Eskom

MEMORANDUM

To: Mr Jaybalan Pillay, Chief Procurement Officer

From: Wawa Xaluva, Acting GM: Legal & Compliance

CC: Mr Calib Cassim, Acting Chief Financial Officer

Date: 27 September 2017

SUBJECT: RISK BASED CONTRACTS BEING IMPLEMENTED IN ESKOM

PURPOSE

1. To advise the Chief Procurement Officer that risk based-contracts which are being implemented within Eskom require approval from National Treasury before these can be implemented and as such any payments and commitments made in terms of current risk based contracts will be considered as irregular expenditure.

BACKGROUND

2. Eskom has embarked on a number of risk-based contracts for consultants on the panels for Financial Advisory Services ("FAS") and Strategic Business Management ("SBM"), commencing in 2016 without National Treasury ("NT") approval being obtained.

3. In such contracts, consulting fees are determined as a percentage of the value created by the consultant.

4. Subsequently, Group Commercial issued "Procurement Instruction 02 of 2017: Practice Note for Risk-Based Task Orders" dated 24 July 2017 (document no. 240-119377796) (the "Eskom Procurement Instruction") to the business to provide guidance on the governance and implementation of task orders compensated on risk-based fees (attached as Annexure "A").

5. Paragraph 2.1 of the Eskom Procurement Instruction cites National Treasury Practice Note Number SCM3 of 2003 (2003 NT Practice Note) as the basis for the permissibility

of this type of remuneration model for consulting services (attached as Annexure "B").

DISCUSSION

6. Subsequent to the 2003 NT Practice Note, NT issued Cost Containment Instructions that included the use of consultants and the bases upon which they could be remunerated.

7. These NT Instructions were first issued in December 2013 as Instruction 01 of 2013/14 effective 1 January 2014 (attached as Annexure "C"), succeeded by Instruction 02 of 2016/17 effective 1 November 2016 (attached as Annexure "D") and lately Instruction 03 of 2017/18 effective 15 May 2017 (attached as Annexure "E").

8. None of the NT Instructions mentioned above permit the use of a risk-based remuneration model as contemplated in the Eskom Procurement Instruction. Instead these refer to remuneration based essentially on the calculation of hourly rates.

9. More specifically, rates may not exceed the applicable rates as mentioned in specified guidelines, being those issued by the SA Institute of Chartered Accountants (SAICA), the Department of Public Service and Administration (DPSA), and/or remuneration guidelines issued by professional service organisations or prescribed by regulatory bodies as may be relevant.

10. In the 2016/17 and 2017/18 NT Instructions, it is additionally stated that when negotiating cost-effective consultancy rates for international consultants and expert advisors, the relevant international and market-determined reference rates may be taken into account.

11. Permission for deviation or a departure from the stipulated bases of remuneration may however be applied for in terms of section 79 of the PFMA, which NT may approve "on good grounds" (attached as Annexure "F").

12. This position was confirmed in an opinion obtained from Senior Counsel (Adv. Paul Kennedy SC) received in December 2015 through instructions from Mchunu Attorneys (attached as Annexures "G" and "H"), wherein he stated that although there appears to be doubt as to whether National Treasury's Practice Note SCM 3 of 2003 was expressly repealed, it has impliedly been repealed and superseded by the 2014 NT Instruction.

13. The SC opinion was also communicated to the then Chief Procurement Officer in December 2015 by the GM: Legal & Compliance (attached as Annexure "I").

14. As noted under point 4 above the Supply Chain Management Practice Note SCM 3 of

2003 is cited as the basis for the permissibility of risk-based remuneration in the Eskom Procurement Instruction 02 of 2017 [Practice Note for Risk-based Task Orders] signed into effect on 02 August 2017.

15. Thus the basis of the Eskom Procurement Instruction, being the permissibility of risk-based contracts by National Treasury in terms of Practice Note No SCM3 of 2003, is fatally flawed.

16. The Eskom Procurement Instruction is also contrary to the Eskom Directive for the Implementation of the National Treasury Instructions 03 and 04 of 2017/2018 on Cost Containment Measures authorized by the Acting Chief Financial Officer on 02 August 2017 – document no. 240-122002206 (2017 Eskom Cost Containment Directive) (attached as Annexure "J"), which states that "Consultants may not be remunerated higher than the rates prescribed by either their Professional body or those prescribed by the Department of Public Works." (Subparagraph 5.2 on page 5; paragraph 4.3 on page 7; paragraph 4.4 on page 8)

17. Copies of the contracts (original NEC3 contracts and the Addendums) with Price Waterhouse Coopers ("PWC") one of the consultant firms on the panels have been provided to Legal & Compliance. Similar contracts have been concluded with other members of the panels in question.

18. The original are New Engineering Construction ("NEC") Professional Services Contracts with standard terms and conditions (referred to as the "NEC3 contract"). These are Option G (Term Contracts) with secondary options X1, X2, X7, X9, X10, X11, X12, X18 and Z clauses (attached as Annexure "K"). Deviations to the NEC terms and conditions are attached to the NEC contract as Annexure A in the NEC3 contract.

19. Confirmation is required as to whether these terms and conditions were reviewed and approved by Legal & Compliance as these are deviations to the standard terms of the NEC and as such, in terms of Eskom's Delegation of Authority, require the approval of Legal & Compliance before these can be used in the contract.

20. The scope of work is for the provision of strategic, business and management consulting and professional services, for a period of three (3) years and the term is from 18 July 2016 to 17 July 2019.

21. According to C2.1 of the contract, the Prices are the time charge for items described as tine based on the Task Schedule and the lump sum price in the Task Schedule for each other item;

21.1. Staff rates and expenses are established in one of three ways:

21.2. Rates for named staff

21.3. Rates for categories of staff; or

21.4. Rates related to salaries to be paid to staff

22. The original contracts appear to be in order and do not contain any clauses that raise concern in respect to the concerns raised in this memo, save in instances where stipulated hourly rates are in excess of those permitted in the NT Instructions.

23. There are, however, addenda to the NEC contract which were signed by panel members. This is referred to as "Addendum 1" and is dated 1 October 2016 but is effective from 1 November 2016 to 17 July 2019 (attached as Annexure "L"). It states that the addendum *"supplements the enabling panel contract and sets out the agreed terms which shall be applicable for all Task Orders issued on a risk fee basis."*

24. In the opinion received from Senior Counsel (December 2015), he also reviewed the terms and conditions of the McKinsey risk-based contract, signed in January 2016 (attached as Annexure "M").

25. The terms and conditions of the addenda which were signed by the panel members of the SBM and FAS have been compared to those in the Service Level Agreement concluded with McKinsey in January 2016 ("the McKinsey contract") and are almost identical. Hence the issues raised by senior counsel on the McKinsey contract are applicable to these addenda and need to be addressed urgently.

26. Senior Counsel advised that risk based contracts required an approval from NT for a deviation from its Instructions (No 1 of 2013/2014) dealing with Cost Containment Measures, including for the use of consultants (2014 NT Instruction).

27. This was the prevailing Instruction at the time the McKinsey contract was signed, and the reason an application for deviation was required is because the remuneration model employed, being one where the remuneration would be fully at risk where any payment would be calculated as a percentage of measurable savings delivered, was a model that was not permitted by the 2014 NT Instruction.

28. As far as Legal & Compliance is aware approval for deviation has not been applied for from National Treasury for any of the risk-based contracts signed to date, nor for those contracts where the hourly rates exceed the limits referred to in the NT Instructions.

29. In addition to the concerns raised by senior counsel, an independent peer assessment review was conducted by external consultants (Oliver Wyman) on the reasonableness of the conditions, performance measurement and remuneration on the work done by McKinsey and its BBBEE partner (attached as Annexure "N"). There are several areas of concern regarding the contractual terms used, including but not limited to the following:

29.1. There are several terms that favour the Consultant;
29.2. There is ambiguity in the contract terms that deal with payments;
29.3. The contract lacks key details about outsourcing;
29.4. Reference is made to the baseline value and baseline renegotiation parameters but it

is not clearly set out in the agreement as to how and when they apply;

29.5. There are important clauses missing, for example the warranty clause and breach clause;

29.6. There is reference to a tracking tool which is designed by the Consultant and there is concern as to whether this tool has been verified and has the necessary controls to allow for the reasonable audit of the data.

30. In light of the above, the terms and conditions of Addendum 1 signed by the panel members are of great concern, not only in terms of the exposure that Eskom faces with respect to the terms and conditions, but also in light of the fact that any payments or commitments made in terms thereof may be regarded as irregular.

31. Legal & Compliance has been advised that, although the addenda have been signed by all panel members, instructions based on the risk-based remuneration model have only been issued to one consultant firm (PWC) and payment of approximately R270 Million has been invoiced for work done, based on the risk-based remuneration model.

32. Interim payments have however been made in the amount of approximately R60 million to date, but this was based on work already done and calculated per the contract's hourly rates (as averred by the GM: Special Projects).

33. The Employer's Representative and Contract Manager for this contract have also advised that a majority of the risk-based invoice amount (approximately R260 Million) is subject to dispute by Eskom. The Work Package Manager has confirmed via e-mail that for the "No loads tech plan and No loads outages- The savings were identified by Eskom but only verified by the Consultant and thus there was NO value added" (attached as Annexure "O").

CONCLUSION

34. In light of the above, it is apparent that these contracts are not in line with the 2014 and 2016 NT Instructions, with the major concern being the impermissibility of employing a risk-based remuneration model based on a percentage of measurable savings or similar, as no prior approval was obtained from National Treasury for a deviation from the applicable NT Instructions.

IMPACT: FINANCIAL IMPLICATIONS

35. Any commitments and/or payments made in terms of the risk-based remuneration provisions of these contracts, contained in the addenda, will be classified as irregular expenditure.

36. In addition, if any commitments and/or payments were made in terms of the hourly rates stipulated in the NEC3 provisions, these hourly rates must be in accordance with the guidelines stated in the NT Instructions and any payments under rates in excess of the guidelines will similarly be classified as irregular expenditure.

37. Both the above will require disclosure in the Annual Financial Statements if they materialise, which will raise the risk of an audit qualification by the external auditors for the 2017/18 financial year.

38. An audit qualification for the 2017/18 financial year could in turn trigger immediate repayment of all outstanding debt obligations to lenders.

BUDGET IMPLICATIONS

39. None.

RECOMMENDATIONS

40. In order to assess Eskom's exposure, it is necessary that the following actions be urgently attended to by the CPO:

40.1. The Eskom Procurement Instruction 02 of 2017: Practice Note for Risk-based Task Orders must be withdrawn with immediate effect

40.2. An instruction must be issued to the business that Eskom will not be proceeding with any risk based contracts;

40.3. A further instruction to be issued advising that all hourly based contracts/ task orders with Consultants may NOT exceed the hourly rates allowed in the NT Instructions and guidelines

40.4. The CPO is also to provide urgent feedback on the extent of risk-based contracts being concluded in Eskom, including details of any amounts paid to date as well as the bases of the payments;

40.5. Urgent feedback is also required as to any contracts with Consultants where commitments and/or payments have been made in terms of the hourly rates that are higher than those allowed in the NT Instructions and guidelines

41. The Consultants on the FSA and SBM Panels must be advised that:

41.1. the remuneration model in the Addendums is contrary to National Treasury Instructions and as such the terms and conditions, including the remuneration model, of the original NEC contracts will need to be re-instated, subject to the approval of any deviations to the standard terms and conditions to the NEC by Group Executive: Legal & Compliance;

41.2. where the NEC3 hourly rates in any contract/ task order exceeds the hourly rates allowed in the NT instruction and guidelines, then these will need to be amended to bring them in line with the rates referred to in the NT Instructions.

42. In respect of the invoice that has been submitted by PWC, it is recommended that Eskom advise PWC to revert to a time/ materials basis at rates that are allowed as per the NT Instructions and Guidelines and to re-submit the invoice for payment in accordance with allowed rates.

43. Furthermore, any invoices for <u>any</u> consulting contract within Eskom that is not in accordance with allowed rates as per the NT Instructions and Guidelines will need to be amended and re-submitted in accordance with the allowed hourly rates.

44. To the extent that any irregular expenditure has already been incurred (namely any remuneration paid to the consultants either under the risk-based percentage model or where the hourly rates used exceeded the rates referred to in the NT Instructions), condonation will need to be sought from National Treasury.

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Date: