ARMS PROCUREMENT COMMISSION

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

WITNESS STATEMENT – JAYENDRA NAIDOO

1.

I am an adult male South African citizen, currently the Executive Chairman of J & J Group.

I have attached a short Curriculum Vitae to this statement marked "**JN 1**".

2.

I have been requested by the Arms Procurement Commission (the Commission) to provide evidence at its hearing regarding my involvement as the Chief Negotiator representing the Presidency in 1999 in connection with the SDPP.

3.

I had previously been requested in 2001 by the Joint Investigation Task Team (JIT) to provide information on the SDPP and I have decided to incorporate my briefing to the JIT in this statement because it is my humble submission that it is relevant to the work of this Commission.

4.

Despite the incorporation of my briefing to the JIT in this statement, I will also attend and respond to any issues which are raised during my appearance before the Commission, which are within my personal knowledge, and corroborate my statement with the relevant documents where these are available.

5.

I have been advised by the evidence leaders and my legal team during the preparation of this that some of the issues raised in my statement have already been exhaustively dealt with by various witnesses. Accordingly I have been advised to limit my statement to the following matters and to exclude other sections which have been covered in my earlier evidence to the JIT in 2001.

THIS STATEMENT WILL DEAL WITH THE FOLLOWING SUBJECTS:

1. Chronology of Events
2. Background
3. Terms of appointment of the Chief Negotiator, and composition, terms of reference and mandate of the Negotiating Team (NT) and Affordability Team (AT).
4. Assessment of the negotiating position
5. Industrial Participation system
6. Legal frame work
7. Finance contracts.
8. Review of defence equipment
9. Costs of the package
10. Affordability report.

11. Risks.

12. Main conclusions of the modelling exercise

13. Outcomes: NIP

14. Outcomes: Loan Packages

15. Conclusions

1. CHRONOLOGY OF EVENTS

1. Appointment of Chief Negotiator, representing the Deputy President **(9 December 1998)**

2. Establishment of interdepartmental International Offers Negotiating Team **(25 January 1999)**

3. First Ministers Committee (MC) meeting to determine the Terms of Reference **(20 January 1999**)

4. Commencement of the work programme **(20 January 1999)**

5. Two week trip by NT to meet with Defence companies and Banks

6. Preliminary DIP and Technical negotiations commence

7. Preparatory work on Finance agreement proposal

8. Preparation of legal contractual framework

9. Screening of NIP projects and review of NIP system

10. Second Ministers Committee meeting **(6 April 1999)**

11. Establishment of Affordability Team and commencement of work

12. Commencement of preliminary Finance contract negotiations

13. Finalisation of draft legal contract architecture and terms

14. Review of the Defence equipment requirement

15. Initial proposals on Gripen and submarine packages

16. Third Ministers Committee Meeting **(26 May 1999)**

17. Completion of preliminary negotiations with the German Submarine Consortium (GSC)

18. Completion of preliminary negotiations with Augusta

19. Draft of ROU with the German Frigate Consortium (GFC)

20. Completion of ROU with BAe/Saab

21. Consultation with stakeholders

22. Completion of ROU with GKN

23. Completion of report of the Affordability Team **(14 August 1999)**

24. Fourth Ministers Committee meeting **(31 August 1999)**

25. Briefing to Chairpersons of Parliamentary Committees

26. Final preparation with Ministers Committee for Cabinet

27. Report to Cabinet and final decision **(15 September 1999)**

28. Public announcement – **(16 September 1999)**

29. Final contract negotiations – Augusta, GSC, BAe/Saab, GFC/CC

30. Final Finance contract negotiations

31. Final Ministers Committee meeting (Nov)

32. Signature of contracts **(3 December 1999**)

33. Signature of Finance contracts **(January 2000)**

2. BACKGROUND

1. I was appointed as theChief Negotiator on the defence packages by the then Deputy President Thabo Mbeki on the 09th DECEMBER 1998. However, I commenced my duties earlier on the 20th November 1998. I was contracted by Armscor to provide the service of Chief Negotiator and was provided with a budget enabling me to employ a Personal assistant and to contract professional support staff.

2. I reported directly the then Deputy President Mbeki (who subsequently became the President and the Ministers Committee which was constituted as follows, then Deputy President Mbeki, the late Mr J Modise, Minister of Defence, Mr E Erwin, Minister of Trade and Industry, the late Ms Sicgau, Minister of Public Enterprise, and Mr T Manuel, Minister of Finance. I met with the Deputy President Mbeki prior to each meeting of the Ministers Committee except the Ministers Committee meeting in April 1999. I briefed him on progress, the critical issues for consideration, the various dynamics of each issue, and to obtain feedback in preparation for the meeting.

3. I also met separately with each of the Ministers who were members, prior to each Ministers Committee meeting, to brief them on progress and to understand their perspective on the issues. It was generally the case that each Minister was

concerned with matters from the point of view of their own responsibilities, making these meetings an important mechanism to enable me to position issues in a way which would facilitate decision making amongst the Ministers. In this statement I will where necessary refer the commission in particular to the minutes of the Ministers Committee of 20 January 1999, 6 April 1999, 26 May 1999, 31 August 1999 and 24 November 1999 annexed hereto and marked " **JN 2**" to "**JN 6**". Further, I made a presentation to Cabinet on 15 September 1999 which was followed by a public announcement made by Cabinet on 16 September 1999 attached and marked respectively as annexures "**JN 7**" and "**JN 8**".

4. From time to time, I met with the heads of departments, or advisers to Ministers, or had additional meetings with the Ministers, to maintain an effective two-way communication.

5. I also had numerous discussions (in some cases repeated discussions) with various interest groups. In meetings facilitated by NEDLAC, I briefed and received feedback from representatives of trade unions, business associations and community based organisations. In addition, I met research groups, SA and foreign embassy officials, and members of parliament to provide information on progress and receive information and opinion. I also met groups opposed to the procurement or who raised specific problems and who sought to meet with me. This included religious groups, NGOs against the 'arms deal' and certain individual members of the public who approached me.

6. Through the Government Communication and Information System (GCIS), I maintained open contact with several editors and members of the press who were following the defence procurement story.

3. TERMS OF APPOINTMENT AS CHIEF NEGOTIATOR REPRESENTING THE DEPUTY PRESIDENT

1. My appointment in this role was publicly announced by the Deputy President’s office through a media statement in December 1998.

2. My term as chief negotiator was formally concluded on 3 December 1999, after the contracts were signed with the various defence suppliers. However, I remained involved with certain matters regarding the Finance contracts until they were completed and signed towards the end of January 2000.

3. My core function was to chair the negotiations with the preferred bidders, to direct and lead the South African negotiation team to the desired outcomes in respect of an agreed ‘affordable package’ . The mandate required consensus internally within

the South African Government, with the preferred bidders, the finance institutions and Deputy President Mbeki and the Subcommittee of Ministers.

4. Initially the appointment was envisaged as a six month project, with provision for extension on a monthly basis.

ESTABLISHMENT AND TERMS OF REFERENCE OF THE NEGOTIATING TEAM (NT) AND AFFORDABILITY TEAM (AT)

1. Immediately following the Cabinet meeting of 18 November 1998, steps were taken to establish a Negotiating Team. The Minister of Trade and Industry convened a meeting on 20 November 1998 of representatives from DOD, DTI and DOF, and myself, to discuss issues relating to the composition, mandate and objectives of a Negotiating Team.

2. A terms of reference document was drawn up, and finally approved on 20 January 1999 by the first meeting of the Ministers Committee. The NT was required to negotiate an ‘achievable funding arrangement, and an affordable package with the preferred suppliers, which will result in final contracting’. It was to ‘negotiate and conclude an affordable set of contracts which satisfactorily combines the technical, industrial participation and financial imperatives’. The Ministers Committee (MC)

minutes dated 20 January 1999 attaching the terms of reference documents dated November 1998 are attached and marked “**JN 2**”.

3. The Negotiating Team consisted of representatives of the DOD, Armscor, DOF and DTI, chaired by myself, as Chief Negotiator representing Deputy President Mbeki. A mechanism for liasing with the heads of the participating departments, as well as the Department of Public Enterprise, was set up. The Negotiation team reported, through the Chief Negotiator, to the Ministers Committee.

4. The terms of reference provided that, under the leadership and co-ordination of the Chief Negotiator, the NT members would each concentrate on their own sphere of responsibility, namely the DOF representative on finance, the DTI representative on Non-defence Industrial Participation (NIP), and the Armscor representative, supported by the DOD representative on Defence Industrial Participation (DIP) and the technical/ supply areas. In practice, the full NT became the vehicle for the bulk of direct negotiations with the preferred bidders, except for the technical area which was largely left to Armscor/DOD provided they did not exceed the cost approved by Cabinet in November 1998. The whole negotiation of the NIP terms was conducted by the full NT, rather than separately by the DTI. While initially the Chief Negotiator and the DoF engaged in the finance negotiations, subsequently these were concluded by the DoF assisted by the DoD .

5. Apart from myself, the other members of the NT were Mr. L. Swan, CEO of Armscor, Mr. R. White, Senior Manager in the DOF, Mr. S. Shaik, the chief of procurement of DOD, and Mr. V. Pillay, Director for Industrial Participation in the DTI. Mr. P. Jourdan, Deputy Director-General of DTI, became part of the NT as did Mr. J. van Dyk, senior manager for DIP in Armscor.

6. The Negotiating Team was supplemented in its tasks by Technical/project teams of Armscor/DOD who were responsible for matters relating to selection and pricing of the defence equipment. Contract staff linked to the DOF assisted in the financial modelling and analysis, and staff within the DTI assisted in analysis of the proposed NIP projects.

7. From the outset, it was agreed that a task of this magnitude needed serious capacity and the services of world class legal advisers were sought, in addition to the Armscor and DOD legal capability. A team of financial advisers experienced in government to government undertakings was also sought. Through processes involving the NT, but managed through the DOD and DOF respectively, the services of White and Case, an international legal firm, was engaged to assist with the drafting of the legal contracts and Warburg Dillon Read, an internationally respected London Investment Bank, was engaged to support the team in the negotiations with the banks and Export Credit Agencies (ECA). In particular, the strategic finance negotiation strategy followed during the negotiations was outlined in the report

prepared by Warburg Dillon Read on behalf of DOF attached hereto and marked "**JN 9**"

8. On 6 April 1999, after consideration of a report by the Negotiating Team, the MC agreed to establish a separate team to investigate issues relating to the affordability of the packages.

9. The Affordability Team (AT) was to operate under the strictest confidentiality with the brief to evaluate the overall economic, fiscal and financial impact of the procurement. The primary focus was on the timing and need for the defence equipment, the economic benefit of the industrial participation, and the fiscal and financial risks. The AT was to prepare alternative scenarios for consideration by the Ministers Committee to enable the Ministers Committee to make a final decision about the scale and nature of the procurement.

10. The Affordability Team was comprised of four members, namely myself, Mr Roland White of the DOF, Dr. Paul Jourdan of the DTI and Mr. Chippy Shaik of DOD. The AT was supported by Dr. Stephen Gelb, a prominent economist who was contracted in by the Chief Negotiator, and Mr. Clive van Horen, who was contracted in by the DOF. At a later stage, the IDC and thereafter the Bureau of Economic Research at the University of Stellenbosch were contracted to assist the AT with the economic modelling exercise. In addition, a consortium of three US

consulting firms specialising in steel market analysis, as well as Mr K Yamaguchi, the steel analyst attached to Warburg Dillon Read (London), were contracted to provide reports on the viability of the three steel projects proposed as part of the offset arrangements for the German Submarine Consortium (GSC), German Frigate Consortium (GFC) and Light Utility Helicopter (LUH) packages respectively.

11. Obviously, due to the overlap of the brief and of people who were members of both the affordability team and negotiation team, there was a constant and dynamic interaction between the work of the two teams. Furthermore, within the NT there was a sharing of resources and personnel and considerable interdepartmental joint activity. For example, due to capacity constraints within DTI, Armscor's senior manager for DIP provided assistance to DTI for a period.

4. ASSESSMENT OF THE NEGOTIATING POSITION

1. It was an enormous project, comprising altogether 30 separate major activities, almost all of which had to be conducted in parallel.

2. The initial scope of the work was as follows: six sets of contract negotiations, each with a separate defence company. Each contract would comprise of 3 separate sub-agreements - on the supply of equipment, DIP terms and NIP terms. Associated with each contract was a separate finance contract to be negotiated with an international bank. Finally, there were negotiations with four

different export credit agencies, in the United Kingdom, Sweden, Germany and Italy.

3. In addition, there was an exercise of investigating ‘affordability’ which included a macroeconomic modelling analysis, as well as analysis of the major NIP project proposals. An ‘internal negotiation’ amongst the participating government departments on the size of the package that was deemed to be affordable also had to be managed.

4. Apart from the mainly internal affordability exercises, the South African (SA) team would be contending with a separate well resourced team representing either a preferred bidder or a bank on each of the 24 major contracts. The first problem was to manage the imbalance of resources so as not to be swamped. The solution to this in practice was careful sequencing of the negotiations, so as to maximise the bargaining position of the SA government.

5. The SA team had to seek to reduce the cost of the package, and ensure that the DIP and NIP commitments were both substantial and solid, in circumstances where a single preferred bidder had already been chosen for each of the six types of equipment. This would have left the bidders with the understandable feeling they had already won, on the basis of their tender submissions, thus reducing their incentive to negotiate beyond the terms of what they had already spelt out in their tender bid on either price or industrial participation commitments.

6. The outstanding issue of affordability raised the possibility that the purchase of any one of the equipment types could be reduced in number from the original tenders, or even cancelled. This became the main source of bargaining leverage for the NT against the preferred bidders. In addition, the defence industry was in a global downturn, which created a window of opportunity for SA, especially with regard to support from the affected foreign governments for preferential export credit facilities.

7. A comparison of prices on defence equipment was also conducted by the AT which showed no evidence of the SAG paying a premium to international prices for comparable equipment. However, there are inevitable limitations on comparisons where the underlying specifications of equipment are not the same.

5. CHANGES PROPOSED TO IMPROVE THE NATIONAL INDUSTRIAL PARTICIPATION (NIP) SYSTEM

1. The DTI's industrial participation system for non-defence projects was a relatively untested system, established during 1998, unlike the DIP system which had been in operation for some time. Upon closer examination, it was clear there were serious problems with the NIP system that needed to be remedied. The NT, mandated by the Ministers Committee, introduced certain NIP system amendments which required the preferred bidders to improve their offer significantly above the tender requirements, and was only effected with the agreement of the preferred bidders.

2. The tender requirements for DIP and NIP were each equivalent to 50% of the contract price measured in accordance with the rules of the respective industrial participation programmes of DoD and DTI. In their bids, the tendering companies were required to present business plans for projects which would fulfil their NIP and DIP obligations. Typically, the preferred bidders presented a large number of projects with inflated potential in their business plans, but committed to delivering no more than the required 50%. This enabled the companies to commence investigating all their projects and then to drop those which proved unviable, while still meeting their DIP and NIP obligations from the original list submitted.

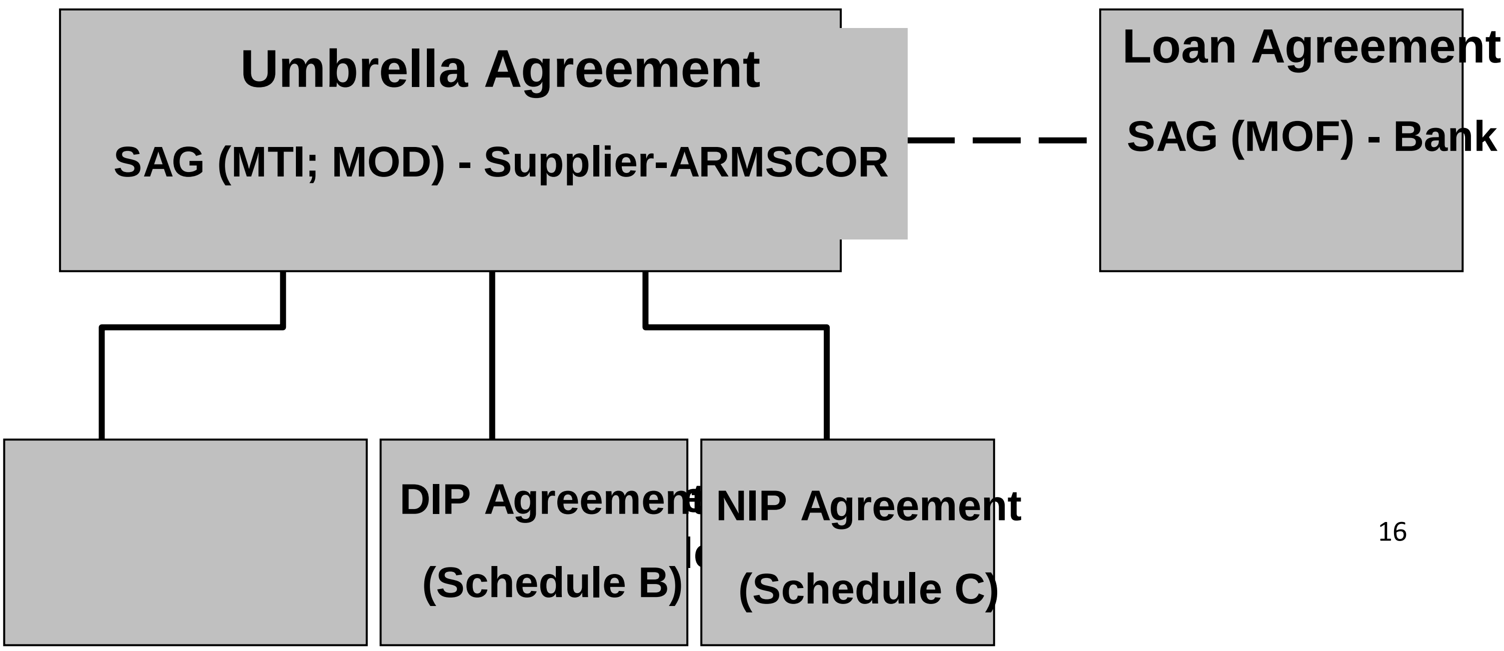
3. The NIP system, as used to evaluate the tenders in November 1998, allowed suppliers to meet their obligations through a combination of actual economic activity (such as investments, exports or sales). The NIP system awarded suppliers with rand value credits for investments, exports and sales with multipliers for exports and PDI equity participation, training and technology innovation. The November 1998 Cabinet decision reflected an industrial participation performance in excess of R100bn, even though the actual Rand value amount committed did not exceed R30bn for DIP and NIP combined. The NT concluded that the administrative requirements of such a system in the context of a programme as large as the defence procurement would place a high level of stress on the Department of Trade and Industry, and was also likely to lead to limitations in respect of transparency and public oversight.

4. With the consent of DTI, the NT proposed amendments to the NIP system for the purpose of the defence procurement to avoid such exaggeration of benefits. For the defence procurement, a revised system was agreed based only on investments, exports and sales on a basis of one rand (R1) for one credit and all the multipliers as envisaged in the existing NIP system were eliminated.

5. In negotiations with the preferred bidders, the NT targeted a minimum of a 1:1 ratio between NIP plus DIP investments and the contract (equipment purchase) price, with exports and sales additional. In all cases, these amounts were assessed over a period of 7 years. In some contracts a portion of the export commitments were front-loaded into the first 4 years in order to improve the overall national balance of payments situation during that phase of the procurement.

6. THE LEGAL FRAMEWORK

The following is the architecture of the legal agreement proposed by White & Case which was the format for negotiation and contracting..



FINANCE CONTRACTS

Original offers

1. As requested per the tender process, each offer for the supply of military equipment was accompanied by a financing package to fund the purchase of the equipment by the SAG. The original finance offers from all of the preferred bidders provided finance for 100% of each contract in the form of foreign currency offshore loans consisting of:

2. Export Finance officially supported by the Export Credit Agency of the supplying country (ECA Loans).

3. Foreign Commercial Credits at normal market rates and terms (Commercial Loans).

4. The ECA Loans covered up to 85% of the imported value of each contract, with further amounts to a maximum of 15% of the imported value to finance work in SA. In every case the Export Credit Agency required that the borrower pay the balance of 15% from its own resources, as a down payment. It was expected that this be

funded in hard currency from the Commercial Loans offered at LIBOR plus a substantial margin based on South African risk.

5. The ECA guaranteed credits provided the most favourable foreign currency borrowing terms, significantly better than what would be available to South Africa in the commercial markets. They also have the least impact on the availability of credit for other South African borrowers including the Government, although they may have an impact on the availability of ECA guarantees for future South African importers.

6. Commercial credits amounted to about 15% of the financing package originally on offer. The use of these lines would have a significant impact on South Africa's future offshore borrowing ability.

7. Aside from the loan packages, the only other viable source would be domestic (Rand) financing to match the Rand value (the local content) of the packages. This would reduce exchange rate risks.

8. The overall objective of the NT was to reduce costs, mitigate the impact on Government's future borrowing ability and reduced exchange rate risks. In respect of the finance negotiations, the NT's specific objectives included:

- To raise ECA loan coverage to cover the total imported content of the packages.
- To finance local sub contracts with ZAR raised in the normal course of business by the Treasury.
- To achieve the best currency and interest rate options on offer for all other ECA loans.
- To reduce bank margins and fees.

9. Maximum leverage was achieved by contract and loan negotiations being tightly co-ordinated. Financing discussions on ECA matters proceeded in parallel with contract negotiations until acceptable terms were agreed.

10. The ECA terms varied between countries and a cornerstone of the negotiating strategy was to use competitive pressure to get ECAs to match each other's best terms, so as to include the best features from each package in a common finance arrangement. Thereafter efforts were made to improve the packages to eventually match the Best Case Scenario.

8. REVIEW OF THE DEFENCE EQUIPMENT

1. Following consultations with the Chief of the Airforce, Chief of the Navy, Chief of the SANDF and Minister of Defence on the need for the defence equipment under consideration, the timing of these needs, alternative approaches to meeting these needs, and the requirements of an affordable package, the NT recommended 26 May 1999 that the procurement of the ALFA (the fighter aircraft to be supplied by BAE/SAAB) be deferred, on the basis of the priority ranking outlined below.

TYPE OF EQUIPMENT	**PRIORITY RANKING**
LUH	Urgent Replacement
LIFT	Urgent Replacement
ALFA	Not Required Immediately
SUBS	Urgent Replacement
CORVETTES	Overdue
MARITIME HELICOPTERS	Secondary Requirement

2. At the time of the negotiations, the airforce had 50 supersonic Cheetah fighter aircraft (including twelve dual passenger cheetah aircraft) which had recently had a midlife upgrade. These aircraft are able to operate until 2012. With regard to trained pilots for supersonic aircraft, the NT understood there were insufficiently trained personnel to absorb the Gripen aircraft should these be supplied earlier than the time required.

3. From a financial perspective, there was a currency risk associated with procuring the equipment in advance of need, as well as the possibility that better priced alternatives could become available at the appropriate time. The prevailing financing arrangement would have resulted in the cost of procurement being higher to the DOD budget than if the equipment were procured later.

4. On the other hand the planned procurement of the Gripen could generate significant industrial participation benefits for Denel, the defence industry and the DTI via NIP.

5. The recommendation of the negotiating team was to seek a deferment of the Gripen procurement on terms and conditions practical and favourable to the government.

6. In response to this proposal from the NT, BAe/SAAB indicated that this option did not interest them. Hence they would not be able to deliver on their DIP commitments linked to the Gripen. Work for Denel related to the Gripen would also not materialise thus affecting the viability of Denel. In the circumstances, there was little incentive for them to undertake their NIP commitments in advance.

7. As an alternative, BAe proposed a full transaction for the supply of 24 Hawk and 28 Gripen, with a first delivery of 12 Hawk aircraft and the dual seater Gripen aircraft and an option to the South African Government (SAG) to cancel on the supply of the remaining Hawk aircraft followed by another option to cancel on the single seater Gripen aircraft.

8. The option involved a purchase contract for the full amount, with the aircraft to be constructed and delivered in three batches. The SAG, however, had the right to cancel tranches 2 and 3 without paying any cash breakage costs in cash. This offer was different from a contract to procure, say, 12 Hawk and 9

Gripen with a cost-free option to order another 12 Hawk or 19 Gripen at a later date. In the latter case government would sign a contract for expenditures for tranche 1 only; in the former, the government would need to secure finance for all three tranches at the outset, albeit with an “escape” clause covering the latter two tranches.

9. The concept of an “option to cancel” was motivated by BAE/SAAB on the grounds that it would allow the financing terms to be contractually locked in without prejudice to the SAG’s right to decide not to go ahead with the rest of the procurement. Either option could be structured without restricting Government’s capacity to decide whether or not to acquire the additional equipment, and no costs would be payable should the SAG elect to exercise its option to cancel. On the other hand, the structure of an option to cancel could achieve the purpose of contractually locking in price and loan terms.

10. The choice posed to the Ministers Committee on 31 August 1999, then, in the light of its previous decision, was *either* to fully defer the ALFA package without taking any options, *or* to accept the proposed combination package. The latter option was recommended by the MC, and accepted by Cabinet.

9. COSTS OF THE PACKAGES

1. Cost estimates presented to Cabinet in August 1999 included a number of items in addition to the tender price of the actual equipment as provided by the suppliers. The costs as presented to the Cabinet in November 1998 had not taken into account all the costs . The complete list included:

   (i) Statutory costs such as freight, insurance and taxes;

   (ii) Project management costs incurred by the Department of Defence and Armscor in administering the procurements;

   (iii) Financing costs for deferred payments to suppliers to optimise cash flow;

   (iv) Premiums payable on all loans backed by export credit agencies;

   (v) Escalation costs to cover inflation in supplier countries in future years (standard in multi-year contracts);

2. The cost estimates were done on two different bases. The first assumed a Rand exchange rate fixed at the August 1998 rate, to calculate a nominal or

‘cash’ price, that is, the cost ‘as if’ a single payment were to be made at the date of signing. The second cost estimation basis calculated the real cost, by taking account of the expected rate of depreciation of the Rand exchange rate over the repayment period, as well as the ‘inflation differential’ between South Africa and supplier countries over the period. All foreign currencies were converted to Rand at an estimated foreign exchange rate closely linked to the ‘forward rates’ for the Rand prevailing in the financial markets at the time of estimation. The results were then discounted back to 1999, to give an estimated real Rand cost to government at 1999 prices. In the presentation of costs to Cabinet both the nominal cost (the ‘cash price’) and the real cost (using the forward exchange rate curve and discounting back to 1999) were included.

3. The cost on a cash price basis was R29.9 billion, as announced at the time of the Cabinet decision in September 1999.

10. AFFORDABILITY REPORT

1. The Affordability Study had two objectives. The first was to assess the macroeconomic, fiscal and financial impacts of the expenditure on armaments. The issue addressed in this respect was whether the procurement would create undue pressure on South Africa's overall economic performance (as measured by GDP growth), employment levels, external economic position (as measured by the current account deficit of the balance of payments) and the government's financial position (as measured by the fiscal deficit and public debt). In analysing this question, the impact of different levels of total expenditure was analysed, with correspondingly different levels of offset commitments.

2. The second objective of the Affordability Study was to analyse the risks involved in the procurement. A number of risks of the procurement were identified. These risks are spelled out below.

3. The Affordability Study defined 'affordability' in terms of the capacity of the economy to absorb the overall costs of the exercise, as well as the possible increase in cost levels which might occur if the associated risks were experienced. Affordability was *not* defined in terms of the concept of

‘opportunity cost’, that is, the possible alternative uses of the funds on meeting other policy objectives.

4. The methodology adopted in the Affordability Study involved :

(i) the thorough evaluation of financial market and offset commitment risks which might be experienced in the implementation of the procurement, in order to assess the likelihood of various risk scenarios materialising;

(ii) the use of two well-tested and highly reputable macroeconomic models of the South African economy to assess the economic impact of the procurement in the context of the various risk scenarios;

(iii) an evaluation of the impact of the procurement on the economy’s capacity to absorb economic shocks which arose independently during the implementation period; and,

(iv) comprehensive analysis of key industrial participation projects.

5. The Affordability Report presented the implications of different expenditure options, including the implications of various risks at the respective expenditure options.

11. RISKS

1. Risks identified included an increase in domestic interest rates upon the announcement of the packages, non-performance of the offset commitments, more rapid depreciation of the rand exchange rate than assumed in the costing calculations, and an exogenous economic shock.

2. In assessing the interest rate risk, two possibilities were considered. The first was a high risk scenario, that is, a large shock was presumed to occur in the wake of the announcement of the expenditure. In this scenario, the financial markets react strongly to the increased public expenditure, on the grounds that the increase would prevent government meeting its fiscal deficit targets, thus destroying its growing credibility with bondholders. The resulting panic reaction would lead to large capital outflows, rapid exchange rate depreciation and a possibly <u>large</u> interest rate hike if the outflow continued (depending on

the reaction of the SA Reserve Bank). The interest rate hike would in turn depress domestic economic activity. There was a corresponding low risk scenario for the interest rate, which assumed a small but positive rise in the rate, resulting from little reaction to the announcement but a small increase in the international risk premium on SA government bonds.

3. The economic impact modeling exercise included both high and low risk scenarios as regards the interest rate. The AT consulted with SA Reserve Bank officials and with Warburg Dillon Read in assessing the relative probabilities of the two risk scenarios. Other private banks could not be consulted because of the need to avoid premature leaks to the financial markets. The consensus view was that the low risk scenario was more likely than the high risk scenario, even at the higher expenditure levels, and this was reported in the presentation to Cabinet. In retrospect, this view has been borne out by events.

4. Two types of NIP risk were identified: contract risk and market risk. Contract risk refers to the failure of offset commitments to materialize due to suppliers' inability or failure to deliver on their commitments. It is commonly assumed that defence suppliers inevitably fail to deliver on their offset commitments, and indeed this view was held within the AT itself. However, the AT undertook a careful investigation of the experience of other countries in this respect,

examining voluminous literature as well as contacting relevant officials in several countries to obtain information. It emerged from this research that the record of delivering on offset commitment is in fact rather mixed, and includes both significant success as well as significant failures in securing offset commitments. A key issue in determining success or failure is the capacity of the buyer to monitor the process, and to embed the offset commitments within a clearly-defined industrial strategy. Success is associated with strong follow-up organisation and with the ability on the part of the buyer to develop alternative projects, when initial proposals falter. Recommendations on all of these issues were incorporated into the AT report. The affordability team report is attached and marked "**JN 10**".

5. Contract risk was additionally addressed via the performance guarantees, which were improved during the negotiations from an average of below 5% to 10%.

6. Market risk in relation to the NIP commitments relates to the failure of projects to deliver once investments have been made, due to unfulfilled expectations regarding market size, production costs and profitability, available technology and so on. To evaluate the market risks associated with the offset commitments, the AT commissioned two independent assessments of the

three largest offset projects identified as at mid-1999. These were the three steel mills associated with the submarines, corvettes and utility helicopters respectively. As noted above, the steel assessments were carried out by a consortium of three US consulting firms specialising in steel market analysis, and independently by Mr K Yamaguchi, a steel analyst employed by Warburg Dillon Read (London). The authors of the reports are all highly reputable in the international arena, and furthermore were not associated with parties potentially interested in the realisation or non-realisation of the projects. Their conclusions were summarised in the AT report and varied from extremely positive in the case of one of the three proposals, to cautiously positive, to pessimistic for the third proposal. These views were fully substantiated in their reports which were appended to the AT report.

7. The economic impact modeling exercise included both high and low risk scenarios for the NIP projects. However, a conservative approach to NIP risk was adopted, and even the 'low risk' scenario assumed only adequate performance, that is, 65 – 80% delivery of NIP commitments. By contrast, the high risk scenario assumed substantial underperformance, at 33% of delivery commitments.

8. The modelling exercise also explicitly included an assessment of the impact of more rapid depreciation of the Rand than had been assumed in the cost calculations. In order to assess the additional fiscal costs that would be incurred, the modelling exercise looked at the impact on the economy of an exogenous economic shock due to factors unrelated to the procurement itself. This was to assess whether the procurement would negatively impact upon the economy's capacity to absorb such shocks.

12. MAIN CONCLUSIONS OF THE MODELLING EXERCISE

1. The modelling exercise took account of expected inflation and exchange rate depreciation, that is, the differences between nominal and real costs of the procurement. It focused on three possible expenditure levels – low, medium, and high – each combining different levels of procurement of the various defence systems. These three expenditure levels were analysed in conjunction with the two interest rate risk scenarios, and the two NIP commitment risk scenarios, so that a total of 12 different scenarios were examined. In each scenario, approximately a dozen key economic variables were calculated over an eight-year time horizon, with four of these variables being the main focus: GDP growth; the fiscal deficit; the current account deficit on the balance of payments; and the employment impact. The

performance of all variables was related to a ‘baseline scenario’ which assumed that no procurement took place.

2. The broad conclusion of the modeling exercise was that the impact of the procurement would be approximately neutral over the full eight-year period even at the highest expenditure level, *if* the high risk scenarios were avoided in relation to both interest rate and NIP commitments. But the model clearly identified two separate phases in the process, with the initial (construction) phase of about 4 years being far more import-dependent, in that both the defence systems and the offset projects would require substantial levels of imported equipment. As a result, economic performance during this phase was noticeably worse compared with the baseline (no procurement) scenario. In the second phase, as imports tailed off and the offset projects began production and exports, economic performance improved relative to the baseline.

3. If either or both high risk possibilities were to occur, the modeling exercise predicted that the macroeconomic costs would become significant, with the size of the cost rising quickly as the overall expenditure level rose and as the risk level rose. Furthermore, if there was a macroeconomic shock for exogenous reasons (especially during Phase I of the process), the overall impact of the programme would be expected to deteriorate further, and government’s ability to manage the economic shock severely attenuated.

4. The modelling exercise further analysed the impact of the additional expenditure on the national debt, looking at both the impact on government's debt servicing capacity, as well as the impact on the demand for South African government debt in domestic and foreign financial markets.

13. OUTCOMES: NIP

1. Relative to commitments in the tender submissions, the NIP commitments were improved by over 100%. A degree of flexibility was permitted whereby local sales could substitute for exports, and, in certain cases, indirect DIP for export sales. But no substitution of the investment commitment was permitted.

2. To maximise the chances of reaching the target, negotiations were carefully sequenced and co-ordinated, in particular with the financial terms negotiations. The NIP and DIP commitments of suppliers as at August 1999 are summarised in the table below, with the November 1998, pre-negotiation, data included for comparison.

NIP and DIP commitments (Rm 1999, based on R6,25:$1)

Package	NIP			Total DIP	NIP Performance guarantee
	Invest-ment	Gross exports	Local sales		% of contract price
Corvettes	4 375	16 625	Included	2 899	5%
Submarines	6 242	10 669	1 629	1 139	10%
LUH	1 153	2 926	720	1 410	10%
MH	658	2 453	Included	576	10%
LIFT	2 000	2 500	4 500	3 125	10%
LIFT & ALFA	12 500	32 500	Included	9 302	10%
Total (incl ALFA)	**24 928**	**65 173**	**2 349**	**15 326**	
Cabinet Nov 98	25 336	56 204	17 861	11 176	

3. The overall DIP outcome was valued at R15.3 billion, which included direct participation in the equipment procurement (R4.6 billion), technology transfers (R3.1 billion), and indirect DIP via foreign suppliers engaging South African defence companies (R7.6 billion).

4. The table also summarises the performance guarantees negotiated with suppliers in respect of their NIP commitments. These guarantees were generally double those normally applied by the DTI. In addition, the DIP performance guarantees – contracted at 5% of the DIP commitment – were 37% higher than in the tender submission.

5. All the contracts refer to the NIP implementing system to take responsibility for this programme. This allowed the Minister of Trade and Industry to establish a suitably resourced mechanism to deal with the programme. In my concluding letter to President Mbeki and the Ministers Committee on 30 January 2000 I pointed out that this was the last outstanding matter to be addressed.

14. OUTCOMES: LOAN PACKAGES

Negotiation outcomes: current financing arrangements

1. Following extensive negotiations the need for Commercial Loans was completely eliminated and ECA finance could be used for all the imported content including down payments in respect of imports

2. The non-UK Agencies, to different degrees, matched the attractive options, offered by the UK, ECGD.

3. As a result, the ECA Loans included options to select different currencies, and with the exception of the German offer, a range of interest rate options.

4. The ECA premia were to be financed from the ECA Loans for all packages. Bank margins and fees were reduced.

5. These concessions by the ECAs are largely unprecedented.

6. The terms achieved with the ECAs and banks have substantially improved the financing in terms of cash flow, exchange risks as well as producing substantial savings for the SA Government.

16. CONCLUSION

1. In summation my assessment is that, during 1999 from the period commencing after the Government selected the preferred bidders up to the final signing of contracts, the negotiation process was conducted with great intensity and professionalism by the departments and officials participating, with the result being a consensus between the Government departments and Ministers that an improved outcome had been secured and one which was affordable for the SA government to enter into.

2. Thereafter my contract with the SDPP ceased and I have had no further involvement with it in any capacity thereafter.

3. On 13th and 14th June 2001 I participated in the public hearings before the Joint Investigative Committee. The relevant findings on the role of the IONT which I led as the Chief Negotiator are fully set out in Chapter 8 of the JIT report attached and marked "**JN 11**".

JAYENDRA NAIDOO

7 June 2014