documents and they have been heavily quoted, and secondly the documents were also given to the third parties for perusal, and they have since been retrieved from the third parties.

Now that retrieval does not then necessarily mean that the information is no longer in the public domain, it remains in the public domain, so what we seek to do is to hold a conversation with the Department of Defence represented by Admiral Green who is present today so that this problem can be resolved amicably. So, in the circumstances we request that this hearing be postponed to tomorrow.

CHAIRPERSON: Then I suppose you are representing the National Treasury?

ADV BRUINDERS: Yes, we are. It's, Ms Biza and I are representing, ... Ms Biza and I represent National Treasury. I came on record a long time ago, you will recall Chair right at the start I came on record for National Treasury. We're only here while Mr Donaldson gives evidence and anybody else from Treasury. The one thing we don't understand is the two documents in question are both Treasury documents and so in terms of the MIS [sic] it's the author of those documents who declassifies them, in this case the DG of Treasury. I understood that the DG had declassified them but I'm told by my client they haven't yet been declassified, but their declassification doesn't depend on whether somebody else does or doesn't want to declassify them. If it is a National Treasury document which the two documents are, well, then the DG must declassify them, that's the DG of National Treasury. I suppose we should speak to him about declassifying them because National Treasury itself has no difficulty with those, they're relevant to the issues, it has no difficulty with those documents, or Mr Donaldson dealing with them in this Commission.

CHAIRPERSON: I suppose your clients (indistinct) declassified because you know if they are not declassified that (indistinct) in the sense that certain documents is in the public domain, they are going to say, or the DG will say that "I don't want to declassify them" and they will be in the public domain because you know today they have been quoted from quite extensively and (indistinct) those documents, so I think it will be in the interest of everybody if the DG of the National Treasury can try and help to declassify these documents so that tomorrow morning we can proceed with the witness.

ADV BRUINDERS: We'll do our best.

CHAIRPERSON: Thank you. Then I think in that case let's adjourn until tomorrow morning at 10h00. I hope in the meantime the parties will be in a position to resolve this difficulty of declassification. Thank you.

(COMMISSION ADJOURNS)