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SONA: Energy crisis tops government's agenda

Highlights

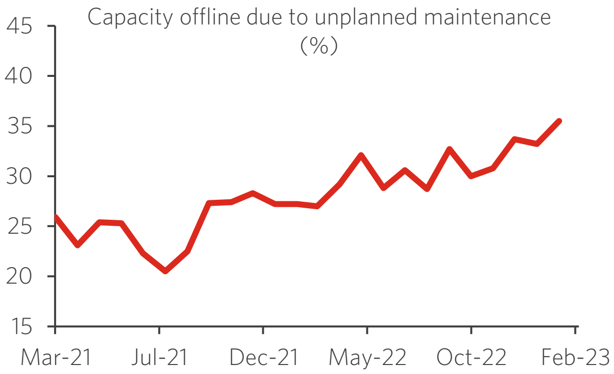
- The rand and local bonds showed little movement in reaction to the State of the Nation Address (SONA), but financial markets are likely to view the announcements as being broadly positive. The success of these interventions relies heavily on government funding and as such the upcoming national budget plays a pivotal role in getting the ball rolling on the implementation of the announced plans.
- The SONA emphasised the risk that insufficient energy supply poses to growth and investment in the economy. It also noted the need to arrest the deterioration in basic service delivery rolled out from defunct municipalities. As part of the ruling party's larger renewal campaign, government acknowledged the widening trust deficit between itself and other key stakeholders in the economy as is evidenced by slow progress in socioeconomic development. The SONA further highlighted the shortcomings of our law enforcement agencies which have led to a rising level of lawlessness in the country.
- In addition to committing to previous plans, government announced new interventions aimed at resolving the insecurity of energy supply, including a state of disaster to prevent a total blackout, a dedicated resource in the way of a new Minister of Electricity to oversee government's short-term energy crisis response and increased funding for diesel to lower the intensity of loadshedding in the near term.
- The speech also confirmed the continuation of the social relief of distress (SRD) grant, but the president did not outline specific details for a more permanent solution to respond to the needs of the most vulnerable. Previously, Treasury confirmed that a permanent extension or replacement would only be possible through a reduction in spending elsewhere or a permanent increase in revenue (or a combination of the two) to ensure the stability of the public purse.
- The speech emphasised the poor performance of the country's municipalities and offered up interventions to improve professionalism in public service.
- Reducing policy uncertainty and fast-tracking the implementation of structural reforms that have wide-reaching benefits to improve the country's growth trajectory and job outlook require a broader political consensus on what is needed to fix South Africa's (SA) ailing growth rate.
- In our view, garnering positive consumer, business and investor sentiment requires a concerted effort to align interests between government, business, labour and civil society. The SONA highlighted that as a country we have not yet achieved this. Nevertheless, the intention remains to conclude a social compact to enact joint action in a number of areas that are central to growing the economy.

Energy insecurity is crippling growth

While the SA Reserve Bank (SARB) had previously estimated that the impact of loadshedding would erase 0.6% from the projected growth rate this year, more intense loadshedding has led the SARB to detract 2% from its assumed growth rate for 2023 based on loadshedding alone.

Government highlights that electricity supply constraints, which have left Eskom's energy availability factor (EAF) at 53% in recent weeks, remain one of the greatest impediments to growth and investment in SA. The level of unplanned maintenance has ratcheted higher, exacerbating the low level of supply relative to demand (see chart 1).

Chart 1: Poor plant performance driving EAF lower



Source: Eskom, Momentum Investments

The president noted that the unreliable supply of electricity due to insufficient maintenance and corruption is impeding our post-pandemic recovery. He further highlighted the importance of energy supply on government's agenda. The president reiterated government's plan which includes:

- Fixing Eskom's coal-fired power stations and improving availability of existing supply.
- Accelerating investment in generation capacity.
- Procuring new capacity from renewables, gas and storage.
- Unleashing investment from business and households for rooftop solar.
- Achieving long-term energy sustainability.

While the president did not announce any timelines related to finalising a solution to Eskom's debt problem, he did reveal a few new market-positive interventions, including:

- Additional funding for diesel for the rest of the financial year to reduce the severity of loadshedding.
- A tax incentive on solar panels for businesses and households. The president reported that Treasury is currently working on the details and further announcements will be made in the national budget.
- A state of disaster was declared to exempt critical infrastructure (hospitals and waste treatment plants) from loadshedding. To address concerns over opportunities for further corruption, the president noted that the Auditor General would monitor expenditure of funds under the state of disaster. Moreover, rigorous environmental protections will be adhered to and strict procurement principals and technical standards will be adopted.
- A Minister of Electricity in the Presidency will oversee the country's electricity crisis response. This is a bold move by the president and it alleviates concerns that efforts to correct the energy crisis would be stymied by an influence of the Mineral Resources and Energy ministry.
- Eskom will remain under the Department of Public Enterprises, which will steer the Eskom restructuring, oversee the just energy transition programme and the establishment of the state-owned enterprise holding company.

Fixing units at Medupi and Kusile (4 500MW), undertaking critical maintenance, filling vacancies at power stations and at executive management level with skilled individuals, deploying skills to underperforming power stations, addressing sabotage, theft and corruption at power stations and streamlining procurement measures are among the key focus areas that the president raised in the SONA to ensure sufficient electricity supply in the near to medium term.

Government remains committed to the Integrated Resource Plan 2019, which includes 18 000MW of new generation capacity and details the direction of energy policy in SA, as well as the Just Energy Transition Investment Plan, which is expected to mobilise funds to upgrade Eskom's transition network, which is vital for the entry of new generation capacity.

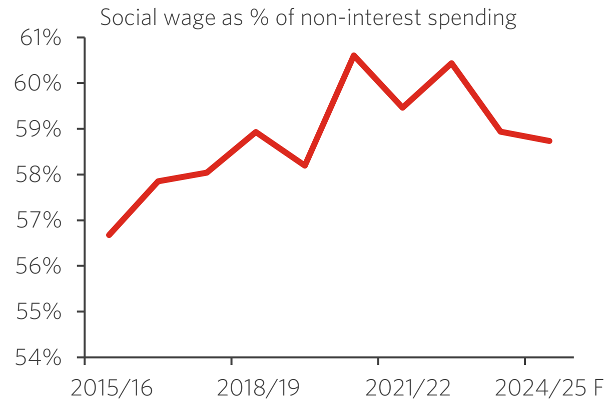
What this means: The SONA announced a number of new interventions to alleviate the short-term crunch in energy supply. A new position in the Presidency focusing on the country's electricity crisis response could fast-track the implementation of government's Energy Action Plan, through more decisive action. Meanwhile, increased funding for diesel and the procurement of emergency power can lessen the intensity of loadshedding and the negative effects on growth in the near term. Nevertheless, we suspect that a delay in bringing units of Kusile back online could still result in an energy supply gap in the coming months.

Difficult to pull the rug out from the most vulnerable in society

With real growth in SA barely averaging more than a 1% in the past decade, employment opportunities have fallen short. The rate of unemployment has averaged 28% in the past decade and 30.3% in the last five years. On the expanded definition (which includes discouraged work seekers), the total number of unemployed persons has risen to 11.2 million.

High jobless rates have raised demands on the fiscus. With government already spending a substantial amount on free housing, utilities, education and health, in addition to social grants, SA's social wage has neared 60% of non-interest spending and around 52% of consolidated government expenditure, substantiating the highly distributive nature of the budget (see chart 2).

Chart 2: SA's budget is highly distributive



Source: Treasury, Momentum Investments

In its 2018 paper, *Overcoming Poverty and Inequality in SA*, the World Bank noted that SA was placed within the top 15 percent of countries for the amount of resources spent on social assistance as a share of gross domestic product (GDP) (based on data from 2015). The paper also found that 'in comparison with other upper middle-income countries, SA devotes a relatively large amount of resources to public works programmes' (9.7 times the upper-middle-income country median), cash transfers (3.4 times), and social pensions (3.1 times).

Changes to the cost of living require Statistics SA (Stats SA) to regularly adjust its national poverty lines. The inflation-adjusted national food (or extreme) poverty line was recorded at R663 per person, per month in 2022. This is the amount of money an individual needs to afford the minimum required daily energy intake. In 2021, the Pietermaritzburg Economic Justice and Dignity group (PMBEJD) estimated that 13.8 million people in SA lived below the food poverty line.

The lower-bound food poverty line (which includes expenditure on essential non-food items and food spending that is below the food poverty line) was calculated at R945 and the upper-bound poverty line registered at R1 417 (includes expenditure on essential non-food items and food spending that is above the food poverty line). In 2021, the PMBEJD postulated that 30.4 million South Africans lived below the old upper-bound poverty line.

In the medium-term budget in October 2022, Finance Minister Enoch Godongwana announced an extension of the SRD grant for an additional year up to the end of March 2024. The SRD grant was initially introduced in May 2020 as a temporary measure to support the most vulnerable.

While the president announced an extension of the grant, timelines were not clear. However, his closing remarks noted that an expanded social protection system will reduce poverty. The speech intimated that Treasury was also considering urgent measures to mitigate the effect of loadshedding on food prices, but no further detail was outlined.

Notably, the number of people that has been approved for the grant have declined considerably. Stringent bank verification requirements and exclusionary provisions led to a decrease in the number of applications from 15.9 million (10.9 million approved) in March to 12.2 million in August (7.4 million approved). The president noted that the SRD is currently reaching 7.8 million individuals. The initial decline in approvals was due to a cut in the means test threshold to R350, which excluded several beneficiaries. This threshold has since been raised to R624 after civil rights action.

The ANC 2022 policy conference concluded that to effect economic empowerment, the grant should be indexed to the lower-bound poverty line and the financing strategy should include a wealth tax, closing tax loopholes, addressing base profit shifting by corporates and a transactions tax. At the ANC's elective conference in December, the ruling party confirmed its stance that it wanted the social grant to continue in the form of a basic income grant after the SRD lapses in March 2024. In 2018, the World Bank found that between 2006 and 2015, labour income remained the most important source in reducing the level and depth of poverty. Labour income accounted for 60.2% of the decline in the poverty headcount, while income from grants and pensions contributed toward 24% of the improvement. But for rural areas, the World Bank found that income from grants was the largest contributor.

What this means: The SRD grant is likely irreversible, but there remains contention over the amount it should be adjusted to once the grant expires at the end of March 2024. The Institute for Economic Justice calculated that a universal basic income grant would amount to between R275 billion and R355 billion per annum (government's social grant allocation for fiscal year 2022/23 amounts to R250 billion). In addition, the financing of the social grant remains a challenge in the context of Treasury's commitment to fiscal consolidation over the medium term, which would imply a more permanent tax adjustment or a decrease in other forms of social expenditure to protect government's purse. In our view, rating agencies are unlikely to react negatively to making the social grant permanent, given its ability to offer significant redistributive opportunities, as long as it can be introduced in a manner that is fiscally and economically sustainable. The World Bank proved that the system in SA is particularly successful in reaching the poorest individuals, given that social assistance programmes in SA reduced the poverty gap by 31.9% relative to 26.7% for the typical upper-middle income country.

Jumpstarting SA's growth engine

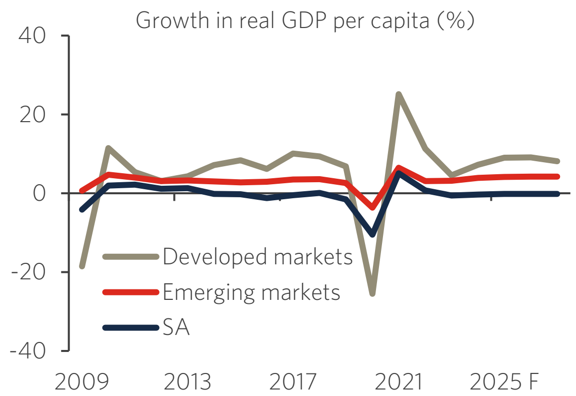
Despite the level of economic activity shifting back to pre-pandemic levels, as noted by the president in the SONA, growth in SA is steadily falling behind its peers to the extent that growth on a per capita basis has moved largely sideways since the global financial crisis.

While growth in GDP on a per capita basis averaged 4.6% for developed markets during this period and 2.9% for emerging markets, growth in GDP per capita has declined by 0.4% on average for SA (see chart 3).

The ruling party noted in its January 8th statement that for SA to address its highly unequal distribution of wealth and income, preferential procurement and competition policy should be used more extensively to address high levels of industry concentration. The ruling party also acknowledged small and medium enterprises and informal businesses are key to fostering inclusive growth. Government can create a more enabling environment by:

- Providing good road infrastructure.
- Enhancing digital connectivity.
- Creating trading spaces/industrial parks.
- Lowering regulatory constraints.
- Creating access to finance.

Chart 3: Stagnant standard of living in SA



Source: Treasury, Momentum Investments

The president noted a number of initiatives aimed at accelerating growth:

- Transport and logistics:
    - Creating a separate infrastructure manager for the Transnet rail network by October 2023 which is aimed at creating efficiencies and reducing costs
    - Concluding partnerships between the private sector and Transnet to allow for new investment in our ports
- Ensuring water security:
    - Lesotho Highlands Phase Two project will commence this year after a long delay
    - Department of Water and Sanitation investing in major infrastructure projects
    - Dam construction
    - Backlog of water use licences cleared
    - Turnaround time for water use licence applications reduced to 90 days
- Infrastructure:
    - R600 million set aside for project preparation in rural areas
    - R232 billion worth of projects under construction and R4 billion completed
    - SA National Roads Agency (SANRAL) has awarded R18 billion in contracts for road construction
    - R367 billion in investment commitments was raised at the fourth Investment Conference
    - Fifth Investment Conference will be held on 13 April
- Telecommunications:
    - Analogue transmission will be switched off this year after the remaining households are migrated to digital signal
- Job creation and support for small businesses:
    - Extended employment tax incentive
    - R1.4 billion in financing to more than 9 000 entrepreneurs through the Small Enterprise Finance Agency
    - Plans to establish a R10 billion fund (R7.5 billion to be funded by the private sector) to support small business growth
    - Licensing of PostBank to provide financial services to small businesses (foundation for a state bank to be formed)
- Reducing red tape:
    - Mining rights
    - Tourism transport operator licences
    - Visa and work permits
    - Informal sector
- Tourism and skilled immigration
    - Plans to introduce a remote worker visa
    - Plans to establish a points-based system to attract skilled immigration
    - Streamlining visa application requirements (trusted employer schemes)
- Consolidation of government departments
    - Could result in an estimated R27 billion in savings
- Creating value for poor households and land reform
    - Addressing the one million backlog in title deeds for subsidised housing
    - Department of Public Works and Infrastructure has finalised the transfer of 14 000 hectares of state land for housing

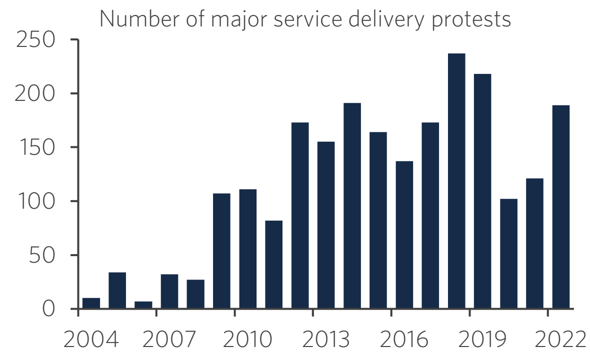
- Higher education:
    - Comprehensive student funding model is to be finalised this year to address the 'missing middle' who do not qualify for other forms of government funding

What this means: If effectively implemented, many of these announced reforms would create more employment opportunities (through labour-intensive roles), refurbish SA's infrastructure and enhance service delivery. The pace of implementation however has disappointed the investor community, particularly against a background of pedestrian growth and a slow recovery in jobs. A lack of further detail around the potential nationalisation of the SA Reserve Bank and the creation of a state-owned bank keeps political uncertainty high, which has dampened foreign and local investor confidence and inhibited growth in fixed investment.

Service delivery malaise

The number of major service delivery protests reported by Municipal IQ picked up to 189 for 2022, up from 121 the year before, when activity was suppressed by COVID-19 lockdowns (see chart 4). Given that we are heading into a general election in 2024, the number of service delivery protests could increase this year.

Chart 4: Major service delivery protests rise after a temporary COVID-19-related dip



Source: Standard Bank Group Securities, Municipal IQ

In June 2022, the auditor general awarded a clean audit to only 16% of SA's 257 municipalities for financial year 2020/21, with Limpopo, Mpumalanga, Northern Cape, Free State and Eastern Cape ranking among the worst provinces. Only 61 municipalities have a better audit outcome than in 2016/17, with 56 municipalities having a worse outcome.

The auditor general notes that in its assessment of the municipalities, the senior management of only 11% of the municipalities was fully effective given instability in political and administrative leadership. Moreover, it assessed that only half of internal audit units were having an impact on financial and performance management and compliance with legislation, given that managers were not implementing their recommendations at the other half.

A sizeable R238 million was spent by municipalities on financial reporting consultants for 2020/21, but the quality of financial statements remained poor given weak internal controls.

Government has responded to the weak state of its municipalities by implementing a District Development Model (DDM), which Cabinet adopted in 2019. Government found that operating in silos led to incoherent planning and implementation. Under the DDM, government aims to reduce duplication and fragmentation through a 'One District, One Plan and One Budget' system within the three spheres of government. This should also strengthen budgeting and implementation of more impactful service delivery.

Government envisions four phases for the implementation of the DDM. The establishment phase occurred between August 2019 and March 2020, during which the concept was developed and the organisational structures were formed. The piloting phase occurred between August 2019 and March 2021 in three municipalities (OR Tambo District in the Eastern Cape focusing on 15 projects valued at R14 billion, the eThekwini Metropolitan based on 14 projects valued at R50.8 billion in KwaZulu-Natal and the Waterberg district in Limpopo involving 15 projects valued at R132 billion). These areas account for 10% of GDP and house six million people. The institutionalisation phase started in April 2021 and is expected to end in March 2025, while the (institutional and financial) sustainability phase is expected to follow from April 2025 onwards.

Moreover, in dealing with the quality of public service, the SONA indicated that integrity assessments would be introduced to increase professionalism in public service and the Public Service Commission will guarantee that only qualified people are appointed to senior positions.

What this means: In our view, while better coordination between national, provincial and local government can make a meaningful difference to better management and implementation, it is unlikely to be a silver bullet to resolving poor service delivery. Treasury's previously announced early warning system to detect financial crises at municipalities and municipal borrowing laws (to expand the scope of borrowing and to attract more investors to municipal debt markets) are positive strides but the problem of unpaid bills and accruals in provincial and local government remains a significant risk. With more pressure on government to fund rising social demands, the risk of a further deterioration in the delivery of services to the public remains high, leading to the potential for sporadic episodes of social unrest.

Rampant criminality undermines the foundations of our constitutional democracy

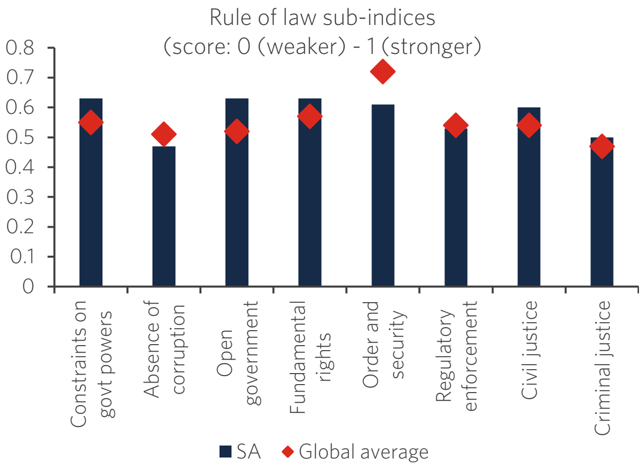
The World Justice Project Rule of Law Index measures the practice of the rule of law, based on the experiences and perceptions of the general public and in-country legal practitioners and experts in 139 jurisdictions. On this measure, SA has shown no progress since 2015, remaining at 0.58 (or 54th out of 140 countries).

The index measures eight scores (see chart 5):

- Constraints on government powers (government powers are limited by the legislature and judiciary and officials are sanctioned for misconduct) – an improvement from 0.61 to 0.63, and above the global average of 0.55).
- Absence of corruption (bribery and misappropriation of public funds) – a decline from 0.51 to 0.47 and below the global average of 0.51.
- Open government (citizen participation in public policy, quality of information provided by government in a transparent manner) – an improvement from 0.62 to 0.63 and above the global average of 0.52.
- Fundamental rights (human rights) – stable at 0.63, and above the global average of 0.57.
- Order and security (security of persons and property) – a drop from 0.62 to 0.61 and well below the global average of 0.72.
- Regulatory enforcement (effective implementation and enforcement of regulations within and outside of government) – a dip from 0.55 to 0.53, but only slightly below the global average of 0.54.
- Civil justice (accessible and affordable civil justice systems, which are free from discrimination and corruption) – a jump from 0.56 to 0.6 and above the global average of 0.54.
- Criminal justice (actions against individuals for offences against society) – stable at 0.5 (but down from 0.53 two years ago) and above the global average of 0.47.

From these indices, the most notable deviation from the global standard resides with order and security. Within this measure, the World Justice Project looks at effective limiting of civil conflict, violence to redress personal grievances and effective control of crime. SA ranks better than the global average for the effective limiting of civil conflict but falls short on the other two measures.

Chart 5: SA scores relatively poorly on order and security



Source: World Justice Project, Momentum Investments

The president highlighted the continued fight against corruption, the intention to rebuild institutions that were subverted by state capture and the need to hold those responsible to account. Even though the country is yet to see a ramp up in convictions of more high-profile individuals guilty of criminal activities, we believe that there has been a notable change in the prosecution rate of individuals and companies involved in state capture. The speech reported that 187 accused persons in state capture and corruption cases have been taken to court by the National Prosecuting Authority Investigating Directorate.

Moreover, the Asset Forfeiture unit has similarly made progress in the fight against corruption. The speech highlighted R7 billion that has been returned to the state from state capture assets and noted R12.9 billion in assets that have been frozen.

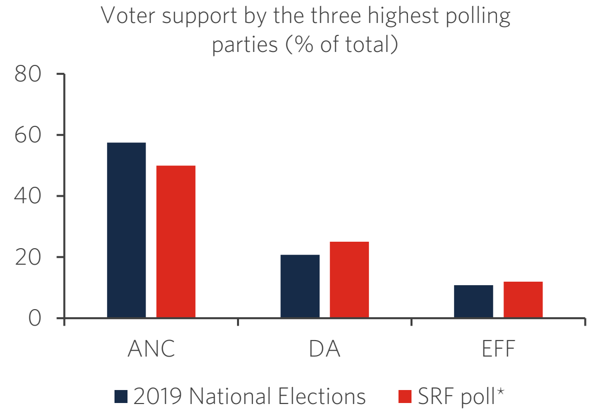
What this means: Given that Ramaphosa has positioned himself as an anti-corruption leader, it is concerning that South Africans perceive corruption as increasing under his presidency, more so after the release of the findings of the Independent Panel looking into the Phala Phala matter. Allegations and incidences of state capture, corruption and the mismanagement of public funds have tarnished the attractiveness of SA as an investment destination. Plans to recapacitate institutions to deal with cases of criminality, are welcome steps to improve confidence in SA's rule of law, but a timeline is critical in boosting confidence in government's willingness to root out corruption. Public trust in state institutions is unlikely to change unless the fight against corruption gathers momentum, those who are guilty of wrong-doing are apprehended and there are tangible indications of an improvement in the performance of crime-combatting agencies.

Falling support for a wounded ANC

Given continued electricity woes, elevated criminal activity, a backdrop of slowing global growth and noise around the Phala Phala issue, levels of support are expected to drop for the ANC in the upcoming 2024 national elections. Nevertheless, the Institute for Security Studies notes that the ANC's fortunes are inextricably tied to Ramaphosa, who remains SA's most popular political leader. As such, the ANC likely has more to lose if Ramaphosa does not stand as the ANC's candidate in 2024.

There is an increasing likelihood of a coalition government having to form at a national level. According to research by the Social Research Foundation (SRF), ANC support has likely fallen to below 50% at a national level. This estimate is based on a survey of 3 204 registered voters in July 2022 and uses the assumption of a voter turnout of 66% (similar to the 2019 election when the ANC won 57.5% of the vote, see chart 6). The SRF projects a win of 25% of the vote for the official opposition, the Democratic Alliance (DA), while it anticipates that the Economic Freedom Fighters (EFF) would amass between 11% and 12% of the vote.

Chart 6: ANC primed to lose a significant margin of electoral support



Source: SRF, Independent Electoral Commission, Standard Bank Group Securities, Momentum Investments
**Assuming a voter turnout rate of 66%*

The SRF highlights a structural problem facing the ANC. ANC voters are ageing and rural-based in an urbanising economy. The SRF suggests that if only urban voters went to the polls, the ANC would win 33% of the vote, in contrast to two-thirds of the vote if only rural voters headed to the polls. Under the assumption of a 56% voter turnout rate, the ANC could secure a majority win of 52%, but the SRF deems this to be an absolute maximum.

In its January 8th statement, the ANC acknowledged that rejuvenation of the party relies on reinstating the legitimacy of our democratic institutions and the effective use of our policy instruments to drive inclusive growth. The ANC also acknowledges the need to monitor and evaluate the implementation of its programmes and instil a culture of accountability.

The president acknowledged the failure to build a comprehensive social compact even though the desire to do so across the various stakeholder groups remains. This is deemed vital in achieving common goals through joint action and joint resources.

What this means: The increased degree of lawlessness and slow rate of implementation of structural reforms in certain areas of the economy has broadened the gap in trust between government and other stakeholders. A more comprehensive social compact with all economic players is required to ensure that the requisite trade-offs and concessions are considered to further an effective social and economic recovery in SA.