INDEX TO STATEMENT OF MR MASIZAKHE ZIMELA

ARMS PROCUREMENT COMMISSION

INQUIRY INTO ALLEGATIONS OF FRAUD, CORRUPTION, IMPROPRIETY OR IRREGULARITY IN THE STRATEGIC DEFENCE PROCUREMENT PACKAGES

WITNESS STATEMENT – MASIZAKHE ZIMELA

1.

I am the Chief Director: Industrial Participation Secretariat (IPS) Unit, Industrial Development Policy Development Division in the Department of Trade and Industry ("**the dti**").

2.

I have been asked to provide evidence within my knowledge that may be relevant to the rationale of the Strategic Defence Procurement Packages (SDPP) and the implementation of the National Industrial Participation ("NIP") terms by the Industrial Participation Control Committee ("IPCC") within **the dti**.

3.

I commenced employment with **the dti** in July 2001 and was allocated the position of Director Non Defence Portfolio in the Industrial Participation Secretariat. The IPS is one of the structures responsible for management and implementation of the National Industrial Participation Programme ("NIPP")

4.

I remained with the IPS in the portfolio allocated to me until 2005 when I joined the Resource Based Industry Unit of **the dti** as Acting Chief Director. I was appointed chief director to the unit from 2006.

5.

From July 2001 to 2005 I was a member of the Industrial Participation Control Committee ("IPCC") and in 2010 I was appointed chairperson of the IPCC.

6.

In September 2011, I rejoined the IPS as Chief Director. I continue to serve as Chairperson of the IPCC.

7.

Having joined **the dti** only in 2001, I have no personal knowledge of the events leading up to the signing of the Strategic Defence Procurement Package ("SDPP").

8.

The evidence which I present to this Commission will cover the following areas:

a) The National Industrial Participation Programme and its framework;

b) The objectives sought to be achieved by the programme;

c) The governance structures responsible for the management , implementation and monitoring of the programme.

9.

Industrial Participation (IP), also known as "counter trade" or "offsets" or "reciprocal trade" is an international trade practice and forms part of the South African Government's industrial development strategy geared towards achieving the country's developmental objectives as determined by Government.

10.

South Africa developed its offsets programme known as the National Industrial Participation Programme (NIPP) in 1996. In terms of cabinet memorandum No. 10 of 1996 the principle of Industrial Participation (offset) policy was approved and the Department of Trade and Industry was mandated to develop a national policy. Cabinet approved the National Industrial Participation policy and its operating guidelines on the 30th of April 1997. A copy of the policy and the operating guidelines are annexed hereto marked "**A**" and "**B**".

11.

In terms of the policy all Government and parastatal purchases or lease contracts (goods equipments or services) with an imported content equal to or exceeding US$ 10 million (or the equivalent thereof) are subject to an industrial participation obligation. The seller / supplier who incurs an Industrial Participation obligation is required to participate in the South African economy in accordance with the guidelines and evaluation criteria set out in Annexures "**A**" and "**B**".

12.

NIP is one of the policy instruments to leverage Government procurement. Since 1997, new procurement instruments have been developed to support Industrial Development. These include the Competitive Supplier Development Programme (CSDP) managed by the Department of Public Enterprises, the amendments to the Regulations of the Preferential Public Procurement Framework Act (PPPFA), which enable the Minister of Trade and Industry to Designate sectors or subsectors or products for local procurement.

13.

the dti reviewed the NIP policy in 2011 and identified weaknesses which have been rectified in the NIP policy approved by Cabinet in December 2012. The approved policy seeks to strengthen and align NIP with other procurement instruments. The new policy provides a four tier framework to be applied in the case of Government procurement. These include Designation/Fleet Procurement, CSDP, Direct and Indirect NIP. It also places greater emphasis on Direct NIP rather than Indirect NIP. Indirect NIP was applied in greater proportion in the case of the SDPP as compared to Defence Industrial Participation (DIP). Direct NIP refers to projects that are in the same sector as that from which the procurement arise. In other words a seller company undertakes NIP projects in its core business.

14.

The objectives of the NIP policy are to:

a) To ensure sustainable economic growth

b) To facilitate access to new markets and/or establish new trading partners

c) To encourage Foreign Direct Investment (FDI) into South Africa

d) To ensure there is technology transfer to South Africa

e) To encourage R&D collaborations in South Africa

f) To contribute to job creation and / or retention

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g) Support economic development of historically disadvantaged communities

15.

These objectives are interlinked and the achievement of one may result in the achievement of one or more of the other objectives, for example, foreign direct investment into greenfield projects will definitely result in the creation of jobs and may result in technology transfer, Research and Development collaboration between the multinational company and South African companies as well as access to new markets or new trading partners.

16.

I point out that an Industrial Participation obligation is not only limited to arms procurement. All Government and parastatal procurement with an imported content equal to or exceeding US$ 10 million are subject to offset obligations. The role of **the dti** therefore is to track all procurement valued at or above US$ ten million in order to work out the offset obligation. In terms of NIP policy the obligor would incur an Industrial Participation obligation to a value equal to or exceeding 30% (thirty percent) of the imported content of the goods supplied. The obligor would therefore be obliged to submit and implement business projects which generate Industrial Participation credits calculated in accordance with NIP credit methodology equal to or exceeding thirty percent of the imported content.

17.

Projects to fulfil the offset obligations are evaluated and approved by the Industrial Participation Control Committee (IPCC) of **the dti,** with the support of the IPS. The monitoring of the projects carries on until the obligor has discharged all the obligations which is usually a period of 7 (seven years) from the time the main purchase agreement was signed.

18.

Upon being awarded a tender the NIP obligors are expected to sign an agreement recording their NIP obligations with **the dti** for each and every single tender awarded. In line with monitoring their progress, obligors are expected to achieve certain periodic milestones namely thirty percent of the obligations by year 3 (three), 70% (seventy percent) by year 5(five) and 100% (hundred percent) by year 7 (seven).

19.

Obligors have to submit performance guarantees to the value of 5% (five percent) of the total NIP obligations to **the dti**. This performance guarantee is equivalent to the penalty that obligors would pay should they fail to discharge their obligations.

20.

I should point out that the governance structures and the processes outlined in this statement for the performance and monitoring of projects and the manner in which credits are achieved relate to the standard NIP contract. Although the NIP Implementing Mechanism remains in respect of NIP obligations under the SDPP and the performance and monitoring are similar there are important differences between the standard NIP contracts and those in terms of NIP under the SDPP. Some of the more important differences are highlighted in paragraph 48 of this statement.

21.

GOVERNANCE AND THE STRUCTURES IN PLACE FOR PERFORMANCE MONITORING

the dti established the IPS and the IPCC in order to administer the NIPP. The IPS has a core function of implementing and monitoring the NIP programme. It is vested with the task of keeping track of all relevant South African Government and parastatal transactions with offset potential and to assist obligors in fulfilling their obligations. The IPS also administers and monitors the performance of obligors. The IPS is also responsible for compiling regular performance reports to the IPCC and to compile annual reports and recommend the allocation of NIP credits which are a measure of an obligors fulfilment of its NIP obligations.

22.

Two committees assist the IPS by ensuring that NIP is implemented and monitored in an open and transparent manner. These are the Internal Control Committee (ICC) and Industrial Participation Control Committee (IPCC).

23.

The ICC consists of dti officials, from both the IPS and the various sector desks in the Industrial Development Policy Development Division. The sole mandate of the ICC is the evaluation and "in principle" approval of NIP business concepts. It is a committee that assesses whether proposals meet **the dti** and NIP objectives. Its mandate is set out in the ICC Terms of Reference attached hereto as Annexure "**C**".

24.

The IPCC functions as a standing committee. It is an inter-departmental committee established to monitor the performance of the programme and advise on policy changes. Its members consist of officials from:

a) **the dti** as custodians of the NIP Programme,
b) The Department of Finance (National Treasury);
c) The Department of International Relations and Co-operation;
d) The Department of Public Enterprises; and
e) The Department of Defence.

25.

The IPCC's main role is to consider, approve or reject business plans and credit claims based on the NIP criteria and the credit methodology respectively. Its mandate is set out in the IPCC terms of reference attached hereto as Annexure "**D**". A full scope of the responsibilities of the IPCC are set out in paragraph 7.2.3 of Annexure **D**.

26.

NIP OBLIGATION

The Industrial Participation obligation is 30% (thirty percent) of the value of the imported content of the contract. The signed contract is required to set out the extent of the obligation of the obligor. The obligor will then be required to earn sufficient credits (which I deal with in more detail below) over a period of time, usually seven years (stipulated in the contract) so that its obligation is eventually discharged.

27.

On successful award of a contract, **the dti** is in a position to ascertain and make a determination of the estimated obligation value. Companies that incur a NIP obligation are required to sign a NIP Obligation Agreement with **the dti**. The agreement governs the relationship between **the dti** and the obligors and defines, amongst other things:

a) the NIP obligation value

b) the requirements to fulfil the NIP obligation

c) the performance guarantee

d) the performance milestones, and

e) the performance monitoring processes.

28.

Once the obligation value has been established, the terms of the obligation agreement are negotiated and concluded. The obligor is then required to submit a performance guarantee which equates to 5% (five percent) of the obligation value.

29.

PERFORMANCE MONITORING

Obligors are required to submit proposals on how they will fulfil their obligations. These proposals initially take the form of a business concept which is considered by the ICC and if found to be suitable, approved in principle subject to submission of a business plan within six months as shown in the diagram below.

30.

The process flow from receipt of concept to approval of business plan.

concept receipt in the IPS secreariat

- Concept is reviewed within the unit and then allocated to relevant sector for analysis
- Sector specialists together with IPS assess the project and conduct site visit if so required

ICC consideration

- The ICC considers the concept based on additionality, sustainability and causality
- The concept is also assessed based on NIPP objectives
- If the committee is satisfied that the concept meets the requirements they will approve the concept in principle and ask the obligated company to submit a business plan within 6 months

IPCC Consideration

- Financial projections
- Verify role of obligor
- Establish job creation/retention possibilities
- Establish local value addition and other economic benefits (jobs)
- Determine applicable NIPP credit multipliers
- Establish geographic location of the project
- Establish the partners to be involved in the project
- Consider possible credits to be earned by the project
- Once project implemneted approve credits claimed for

31.

The business plan is considered and approved or rejected by the IPCC based on the principles of causality, additionality and sustainability as described below.

32.

CAUSALITY

Causality means that the NIP project must result directly from a NIP Obligation, arising from a purchase contract. In other words, the obligor would not have initiated or participated in the project, had it not been for the NIP Programme or a condition of the purchase contract. There must be a clearly identifiable link between the NIP Obligation, the obligor and the NIP project. In addition causality means that each project must be shown to have been caused by the involvement of the obligor.

33.

ADDITIONALITY

All NIP projects must reflect new or incremental business. Investment type projects only qualify for credits if they are either new facilities or the expansion or upgrading of the existing facilities. Investment in existing facilities should demonstrate, beyond a reasonable doubt, the added benefit accruing from such investments. Export promotion type projects qualify for credits only if they are either for new products or existing products that are introduced into new markets.

34.

SUSTAINABILITY

Industrial participation projects will only be accepted if they are economically and operationally sustainable, even after the discharge period, i.e. they must be commercially viable.

35.

Whilst every effort is undertaken to approve projects that are proven to be sustainable, it is an internationally accepted fact that some projects may not be sustainable due to a number of factors including changed economic environment, poorly conceived business plans, bad project execution and bad project management.

36.

Thus in looking at the performance of the obligors, the approach is one of looking at the aggregate performance of all the projects submitted in fulfillment of a particular obligation. Projects that are not sustainable for any particular reason must be replaced by one or more projects of the aggregate value in order to fulfill the obligation.

37.

BUSINESS CONCEPTS

The obligor first has to submit business concepts for each proposal that will be used to fulfill the obligation. The primary purpose of the business concept is to provide a brief overview of the proposed project. It is primarily used to evaluate whether the business concept meets the NIP criteria before a company can embark on a more detailed business plan. It should contain the following information:

a) A brief description of the type of project.
b) A brief description of the products or services.
c) A brief description of the technologies, processes and systems to be used.
d) The source of raw material inputs and estimated local content.
e) The proposed geographic location.
f) A demonstration of the project's sustainability.

38.

These proposals need not all be submitted at the same time, but the projections must be able to meet all of the three milestones. The business concepts are then placed on the agenda of the ICC meeting for consideration. The ICC is an internal dti committee whose role is to consider the business concepts according to the principles of the programme. It is composed of officials within **the dti** mainly from the various sector/industry business units in the Industrial Development Policy Division. These officials have knowledge of the sectors they work in.

39.

BUSINESS PLANS

If the business concept is approved, the obligor is required to submit a business plan within six months of the approval of the business concept. The business plan is a document that expresses the purpose and direction of the NIP project, clarifies the growth potential of the project and outlines the project deliverables, timelines and resource allocation. It should expand on the information provided in the business concept and include the following additional information:

a) Partners (companies involved in the project)
b) Ownership structure including the role of the obligor
c) Funding details, where applicable
d) Financial projections including estimated credit schedules over the lifespan of the project
e) Employment projections – local and foreign
f) Demonstrate Causality and Additionality.

40.

The business plans are considered by the IPCC. The IPCC's main role with respect to business plans is to consider and approve or reject them based on the

NIP criteria. In certain instances, the business plans are approved with conditions attached. These may relate to minimum local content levels, proof by the obligor of transfer of technology where applicable.

41.

CREDIT CLAIMS

Upon performance of the business plans, obligors are required to submit claims for credits together with supporting documents for that particular claim e.g. copies of invoices, copies of bank deposits, export documents etc. The portfolio managers within the unit are responsible for verifying the claims and then submitting these for consideration by the IPCC.

42.

The NIP guidelines set out the crediting methodology used to award NIP credits. Points are allocated to the following:

a) Sustainable economic growth: for every US$1 revenue generated by the project over the fulfilment period 1 NIP credit;

b) Export promotion: for every US$1 export-revenue generated an additional 1 NIP credit over and above the one allocated for sustainable economic growth;

c) Job creation: for every US$1 spent on salaries and wages over the fulfilment period 1 NIP credit is awarded;

d) Training and development: for every US$1 spent on training and development costs 1 NIP credit is awarded.

e) SMME promotion: for every US$1 of work outsourced to an SMME 1 NIP credit is awarded;

f) Historically disadvantaged individuals: for every US$1 spent on outsourcing to historically disadvantaged SMME's 2 NIP credits are awarded;

g) Investment: for every US$1 invested on capital outlay or capital injections 2 NIP credits are awarded;

h) Research and Development expenses: for all costs expended on RND expenses 2 credits are awarded for every US$1 spent;

i) Technology transfer; 1 NIP credit is awarded for every US$1 offered.

43.

Insofar as investment funding is concerned the NIP obligor is required to provide direct funding to the projects. This funding must have been used to finance:

a) The establishment of a business facility or upgrading of the existing facility;

b) The acquisition of capital equipment;

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c) Technology transfer costs; and

d) Providing support in obtaining recognised international accreditation or certification.

44.

Export promotion involves the export of locally manufactured goods. For export related projects NIP credits are based on:

a) Revenue;

b) Local content;

45.

MILESTONES

In order to monitor the performance of obligations, obligors are required to achieve certain targets for credits, usually set in years 3, 5 and 7. The milestones are normally set at 30 %(thirty percent) of the total value of the obligation within 3(three) years, 70% (seventy percent) of the total value of the obligation within 5 years and 100% by year 7. The milestones enable both the IPS and the obligor to anticipate in advance of the period of fulfilment whether the obligation will be met and to provide remedial actions.

46.

REVIEW MEETINGS

Review meetings are held between the IPS and the obligors at least once a year and sometimes twice a year. The intention of the review meetings is to review the performance of the projects and where there are problems or potential problems to discuss possible remedial actions. It is also in these meetings that the aggregate performance in terms of total credits achieved in respect of milestones is measured.

47.

DISCHARGE FROM OBLIGATION

At the end of the discharge period for a particular obligor, all the credits for the different projects are added up and compared against the total obligation. If the credits are equal to or exceeds the obligation, then a recommendation is made to the IPCC to release the company from the obligation. If the recommendation is approved, then a letter is sent to the company releasing it from the obligation and the performance guarantee is released as well.

NIP obligations under the SDPP

The NIP obligations under the Strategic Defence Procurement Package were also managed and administered under the NIP programme of **the dti**. Although the process of oversight and monitoring was not different from that applicable to any normal NIP obligations there are certain important differences viz:

a) The terms of the contract recording the NIP obligations of the obligors under the SDPP were negotiated by various Departments inclusive of **the dti**. The NIP obligations had already been reduced to writing and the function of **the dti** was simply that of a "NIP Implementing Mechanism" as it is referred to in the SDPP contract;

b) The NIP crediting methodology under the SDPP is significantly different to that under ordinary NIP. The formula proposed with minor variations to achieve NIP credits under the SDPP is the following:

   i) 1 NIP is awarded for each euro or dollar of net export revenues earned by any of the projects in the NIP project;

   ii) 1 NIP credit is awarded for each euro or dollar of investments by the investor in the course of establishing and progressing any project; and

   iii) 1 NIP credit is awarded for each euro or dollar earned in respect of local sales of products produced in any project in the NIP project.

c) The ordinary NIP obligation is determined by calculation of 30 %(thirty percent) of the imported content of the goods supplied the obligor being required to either equal or exceed credits to the value determined. In the case of NIP obligations under the SDPP the credits required to be achieved are specified in the contract.

d) SDPP Obligors have to submit a performance guarantee /penalties to the value of 10% (ten percent) of their total NIP obligations whereas the performance guarantee required in terms of the ordinary NIP contract is 5% (five percent).

e) **the dti** management also undertook to carry out a performance review and accordingly requested the Internal Audit unit to undertake a strategic performance review of the SDP Projects in order to determine the actual performance of the SDPP following fulfilment of their NIP obligations. **the dti** further undertook to make the findings of the report available to the Portfolio Committee. The Final Audit Report on the SDPP project review is attached hereto marked **"E".**

49.

I am aware that in awarding NIP credits under the SDPP multipliers were used in calculating credits. I am also aware that because of certain considerations, Obligors were asked to invest in strategic projects. In those instances, the IPS negotiated multipliers with the Obligors (subject to the approval of the Executive

Authority), i.e. the granting of multipliers for credits that would ordinarily have not been granted. There were strategic matters considered for the use of multipliers which amongst others included:

a) Risky and commercially unattractive projects developed or proposed by government. These projects had significant implications for job creation or the prevention of job losses and were highly unlikely to be funded by the market;

b) Important projects for the development of the essential skills desperately needed in the economy, and which played a crucial role in developing poorer areas of South Africa; and

c) Projects promoting economic transformation, especially promoting the participation of historically disadvantaged individuals in the ownership and control of economic assets.

I am also aware that package deals were negotiated which made provision for multipliers and upfront credits. My colleague Sipho Zikode called to testify before the Commission will deal with factors that were considered by the IPS in determining the value of the multiplier. I wish to point out that at the time that I joined **the dti,** the NIP programme under the SDPP was already being implemented.

MASIZAKHE ZIMELA
15/01/2014