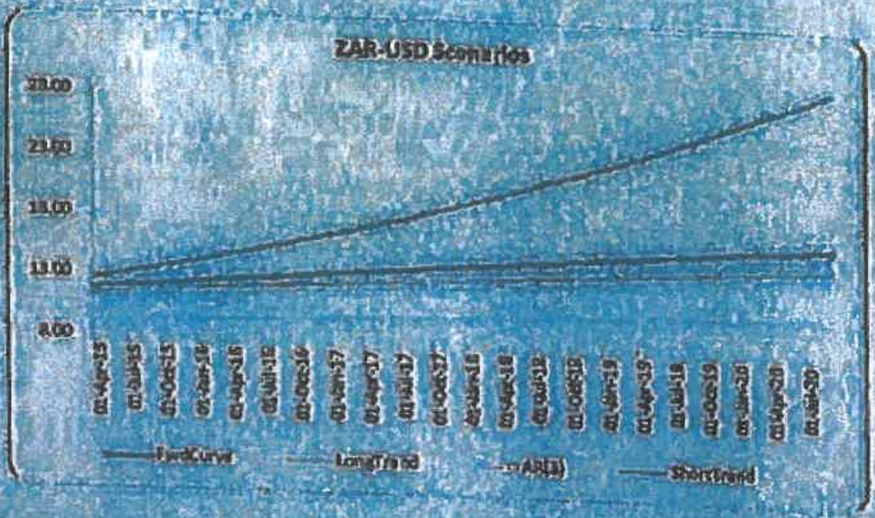
ANNEXURE "MSM 10"

Table 6



38. In addition Regiments Capital conducted various currency trend scenarios as indicated in Table 5 above. All scenarios indicate a general devaluation in ZAR over the medium term.

39. The imminent risk of the Ukraine crisis and its impact on emerging markets also had an impact on the decision to fix the exchange-rate exposure.

40. In addition the delivery schedule of the locomotives, between 31 and 35 months, also impacts the cost of hedging as the length of the exposure impacts the costs. The longer the period the higher the premium paid due to unknown outcomes in the future.

41. Alternative methods, such as call and put option structures, to reduce cost and mitigate against forex exposure risk were explored in conjunction with Regiments Capital including methods in which Transnet would participate in any possible upside in Rand movements. These methods were evaluated from a cost benefit perspective and consequently the FEC route proved most beneficial and practical to mitigate forex risk.

42. In addition the accounting treatment of options was not optimal as per opinion obtained from KPMG as it would result in the creation of an embedded derivative.

43. The cost to hedge this exposure was obtained from banks by the suppliers. This was then vetted by Transnet Treasury and Regiments Capital for reasonability. They both found the rates and cost to be acceptable.

44. Consequently the net 6.6 % per F in Table 2 above is reasonable.

Escalation of Input Costs (Item E of Table 2)

45. Given the size, magnitude and risk tolerance of the company due to MDS execution, cash flow certainty is of paramount importance when trying to plan over a long term horizon.

46. This ensures that the company is able to manage its key financial metrics such as gearing, cash interest cover and the A/B ratio (required by rating agencies).

47. In addition credit rating agencies and bond holders both prefer conservative risk appetites and consequently would also support fixing our escalation exposure.

48. Careful consideration had to be given to accepting other risks such as labour, steel etc. and being exposed to market conditions.

49. Consequently it was decided to fix escalation for these input costs and gain certainty of cash flows.

50. Costs associated with fixing these input costs are largely driven by market sentiment at the time of contracting such as the items mentioned below.

51. Labour unrest and strikes in the platinum sector has put significant pressure on forward looking labour costs. As indicated earlier Transnet is subject to an 8.5 % wage adjustment for the 2014/15 financial year.

52. The contractor has also built a risk premium into their pricing for forward looking inflation, to cater for the unpredictable nature of the labour environment within South Africa and the risk associated with TE carrying out this additional *new* scope of work.

53. Statistics SA reports that the headline CPI annual inflation rate in April 2014 was 6.1 %, and which is further explained in the Business Day article "CPI Breaches Reserve bank target" dated 22 May 2014.

54. The SARB and National Treasury 2014 Budget Review forecasts CPI at 6.2 %, 5.9 % and 5.5 % for the years 2014, 2015 and 2016 respectively.

55. The MPC also is concerned about upward inflationary pressure on the economy as they have increased the Repo rate by 50 basis points recently in response to managing the upward inflationary pressures. Another imminent increase is highly likely at the next sitting of the MPC on 22 May 2014.

56. The high level of local content (60%) makes local indices more applicable to assess the cost of escalations going forward.

57. Applying the relevant proportion of each of the labour, material and other input costs which make up the basket of items required for the manufacture of the locomotives, would result in the net increase in the locomotive price of 9.2 % for electrics and 6.3 % for diesels increase.

58. Hence a CPI of 6 % escalated for 35 months on a compound basis (excluding a premium for risk) results in a 18.54 % increase, thus the net 16.8 % per E in Table 2 above is reasonable.

59. Escalations of input costs have been verified by Transnet by using publicly available data and by Regiments Capital using their intellectual property methodology and techniques.

TE Scope (Item B of Table 2)

60. A strategic decision was taken at a Transnet level that TE should transform to eventually become an OEM of locomotives. This 1064 tender process, together with the 100 equivalent 19E Dual Voltage Electric locomotive process, was used as a catalyst to facilitate this strategy.

61. As such bidders were advised to provide pricing based on providing TE with additional scope for the manufacture of the locomotives.

62. Strategically it was decided that for specific items within the build process where TE were within 10 % of the market price then it would be acceptable to allow TE to retain this scope.

63. The pricing as reflected above in Table 2 is inclusive of this additional scope for TE based on this principle.

64. Bidders have also built a risk premium into their pricing, to cater for the risk associated with Transnet Engineering carrying out this additional *new* scope of work for the 1st time.

65. Consequently the net additional 3 % per B in Table 2 is justified and is reasonable.

Batch Size (Item D of Table 2)

66. As approved by the Transnet Board the preferred bidders were advised that the batch size has been split on a 50/50 basis for the Diesels and a 60/40 basis for the electrics, amongst them.

67. This was done to mitigate locomotive delivery risk and reduce the MDS risk related to volumes.

68. As a result, the fixed costs related to setting up the production line would have to be recouped over a smaller batch.

69. This resulted in an increase in the cost per locomotive.

70. Although the cost per locomotive has increased, an overall saving is realised due to splitting the batch, because of the saving made on future escalations and hedging costs as a result of a shorter delivery period. This has been quantified to be R 4.08 billion.

71. Consequently the net additional 9.4 % per D in Table 2 is justified and is reasonable.

Contingencies (Item G of Table 2)

72. The contracted price of R 49.5 billion excludes the cost of any requirements for capital spares beyond the warranty period, variation orders and options (such as electronically controlled pneumatic braking and wire distributed power etc.) and as such an additional 10 % (R 4,9 billion) has been added into the request for additional ETC for this (refer Item G of Table 2)

73. In order to stimulate development in other parts of South Africa, Transnet have decided that it would be more strategic to have two OEM's manufacture the locomotives in Durban.

74. In addition TE production lines in Koedoespoort cannot accommodate four OEM's as validated by the PWC study.

75. Bidders have based their contracted prices on manufacturing operations being carried out in Gauteng. Bidders have not yet quantified this cost, however this cost is included in the additional 10 % (refer Item G of Table 2).

FINANCIAL IMPLICATIONS:

76. The business need and rationale remains as originally indicated in the business case submission.

77. The Business case resulted in a positive NPV (R2.7 billion at the TFR hurdle rate of 18.56 % and R34.1 billion at the TFR WACC of 12.56 %).

78. The Transnet hurdle rate has since been amended to 15.2 % and the NPV at this hurdle rate using the business case assumptions would be R 16.02 billion.

79. The financial models for the Business case have been updated for the following based on the conditions per the signed final contracts:
    a. Final pricing
    b. Revised cash flow profile for the capital investments
    c. Commensurate changes to the volume ramp up and tariff increases on commodities that are priced relative to the investment outlay

80. The updated NPV result is a positive NPV of R 11.68 billion at the new hurdle rate of 15.2 % and R 22.71 billion at the TFR WACC of 12.6 %. The NPV would become a negative R 1.67 billion at the original hurdle rate of 18.56%.

81. The WACC and hurdle rates are updated annually for changes in economic conditions and are approved by Transnet Exco and reviewed by External audit during the year end audit process.

BUDGET IMPLICATIONS:

82. The investment is included in the 2014/15 seven year capital investment plan.

83. The contracted delivery schedule and cash flows have changed as compared to the investment included in the 2014/15 seven year capital investment plan.

84. In order to ensure that Transnet's approved key affordability limits (gearing and cash interest cover) are not breached, a capital prioritisation process will be undertaken, such that other investments which do not impact MDS volume targets would be deferred.

85. The difference between the 2014/15 seven year investment plan and the projected cash flows based on the supplier agreements with contractors with an additional 10 % added for options, variation orders, special tooling, test equipment, initial spares and capital spares, is illustrated in Table 7 below:

Table 7

	Rand million								
	ETC	13/14	14/15	15/16	16/17	17/18	18/19	19/20	20/21
Budget per Corporate Plan	41 468	-	315	4 188	8 344	9 123	9 420	8 382	1 696
Contracted	49 547								
Add 10 % for options, variations, tools, spares etc.	4 955								
Expected	54 502	4 824	6 308	6 597	18 618	16 970	1 185		
Difference	-13 034	-4 824	-5 990	-2 409	-10 274	-7 847	8 235	8 382	1 696
Corporate Plan alignment to Business Case	-2 868								
Net ETC difference	-15 902								

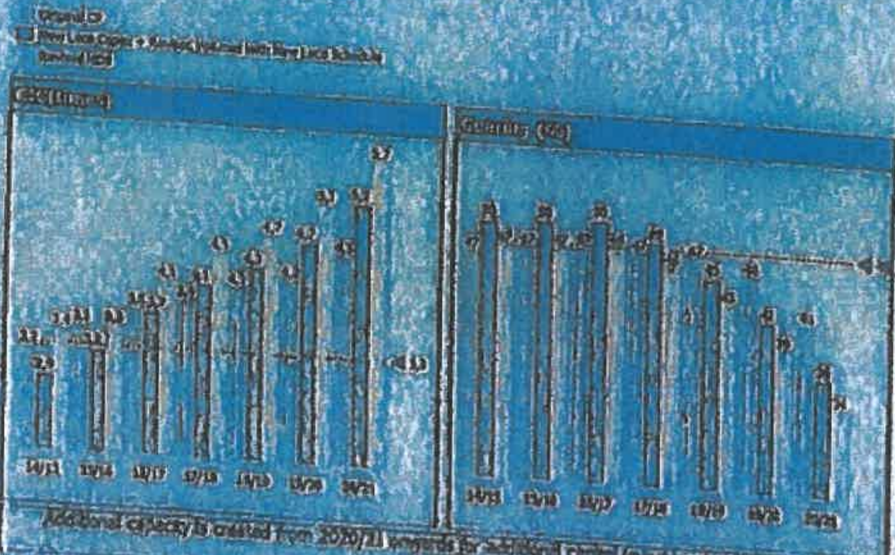
86. In order to secure accelerated delivery of the locomotives to address the MDS volumes at risk, a larger advance payment (R 4844 million) had to be made to the contractors in the 2013/14 financial year.

87. As confirmed by a letter received from the suppliers this was required by the suppliers in order to cover costs to ensure quicker delivery. The rationale as explained by the supplier was confirmed reasonable by Transnet's external auditors and was capitalised accordingly in the Financial Statement at 31 March 2014.

88. Although the accelerated delivery schedule would have resulted in earlier cash outflows for Transnet, an overall saving is realised because of the saving made on future escalations and hedging costs as a result of a shorter delivery period

89. The impact from the locomotive acquisition on the 2014/15 corporate plan as well as the impact of the prioritisation process; updating for the change in volumes, revenue, EBITDA and capital due to the combination of the 100 electric locomotives, 1064 locomotives and 60 Diesel locomotives contracts is reflected in the graph below:

Increase in ETC for 1064 GFB Locomotives



Additional capacity is created from 2020/21 onwards for additional capital investments to meet market demand.

90. As can be seen from the graphs the initial two years of the 2014/15 Corporate Plan has been negatively impacted the by locomotive acquisitions.

91. However after the planned EBITDA and optimisation initiatives that have been factored into the model the ratios are restored.

92. The initiatives identified to meet the Corporate Plan targets are detailed in Annexure A.

RISK MANAGEMENT:

93. In order to manage risks associated with this transaction a risk management framework is in the process of being developed.

94. A Locomotive Steering Committee has been set up to manage the operational issues associated with the locomotive acquisition and will address the following risks:

- Locomotive delivery
- The wagon build program
- Infrastructure requirements
- Operational readiness
- Commercial and Volumes

95. A socio economic monitor will be appointed to ensure socio economic benefits will be realised.

96. 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.

97. Escalation risk has been mitigated by fixing the price of the locomotives.

98. Forex risk has been mitigated by hedging the price of the locomotives by using the suppliers balance sheets.

99. All advance payments are secured by an on demand advance payment guarantee issued by a bank with a minimum long term credit rating of an A- Fitch rating or equivalent.

100. Payment terms have been structured such that the bulk of payments, of between 70 % and 90 %, happens after delivery of the locomotives.

101. In order to manage the total cost of ownership and mitigate against the risk that the locomotives once placed into operation will consume more fuel (diesel locomotives) or energy (electric locomotives) than indicated in bidders responses to the RFP, a penalty clause with a related fuel/energy warranty regime has been included in the supply agreement with bidders.

102. In order to mitigate against default of Supplier Development (SD) commitments, and SD penalty clause has been included in the supply agreements with bidders. An SD bond has also been obtained to cover risk against default.

103. GE have agreed to provide a 30 month warranty on the locomotive as well as a 6 year warranty on the traction motor and a 12 month warranty on spares.

104. CNR, BT and CSR have agreed to provide a 24 month warranty on the locomotive as well as a 6 year warranty on the traction motor and a 12 month warranty on spares.

105. A liability cap of 15 % of the contract price is included in the supply agreement thereby limiting Transnet's exposure in the unlikely event of breach of contract by Transnet.

106. In order to mitigate against the risk of having to accept and pay for locomotives during an economic downturn when volumes from customers may not be forthcoming thereby impacting negatively upon Transnet's loan covenants, bidders agreed to accept a clause in the supply agreement whereby acceptance of locomotives could be deferred for a period of time. Transnet agreed that in return bidders would be reimbursed for reasonable and auditable costs. These costs could include warehousing costs, time value of money costs, costs related to the rolling of hedges etc.

SOURCE OF INFORMATION AND REFERENCES:

107. Data quoted in the memo above has been sourced from:

- Statistics South Africa – release P0141
- Business Day 22 May 2014 – "CPI Breaches Reserve Bank target"
- Business Day 18 March 2014 – "Rocky Ride forecast for still too expensive Rand"
- Reserve Bank and National Treasury 2014 Budget Review
- Regiments Capital (transaction advisory services)
- KMPG (accounting opinions)
- PWC (locomotive localisation opportunities for TE and South African industry)

RECOMMENDATION:

108. It is recommended that:

a) the BOD take note that the main reasons for the increase in ETC is due to the <u>exclusion</u> of the following costs from the 24 January 2014 submission:

i. The cost of hedging for foreign exchange movements;
ii. The cost for future inflationary escalations;
iii. The cost of additional scope for Transnet Engineering (TE);
iv. The cost of changes in economic conditions (forex and inflation) between approval of the business case and award of the contract

b) the BOD approves an increase in estimated total cost (ETC) for the acquisition of the 1064 locomotives for Transnet Freight Rail's General Freight Business from R38,6 billion to R54,5 billion.

Recommended by:

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Date:

Recommended by:

Siyabonga Gama
TFR Chief Executive
Date: 2014.05.21

Recommended by:

Brian Molefe
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Date: 23.5.14