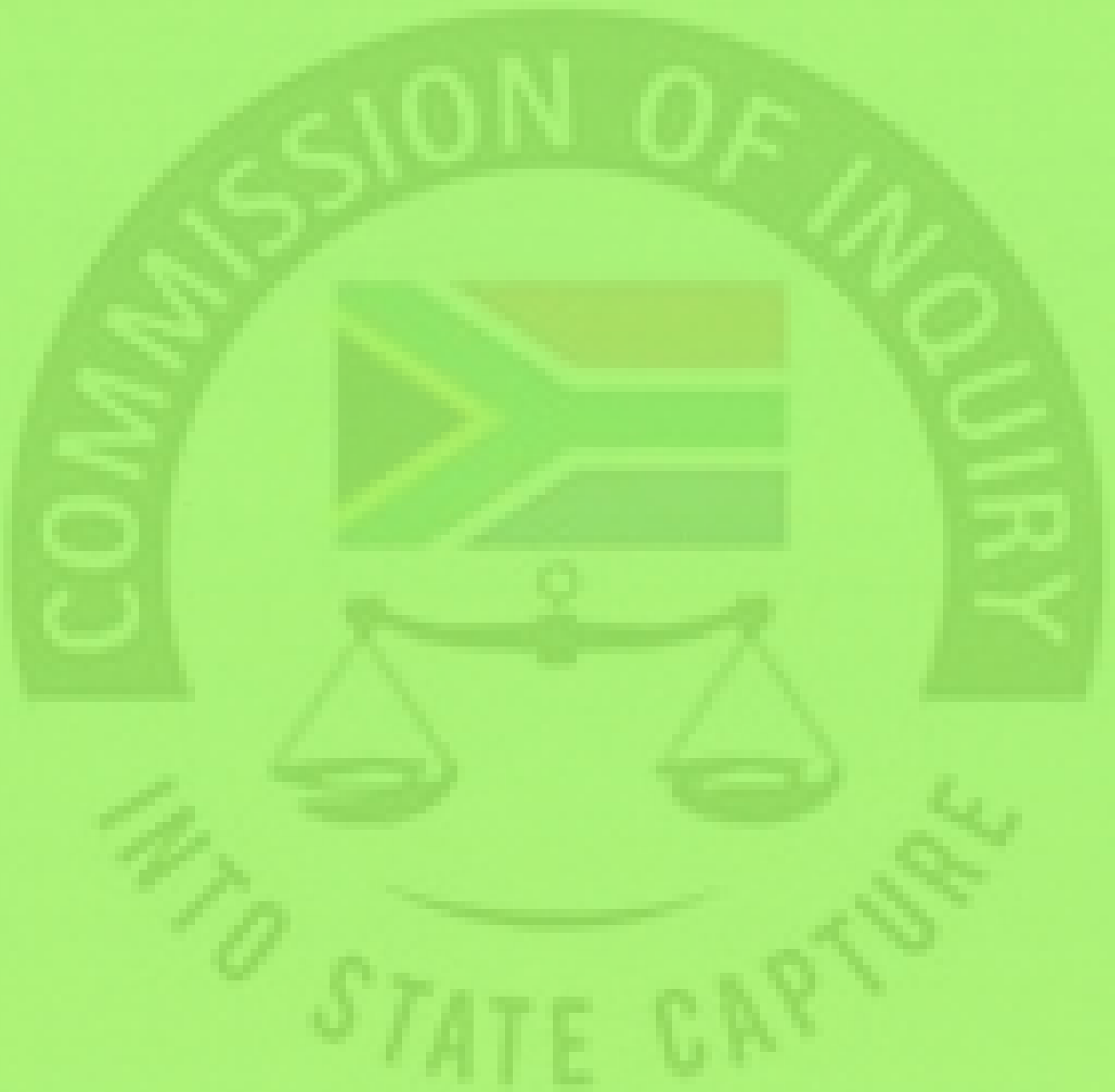


ANNEXURE "MSM 8"



Transnet SOC Ltd
Registration
Number
1990/00090/30

Carlton Centre
150 Commissioner
Str. Johannesburg
2001

P.O. Box 72501
Parkview
South Africa, 2122
T +27 11 308 2326
F +27 11 308 2312

TRANSNET



MEMORANDUM

www.transnet.net

To: Transnet Board of Directors (BOD)

From: Brian Molefe, Group Chief Executive

SUBJECT: INCREASE IN ESTIMATED TOTAL COST (ETC) OF THE ACQUISITION OF 1064 LOCOMOTIVES FOR TRANSNET FREIGHT RAIL'S GENERAL FREIGHT BUSINESS (GFB)

PURPOSE:

1. The purpose of this memo is:
 - a) for the BOD to note the reasons for the increase in ETC.
 - b) to request that the BOD approve an increase in the estimated total cost (ETC) for the acquisition of 1064 Locomotives for the General Freight Business of Transnet Freight Rail from R 38.6 billion to R 54.5 billion.

EXECUTIVE SUMMARY:

2. In summary the increase in ETC of R 15.9 billion can be attributed to the following:

Update of business case for updated economic factors	R 5.4 bn	34 %
Risk Mitigation - Forex and Escalation	R 9.5 bn	59 %
TE Scope	R 2.6 bn	16 %
Contingencies	R 4.9 bn	31 %
Lower capital acquisition cost of the locomotive obtained through the competitive tender and negotiation process less the batch pricing adjustment of R 2.7 billion.	R ~ 6.5 bn	- 41 %

3. 93 % of the ETC increase relates to changes in market conditions and the risk tolerance level of the company. Whilst 16 % of the ETC increase relates to strategic factors such as localisation and competition. These increases have been offset by a competitive tender and negotiation process that realised a benefit of 41 %.
4. On a like for like comparison the new price including TE scope of R 40.09 billion (excluding hedging and escalation) is only 3.89 % higher than the approved ETC of R 38.6 billion. The balance of the ETC increase relates to risk mitigation and strategic

concessions such as batch pricing.

5. Regiments Capital (using an international expert) benchmarked the Capital Acquisition Cost of the locomotives at the "best and final offer" stage of this transaction and the results indicate that the price being offered by the bidders is reasonable. Given that forex, escalation, economic factors and batch pricing impact is subject to market conditions it can be deduced that the final contract price is also reasonable.
6. The need to incur these costs has been justified and the associated costs are reasonable in the circumstances.
7. The NPV of the business case remains positive at R 11.68 billion.
8. Impacts on the 2014/15 corporate plan has been assessed and mitigated. Consequently the R 54.5 billion is affordable and reasonable.
9. Risk mitigation measures have been developed and are being implemented to ensure benefits are realised.
10. Significant socio economic benefits such as localisation and job creation will be realised.
11. Significant benefit will be achieved by the company including additional volumes earlier, additional cash flows, a stronger balance sheet, which should enable greater capital expansion in future.
12. This acquisition in conjunction with other locomotive acquisitions will significantly contribute towards the company achieving its original MDS targets of 350 mt by 2018/19 and consequently is fully aligned with the MDS of the company.
13. The strategic, commercial and socio economic benefits associated with this acquisition will significantly outweigh the capital cost.

BACKGROUND:

14. The acquisition of 1064 Locomotives was approved by the Board of Directors in April 2013 at a cost of R 38.6 billion. This excluded the following costs:
 - a. The cost of changes in economic conditions (forex and inflation) between approval of the business case and award of the contracts
 - b. The cost of hedging for foreign exchange movements;
 - c. The cost for future inflationary escalations;
 - d. The cost of additional scope for Transnet Engineering (TE);
15. The rationale for the investment is to increase the capacity of TFR's GFB from 80mt to 180mt in terms of the Market demand Strategy (MDS).
16. The acquisition of 1064 Locomotives for GFB was approved by the Shareholder Minister (Department of Public Enterprises) on 3 August 2013.
17. Although the approval from the Minister was not subject to a final cost of R 38.6 billion, for good governance and for information purposes a letter will be sent to the DPE

Increase in ETC for 1064 GFB Locomotives

advising of the final ETC.

- 18. Four contracts to acquire 1064 locomotives were concluded on 17 March 2014 at a cost of R 49.5 billion including the cost of future escalations, including additional scope for TE and including foreign exchange hedging costs thus resulting in an increase in ETC of approximately R 15.9 billion (including a 10 % contingency).
- 19. As per the DTI codes for local content, the tender process required that bidders exceed a minimum Supplier Development (SD) threshold of 40 %. All bidders exceeded this threshold. All the bidders met the minimum thresholds for local content of 55 % for diesel locomotives and 60% for electric locomotives.
- 20. The locomotives will be delivered at a rate of 12 locomotives per month per bidder at peak production as per the summarised delivery schedule below (refer Table 1). In order to mitigate against late delivery risk, a penalty regime capped at 10 % of the contract price has been agreed to with all bidders.

Table 1

Delivery Schedule - Diesel Locomotives		
	BT (55%)	CSA (60%)
	CNR 1st 20 from China	GE 1st 6 from USA
by March 2015	0	0
by March 2016	0	34
by March 2017	20	126
by Oct 2017	87	73
by February 2018	84	
	42	
Locomotives will be manufactured at a peak tempo of 12 per month.		
Delivery Schedule - Electric locomotives		
	BT (40%)	CSA (60%)
	BT produce all loco's locally	CSR 1st 40 from China
by March 2016	6	88
by March 2017	137	142
by December 2017	97	
by January 2018		129
Locomotives will be manufactured at a peak tempo of 12 per month.		

Increase in ETC for 1064 GFB Locomotives

DISCUSSION

21. In order to analyse the increase in ETC two factors need to be considered:
- i. Updated economic data from business case date to current (backward looking);
 - ii. Future financial risks emanating from the transaction and costs associated to mitigate these risks (forward looking).
22. This document has been prepared to explain the increase in ETC on this basis, concentrating on why these costs needed to be incurred and were these costs reasonable in the circumstances.
23. The increase in ETC of R 15.9 billion is due to the following reasons (refer Table 2 below):
- a) Escalations from the approved business case to award date (backward looking) (Item A of Table 2)
 - b) Forex from the approved business case to award date (backward looking) (Item C of Table 2)
 - c) Additional scope of work allocated to Transnet Engineering (TE) for the strategy to enable TE to eventually transform to an Original Equipment Manufacturer (OEM) of locomotives (strategic) (Item B of Table 2).
 - d) The cost of reducing the batch size (strategic and risk mitigation) (Item D of Table 2)
 - e) The cost of future escalations over the life of the contract (forward looking and risk mitigation) (Item E of Table 2)
 - f) The cost of fixing forex exposure over the life of the contract (forward looking and risk mitigation) (Item F of Table 2)
 - g) Contingencies related to variation orders, options (such as electronically controlled pneumatic braking and wire distributed power etc.) and capital spares (Item G of Table 2)

Increase in ETC for 1064 GF8 Locomotives

