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**STANDING COMMITTEE ON PUBLIC ACCOUNTS****30 October 2000****SPECIAL REVIEW OF STRATEGIC ARMS PURCHASES - SANDF : FINAL AND DRAFT COMMITTEE REPORT****Relevant Documents:**

Final Report: Special Review of the Auditor-General of Strategic Defence Packages (See Appendix 1)

Draft Report: Special Review of Strategic Arms Purchases South African National Defence Force (See Appendix 2)

Most of the meeting was closed to the public. At the end the public was allowed to rejoin the committee as they went through the grammatical corrections of the draft report. The report should be finalised by the end of the week.

Below find Appendix 1 Final Report Appendix 2 Draft SCOPA Report

**Appendix 1:****Final Report**

Fourteenth Report of the Standing Committee on Public Accounts, dated 30 October 2000: The Standing Committee on Public Accounts, having considered the Special Review of the Auditor-General of the Selection Process of Strategic Defence Packages for the Acquisition of Armaments at the Department of Defence [RP 161-2000], as well as certain papers referred to it, and having heard evidence, reports as follows:

**1. Introductory Comment**

By many accounts the international arms trade industry experiences a high incidence of malpractice, with purchasing countries often having been the victims of very costly exploitation. With this in mind, the Committee has considered the transactions and the broader financial and fiscal implications pertaining to the recent South African arms purchases. These have been considered through the Auditor-General's special review [RP 161-2000] and the Committee's subsequent public hearing concerning these acquisitions and through the substantial quantity of solicited and unsolicited information it has gathered. The Committee's resultant observations and findings provide the basis for the following Report and its accompanying recommendations.

**2. Cost to State**

On 15 September 1999, when announcing its decision to contract for the strategic arms packages, Cabinet presented the total cost thereof to be R29,9 billion. Two months later this was adjusted to R30,3 billion. The Committee has looked into both the validity of this amount and the State's attention to the full financial and fiscal implications of the purchases. Regarding the first issue, it has become clear to the Committee that the Cabinet's announcement omitted to mention certain other cost implications which, it would seem, will significantly add to the State's commitment. These factors included the cost of servicing the loan portion of the payment obligations (i.e. the interest charged), the price escalation conditions contained in the supplier contracts and the cost effects of negative foreign exchange movements.

In September 2000, the cost at current foreign exchange rates, together with contractual

price escalations, had risen to R43,8 billion. This figure, which was quoted by the Department of Defence at the Committee's hearing of the Department on 11 October 2000 and which was later acknowledged by the National Treasury and Industry in writing, excluded the interest obligations which would arise from the associated loans. The Committee expresses its concern at the possibility of the overall cost of the arms packages increasing further over the term of the contracts concerned. As all this is hugely material to the public interest, the Committee believes that the public should have been informed of these possibilities.

The Committee's scrutiny of the documentation presented to it by the various departments, and from which the Cabinet made its ultimate decision, indicates that the Cabinet was sufficiently informed to have made the public aware of the fuller cost possibilities of the deal.

Concerning the second issue, the Committee is satisfied that the National Treasury, in its 1999 "affordability study", did address the foreign exchange, price escalation and interest considerations and that it attempted to estimate and project these considerations into its long-term budget and cash-flow thinking. The National Treasury's submissions to the Cabinet were also careful to point out the risks associated with these factors. The National Treasury is commended for the comprehensive approach used by its study. Nonetheless, the Committee will remain anxious about the movements within certain major currency markets and the realism of the macro-economic assumptions used. In this regard, it intends meeting with the Minister of Finance, together with the Portfolio Committee of Finance, to discuss the ongoing assessment of the economic and financial fundamentals of the defence packages.

It must be pointed out that the Committee does note the partial neutralisation of foreign exchange and balance of payment effects, through the currency-linked arrangements of the anticipated offset-related inflows.

The Committee has at this stage not obtained all the information necessary for it to complete its evaluation of the cost make-up of the prices to be paid for the Gripen and Hawk deals, where there is a doubling of the basic unit prices - apparently for necessary extra features. The Committee will pursue this detail, with the assistance of the Auditor-General, in order to satisfy itself that there was no loading of the price - to cover Industrial Participation guarantees or to offset the cost of any other Industrial Participation obligation.

### **3. Offsets arrangements - Defence industrial participation programmes and national industrial participation programmes (DIPs/NIPs)**

Concern has also been expressed, through the Auditor-General's review, about the government's announcement of the R104 billion in offsets (investment and counter-trade).

A subsequent government press release indicated that this amount represented the nominal value of the offset transactions and that the economic benefit that would flow from this for the country, would be in the region of R70 billion. The government also estimated that this activity would create 65 000 new jobs in South Africa. The Committee has thus directed its attention towards verifying the make-up of both these amounts, their credibility and evaluating the possibility of their realisation.

Also of interest to the Committee is the difference in opinion regarding the essential purpose of the industrial participation contracts which make up the R104 billion. While the government argued mainly from the point of the industrial participation arrangement contribution to economic development, the negotiating team which secured the arrangements and the Department of Trade and Industry say these arrangements are rather about countering the negative economic and fiscal effects of the arms deals.

The Committee acknowledges that substantial thought and effort has been put into the establishing of these arrangements and to secure their certainty.

Of the R104 billion the Committee is advised that R14,7 billion relates to DIPs and R89,4

billion to NIPs. The DIPs would appear to be fairly assured as these projects are directly connected to the production of the armament purchases in question, and therefore payment would only be made once these deals were completed. The uncertainties therefore relate more to the enforcement of the NIPs.

The Committee's considerations therefore focus strongly on the attainment of these vitally necessary offset projects, particularly bearing in mind experience of developing countries. The exceptionally high industrial participation demands on the suppliers and the seemingly low penalties should they default (10% of the contract price in the case of NIPs), are also noted in this regard.

It is this last issue, in particular, raised by the Auditor-General, which is of most concern to the Committee. The NIPs contractual arrangements appear to allow for a supplier, once having supplied the arms and having received payment therefor, to pay over a relatively modest sum of money and be unconditionally excused from all offset obligations.

Notwithstanding the Departments of Defence and of Trade and Industry believing that this is not likely, the Committee remains concerned.

The Committee observes that these deals were negotiated at a time when the international arms industry was in a situational downturn. With international armament markets having since recovered, the Committee fears that the large commitments by suppliers might now be resisted and even reneged upon. With South Africa unlikely to be a serious arms purchaser over the next few decades, this possibility needs to be watched closely.

Notwithstanding explanations by members of the government's negotiating team, the Committee is reluctant to accept that suppliers whose intentions are honourable, would refuse to agree to guarantees of more than 10%. Given that these are essentially business arrangements that are only as good as their viability, two questions arise: Firstly, does the resistance to a higher than 10% guarantee (which need not be limited to bank type guarantees) suggest a lack of confidence in the business viability of the offsets proposed? Secondly, if these business deals are sufficiently competitive to be viable, why then are they only explored via arms procurement deals?

The Committee notes that there is sufficient flexibility for suppliers to respond to changing market and business conditions by proposing alternative ventures, if necessary.

The government-to-government agreements, which make references to NIPs commitments, while noble in intent and of some influence in official international communications, have questionable contractual or legal standing.

The Committee sees the economic benefit of these NIPs as a significant part of the bigger "value-for-money" composition of the arms deals, and as such sees a strong responsibility on the part of the government to enforce them. In addition to an effective monitoring system, the Committee wishes to see the government assertively pursuing delivery of these benefits. Any possibilities for the tightening up of these arrangements should be investigated - especially the proportionately large British Aerospace obligations. The Committee would wish to receive biannual reports on the progressive realisation of these commitments - both at their overall value and the economic benefit value. This is necessary to assure the public on the social payback from this major diversion of public resources (i.e. the matter of the opportunity costs).

Relatedly, the Committee expresses concern at the possibly optimistic estimations of jobs to be created, and advises of its intention to request the Portfolio Committee on Trade and Industry to express its opinion on this.

Finally, the actual written contracts do not appear well prepared, with instances of clumsy language, missing annexures and incorrect references. One of the more important indiscretions is the reference to the use of two different foreign currencies in one of the contracts. The Committee will assess whether these important contracts were subjected to appropriate legal scrutiny during preparation.

#### **4. Selection of prime contractors**

The Committee has noted the processes employed for the selection of the prime contractors. Because of the possibilities of improper influence having been exerted in certain of these selections, further investigation is considered necessary.

In the case of the Lead In Fighter Trainer (LIFT) contract, the Committee is concerned as to the reason why the evaluation system, which was accepted in April 1998, was changed at a combined Arms Acquisition Council and Arms Acquisition Steering Board meeting in June 1998.

A special ministerial briefing concerning the two options were presented to the subcommittee concerned on 31 August 1998, where it was decided to go with the non-costed option. This would appear to have led to the choice of a contractor who otherwise would not have been awarded the contract. The Committee remains unconvinced as to why the change in evaluation method took place (after submission of tenders), and why such change was only introduced in this particular programme. A further unanswered question is whether only the non-costed option was presented to the Cabinet. These matters should also be included in the investigation recommended below.

### **5. Selection of subcontractors**

The Committee is concerned about the possible role played by influential parties in determining the choice of subcontractors by prime contractors. What further concerns the Committee is that the government had no influence in the appointment of subcontractors. The Committee refers to this in its recommendation for further investigation, mentioned below.

The instance concerning the Integrated Management Systems (IMS) of Corvettes should be included in such an investigation, not only because it was included in the review of the Auditor-General, but also because of the large volume of information made available to the Committee on the matter. One aspect that the Committee will particularly examine, is the basis for comparisons of the respective products and the basis upon which the risk for the South African product was loaded.

### **6. Acquisition policies (Ministry of Defence; Armscor)**

The Auditor-General's review raises a number of questions concerning the arms procurement policies and procedures used in the deals in question. This not only relates to their all-round appropriateness, but also to their application. One example was the Armscor tendering processes followed, where conflict-of-interest provisions are clearly weak.

The Committee also questions whether there was not too great a concentration of influence - from documentation through to decision-making. This is to be a part of the investigation recommended below.

There should be a thorough *post mortem* and review of the arms procurement processes. It is recommended that the Auditor-General assist in the conduct of this further review.

### **7. Special forensic investigation**

After the National Assembly had referred the Auditor-General's report to this Committee, the Committee received a large amount of unsolicited evidence, of varying plausibility, from a number of different sources. Amongst the numerous allegations and assertions were those which reflected common ground to a significant degree. It is on the basis of this, and the Committee's perception of the other issues raised in this Report, as well as the need to prove or disprove once and for all the allegations which cause damage to perceptions of the government, that the Committee recommends an independent and expert forensic investigation.

In this regard, the Committee will prepare a brief for such an investigation, which stipulates particular assertions that ought to be investigated, while placing no limitation on the scope of the investigation.

In noting the complex and cross-cutting nature of the areas to be investigated, the Committee feels that the investigation would be best served by combining a number of areas of investigative expertise and a number of differing areas of legal competence and authority. It therefore recommends that an exploratory meeting, convened by the Committee, be held within two weeks of the tabling of this Report in National Assembly. The Auditor-General, the Heath Special Investigating Unit, the Public Protector, the Investigating Directorate of Serious Economic Offences and any other appropriate investigative body should be invited, so that the best combination of skills, legal mandates and resources can be found for such an investigation. Once this is established, the Committee will issue an investigation brief to the team for its input. Also, the chosen investigating body will be requested to report on its progress to the Committee at regular intervals, as well as at the conclusion of its work, so that this can be included in the Committee's final report to the National Assembly on the matter.

In more fully developing its brief for the proposed meeting, the Committee will continue to complete a few areas of its own investigation, and this could well include a meeting with certain Cabinet Ministers. In this regard, the Committee acknowledges the Cabinet's commitment to co-operate fully with the Committee and with any other investigations into the procurement Deals.

### **8. Concluding comments**

As the Committee is still finalising certain aspects of its investigations, a second report will be issued early in 2001, followed by a final report, which will incorporate the report of the investigating body, once its work has been completed.

In conclusion, the Committee acknowledges the extent to which the Department of Defence, Armscor, the National Treasury and the Department of Trade and Industry, with the agreement of their respective Ministers, have met their accountability commitments to Parliament in the course of the Committee's enquiry.

Report to be considered.

## **Appendix 2 DRAFT SCOPA REPORT**

### **SPECIAL REVIEW OF STRATEGIC ARMS PURCHASES - SOUTH AFRICAN NATIONAL DEFENCE FORCE**

The Standing Committee on Public Accounts, having considered the Special Review of the Auditor-General of the Selection Process of Strategic Defence Packages or the Acquisition of Armaments at the Department of Defence [RP161/2000], as well as certain papers referred to it, and having heard evidence, reports as follows:

#### **Introductory Comment**

By many accounts the international arms trade industry experiences a high incidence of malpractice. with purchasing countries having often been the victims of very costly exploitation. with this in mind. the Committee has considered the transactions d the broader financial and fiscal implications pertaining To the recent South African arms purchases. These considerations have been exercised through the Auditor-General's special review [RP 161/2000] and the subsequent public Hearing into these acquisitions and through the substantial quantity of solicited and unsolicited information it has gathered. The Committee's resultant observations and findings, provide the basis for the following report and its accompanying recommendations.

#### **The cost to the State**

On 15 September 1999, when announcing its decision to contract for the strategic arms packages, Cabinet presented the total cost thereof to be R29.9 billion. This was adjusted to R30.3 billion, two months later. The Committee has looked into both the validity of this

amount and the State's attention to the full financial and fiscal implications of the purchases.

Regarding the first issue, it has become clear to the Committee that the Cabinet's announcement omitted to mention certain other cost implications which it would seem, will significantly add to the state's commitment. These factors included the cost of servicing the loan portion of the payment obligations (i.e. the interest charged), the price escalation conditions contained in the supplier contracts and the cost effects of negative foreign exchange movements.

In September 2000, the cost at current foreign exchange rates together with contractual price escalations had risen to R43.8 billion. This figure, which was quoted by the Department of Defence at the Committee's Hearing of 11 October 2000 and which was later acknowledged by the Department of Trade and Industry in writing, excluded the interest obligations which will arise from the associated loans. The Committee expresses its concern at the possibility of the overall cost of the arms packages increasing further over the term of the contracts concerned. As all this is hugely material to the public interest, the Committee believes that the public should have been informed of these possibilities.

The Committee's scrutiny of the documentation presented to it by the various departments, and from which Cabinet made its ultimate decision, indicates that Cabinet was sufficiently well informed to have made the public aware of the fuller cost possibilities of the deal.

Concerning the second issue, the Committee is satisfied that Treasury, in its 1999 "affordability study", did address the foreign exchange, price escalation and interest considerations and that it has attempted to estimate and project these consideration into its long term budget and cash-flow thinking. The Treasury's submissions to Cabinet were also careful to point out the risks associated with these factors. Treasury is commended for the comprehensive approach used by its study.

Nonetheless, the Committee will remain anxious as to the movements within certain major currency markets and of the realism of the macro-economic assumptions used. In this regard, it intends meeting with the Minister of Finance together with the Portfolio Committee of Finance to discuss the ongoing assessment of the economic and financial fundamentals of the defence packages.

It must be pointed out that the Committee does note the partial neutralization of foreign exchange and balance of payment effects, through the currency linked arrangements of the anticipated offset-related inflows.

The Committee has at this stage not obtained all the information necessary for it to complete its evaluation of the cost make up of the prices to be paid for the Gripe and Hawk deals, where there is a doubling of the basic unit prices - apparently for necessary extra features. The Committee will pursue this detail, with the assistance of the Auditor General, in order to satisfy itself that there was no loading of the price - to cover Industrial Participation guarantees or to offset the cost of any other Industrial Participation obligation.

### **Offsets arrangements - DIPS/NIPS**

(defence industrial participation programmes and national industrial participation programmes)

Concern has also been expressed through the Auditor-General's review, regarding the Government's announcement of the R104 billion in offsets (investment and counter-trade).

A subsequent government press release indicated that this amount represented the nominal value of the offset transactions and that the economic benefit that would flow from this for the country would be in the region of R70bn. Government also estimated that this activity would create 65 000 new jobs in South Africa. The Committee has thus directed its attention towards verifying the make-up of both these amounts, their credibility and evaluating the

possibility of their realization.

Also of interest to the Committee is the difference in opinion regarding the essential purpose of the industrial participation contracts which make up the R104 billion, while Government argued mainly from the industrial participation arrangement contribution to economic development, the negotiating team which secured the arrangements and the Department of Trade and Industry say these arrangements are rather about countering the negative economic and fiscal effects of the arms deals.

The Committee acknowledges that substantial thought and effort has been put in to the establishing of these arrangements and to secure their certainty.

Of the R104 billion the Committee is advised that R14.7 billion relates to DIPs and 89.4 billion to NIPs. The DIPs would appear to be fairly assured as these projects are directly connected to the production of the armament purchases in question and therefore payment would only be made once these deals were completed. The uncertainties therefore relate more to the enforcement of the NIPs.

The Committee's considerations therefore focus strongly on the attainment of these vitally necessary offset projects - bearing particular developing country experience in mind. The exceptionally high industrial participation demands on the suppliers and the seemingly low penalties should they default (10% of contract price in the case of National Industrial Participation projects), is also noted in this regard.

It is this last issue in particular, as was raised by the Auditor-General, which is of most concern to the Committee. The NIP contractual arrangements appear to allow for a supplier, once having supplied the arms and having received payment therefore, to pay over a relatively modest sum of money and be unconditionally excused from all offset obligations. Notwithstanding the Departments of Defence and Trade and Industry's belief that this is not likely, the Committee remains concerned.

The Committee observes that these deals were negotiated at a time when the international arms industry was in a situational downturn. With international armament markets having since recovered, the Committee fears that the large commitments by suppliers might now be resisted and even reneged upon. With South Africa unlikely to be a serious arms purchaser over the next few decades, this possibility needs to be closely watched.

Notwithstanding explanations by members of governments' negotiating team, the Committee is reluctant to accept that suppliers whose intentions are honourable, refused to agree to guarantees of more than ten percent. Considering too that there are essentially business arrangements that are only as good as their viability two questions arise. Firstly, does the resistance to a higher than 10% guarantee (which need not be limited to bank type guarantees suggest a lack of confidence in the business viability of the offsets proposed? Secondly, that if these business deals are sufficiently competitive to be viable, why then are these only explored via arms procurement deals?

The Committee notes that there is sufficient flexibility for suppliers to respond to changing market and business conditions by proposing alternative ventures if necessary.

The government-to-government agreements, which make references to NIP commitments, while noble in intent and of some influence in official international communications, have questionable contractual or legal standing.

The Committee sees the economic benefit of these NIPS as a significant part of the bigger "value-for-money" composition of the arms deals, and as such sees a strong responsibility on the part of government to enforce these. In addition to an effective monitoring system, the committee would wish to see Government assertively pursuing delivery of these benefits. Any possibilities for the tightening up of these arrangements should be investigated

- especially the proportionately large aerospace obligations. The Committee would wish to receive bi-annual reports on the progressive realization of these commitments both at their overall value and the economic benefit value. This is necessary to assure the public on the social payback from this major diversion of public resources, i.e. the matter of the opportunity costs.

Relatedly, the Committee expresses its concern at the possibly optimistic estimation of jobs numbers to be created, and advises of its intention to request the Portfolio Committee on Trade and Industry to express its opinion on this.

Finally, the actual written contracts do not appear well prepared, with instances of clumsy language, missing annexures and incorrect references. One of the more important indiscretions is the reference to the use of two different foreign currencies in one of the contracts. The Committee will assess whether these important contracts were subjected to appropriate legal scrutiny in their preparation.

### **Selection of prime contractors**

The Committee has noted the processes employed for the selection of the prime contractors. Because of the possibilities of improper influence having been applied in certain of these selections, further investigation is considered necessary.

In the case of the LIFT (Lead In Fighter Trainer) contract the Committee is concerned as to why the evaluation system which was accepted in April 1998 was changed at a combined Arms Acquisition Council and Arms Acquisition Steering Board meeting in June 1998.

A special Ministerial briefing concerning the two options was presented to the subcommittee on 31 August 1998, at which meeting it was decided to go with the non-costed option. This would appear to have led to the choice of a contractor who otherwise would not have been awarded the contract. The Committee remains unconvinced as to why the change in evaluation method took place (after submission of tenders). And why such change was only introduced in this particular programme. A further unanswered question concerns whether only the non-costed option was presented to Cabinet.

These matters should also be included in the investigation recommended below.

### **Selection of sub-contractors**

The Committee is concerned about the possible role played by influential parties in determining the choice of sub-contractors by prime contractors. What further concerns the Committee is that Government had no influence in the appointment of subcontractors. The Committee refers to this in its recommendation for further investigation mentioned below.

The instance concerning the Integrated Management Systems (IMS) of the Corvettes should be included in such an investigation, not only because it was included in the review of the Auditor-General, but also because of the large volume of information made available to the Committee on the matter. One aspect that the Committee will particularly examine is the basis for comparisons of the respective products and the basis upon which the risk for the South African product was loaded.

### **Acquisition policies (MoD, Armscor)**

The Auditor General's review raises a number of questions concerning the arms procurement policies and procedures used in the deals in question. This not only relates to their all-round appropriateness, but also to their application. One example was the Armscor tendering processes used where conflict of interest provisions are clearly weak.

The Committee also questions whether there was not too great a concentration of influence - from documentation through to decision-making. This is to be a part of the investigation recommended below.

There should be a thorough post mortem and review of the arms procurement processes. It is recommended that the Auditor-General assist in the conduct of this further review.

### **Special Forensic investigation**

Once Parliament had referred the Auditor-General's report to SCOPA, the Committee received a large amount of unsolicited evidence, of varying plausibility, from a number of different sources. Amongst the numerous allegations and assertions were those which reflected to a significant degree of common ground. It is on the basis of this, and the Committee's perception of the other issues raised in this Report, as well as the need to prove or disprove once and for all the allegations which cause damage to perceptions of Government, that the Committee recommends an independent and expert forensic investigation.

In this regard, the Committee will prepare a brief for such an investigation which stipulates particular assertions that ought to be investigated, while placing no limitation on the scope of the investigation.

In noting the complex and cross-cutting nature of the areas to be investigate, the Committee feels the investigation would be best served by combining a number of areas of investigative expertise and a number of differing areas of legal competence and authority. It thus recommends that an exploratory meeting, convened by the Committee, be held within two weeks of the parliamentary tabling of this report. The Auditor General, the Heath Investigative Unit, the Public Protector, the Office for Serious Economic Offences and any other appropriate investigative body should be invited in order that the best combination of skills, legal mandates and resources be found for such an investigation. Once this is established, the Committee will issue an investigation brief to the team for its input. Further, the chosen investigating body will be requested to report on its progress at regular intervals to the Committee, as well as at the conclusion of its work, in order that this might be included in the Committees final report to Parliament on the matter.

In more fully developing its brief for the proposed meeting, the committee will continue to complete a few areas of its own investigation and this could well include a meeting with certain cabinet ministers. In this regard, the Committee acknowledges Cabinet's commitment to co-operate fully with the Committee and with any other investigations into the procurement deals.

### **Concluding Comments**

As the Committee is still finalizing certain aspects of its investigations, a second report will be issued early in 2001, followed by a final report to parliament which will incorporate the report of the investigating body once it is completed.

In conclusion, the committee also acknowledges the extent to which the Department of Defence, Armscor, the Treasury and the Department of Trade and Industry, with the agreement of their respective Ministers, have met their accountability commitment to Parliament in the course of this Committee's enquiry.

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