<u>EXHIBIT BB8(b)</u>

1064
REVIEW OF ESTIMATED TOTAL COST OF R38.6 BN EVALUATION OF R15.6 BN INCREASE IN ESTIMATED TOTAL COST

MNS-AC-01

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ATTORNEYS

1064
REVIEW OF ESTIMATED TOTAL COST OF R38.6 BN EVALUATION OF R15.6 BN INCREASE IN ESTIMATED TOTAL COST

28 May 2019

Legal Expertise In Your Corner

MANDATE

I. Assess the reasonability of the variables and assumptions used in modelling the 18 April 2013 Business Case

II. Assess the accuracy of the Estimated Total Cost (ETC) of R38.6 billion

III. a) Identify the reasons for the increase in ETC from R38.6 billion to R54.5 billion

b) Test the plausibility of the reasons put forward for the R15.9 billion increase in ETC

c) Opine on a reasonable increase in ETC.

I. REVIEW OF THE BUSINESS CASE

- <u>Mandate:</u> Assess the reasonability of the variables and assumptions.
- <u>Finding:</u> Assumptions in relation to the variables were found to be reasonable.

MEASURES APPLIED IN APPRAISINGTHE BUSINESS CASE

- Measures employed:
  - Net Present Value (NPV)
  - Estimated Total Cost (ETC)

- NPV equates to the difference between :
  - Present value of projected revenue
  - Present value of projected costs

- ETC = Sum of costs of the locomotives costs over the scheduled period

VARIABLES MAKING UP REVENUE AS PER THE BUSINESS CASE

- Incremental volume of goods (in net tons) from the 1064 locomotives.
- Average distance per year.
- Tariff per ton/kilometer

VARIABLES MAKING UP COSTS AS PER THE BUSINESS CASE

- Locomotives acquisition costs and related costs (i.e.: personnel, maintenance and insurance)
- Wagon costs
- Infrastructure costs
- Overheads
- Tax

NET PRESENT VALUE OF R2.7 BILLION AS PER BUSINESS CASE

- The Present Value computations based on a hurdle (risk discount) rate of **18.56%** are as per the table below:

	PV
Revenue	109,104
Diesel TCO	(22,080)
Electric TCO	(21,763)
Wagon costs	(12,463)
Infra costs	(18,491)
Overheads	(23,910)
Tax costs	(7,658)
Net Present Value	**2,739**

IMPACT OF HURDLE RATE ON NET PRESENT VALUE

Hurdle rate	18.6%	17.6%	16.6%	15.6%	14.6%	13.6%	12.6%
NPV (R’ bn)	2.7	5.9	9.7	14.2	19.6	26.2	34.1

- Internal Rate of Return (IRR) = R19.6%.

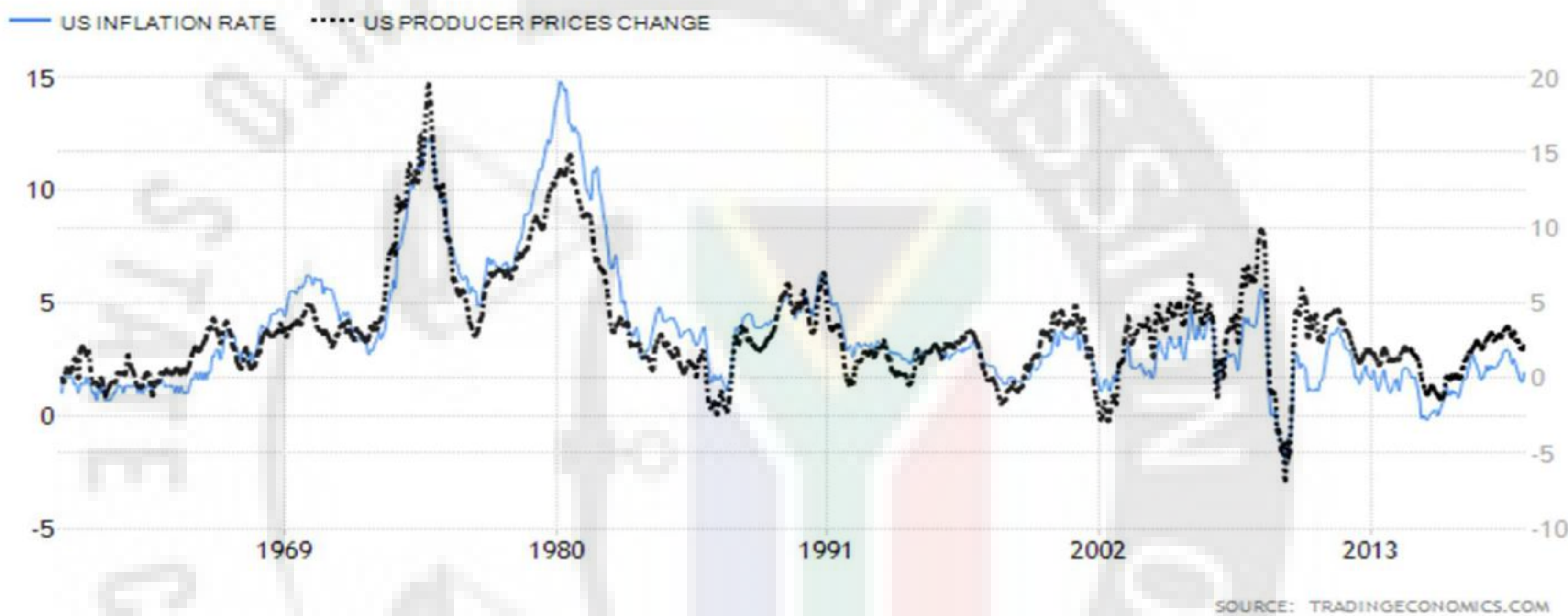
VARIABLES AND ASSUMPTIONS

- SA Inflation: - Use of PPI appropriate for manufacturing sector goods

- Foreign Currency: - Rates used are forward rates as at 18 April 2013 (allowing for costs)

- Hurdle rate: - As per Transnet's policy; 6% spread over the WACC; evidenced-based research; Reasonable.

US CPI vs US PPI



- US Inflation assumptions => Reasonable

IMPACT OF LOCAL CONTENT ASSUMPTIONS

- An increase in Local Content from 50% to 60% results in...

LOCAL CONTENT	50%	60%
ETC	R38.6 bn	R38.555 bn
NPV	R2.739 bn	R2.75 bn

- Local content assumptions => Reasonable

II. ETC OF R38.6 BILLION

- Mandate:
  - Assess whether R38.6 billion was a reasonable cost for the 1064 locomotives
  - Assess whether the ETC of R38.6 billion included foreign currency hedging and escalation costs

- Finding:
  - R38.6 billion was found to be a reliable estimate of the total cost of the 1064 locomotives.
  - The ETC of R38.6 billion included foreign currency hedging and escalation costs.

ORIGINAL DELIVERY SCHEDULE

	2014	2015	2016	2017	2018	2019	Total
Diesel	100	100	100	100	65		465
Electric		65	130	130	130	144	599

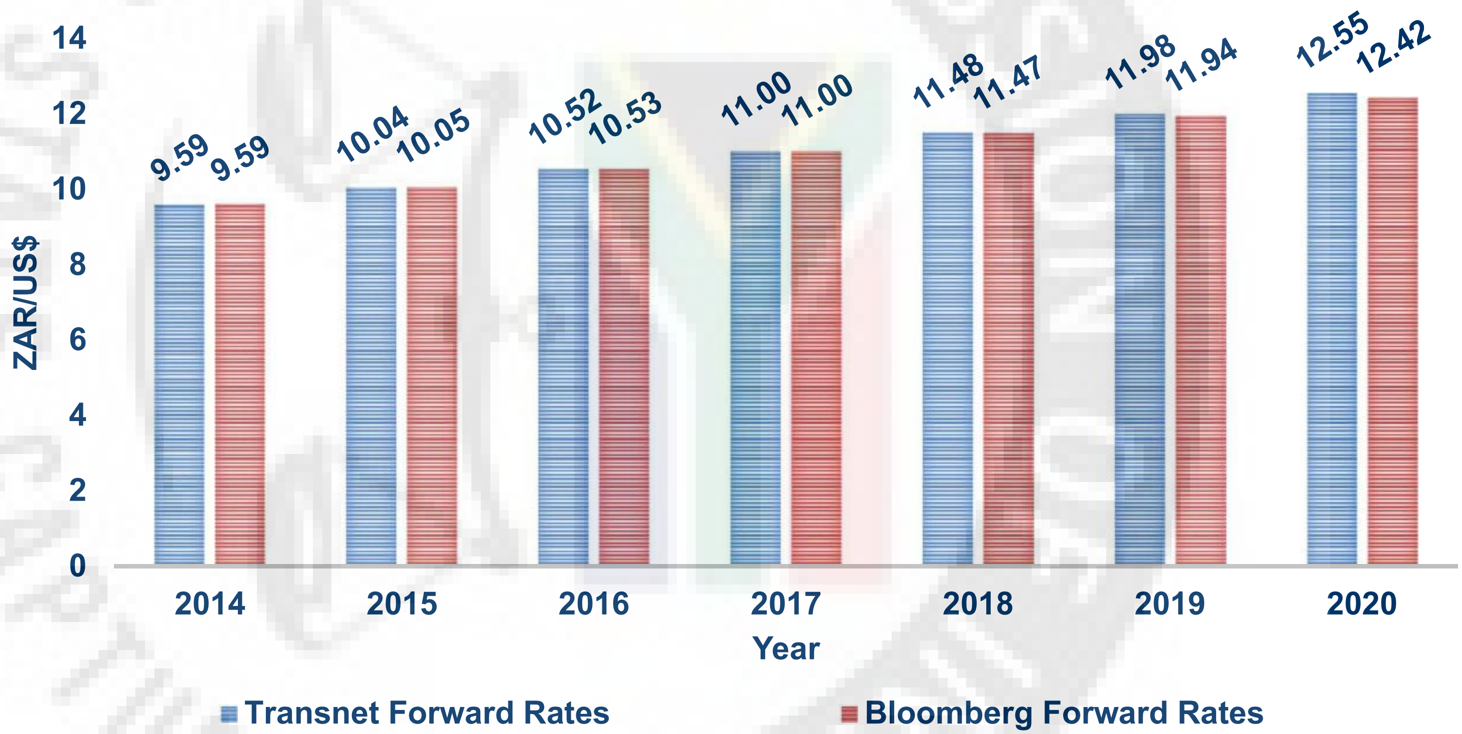
- 4 month testing period means Diesel locomotives although procured from April 2013 start to operate and generate revenue from August 2013
- 4 month testing period means Electric locomotives although procured from April 2014 start to operate and generate revenue from August 2014

BREAKDOWN OF R38.6 BILLION ETC

	Diesel	Electric	Total
Locomotive prices*	11,147	19,329	30,476
SA PPI (escalation cost)	388	1,432	1,821
US CPI (escalation cost)	154	559	713
Forex (hedging cost)	951	2,407	3,358
Contingencies	776	1,456	2,232
	13,416	**25,184**	**38,600**

*includes the localization premium of 2%

COMPARISON OF FOREIGN CURRENCY FORWARD RATES



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FOREIGN CURRENCY - FORWARD RATES vs FORECASTED RATES

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ESCALATION COSTS

- Escalation = Inflation
- Local and foreign escalations applied
- Cost of local escalation = R1.821 billion
- Cost of foreign escalation = R0.713 billion

Inclusion of escalation costs in ETC of R38.6 billion can be demonstrated.

CONCLUSION – BUSINESS CASE

- R38.6 billion an acceptable estimate of the cost of acquisition of the 1064 locomotives.
- R38.6 billion inclusive of Escalation costs.
- R38.6 billion inclusive of Forex Hedging costs.

III. INCREASE IN ETC FROM R38.6 BILLION TO R54.5 BILLION

- Reasons for the increase in ETC from R38.6 billion to R54.5 billion
- Opine on a reasonable increase in ETC

REASONS PUT FORWARD FOR INCREASE IN THE MEMO

- Update of Business Case for economic factors (**R5.4 bn vs R4.4 bn**)
- Risk mitigation – Forex and Escalation (**R9.5 bn vs R6.2 bn**)
- Transnet Engineering (TE) Scope (**R2.6 bn**)*
- Batch pricing adjustment (**R2.7 bn vs R0**)
- Contingencies (**R4.95 bn vs R2.8 bn**)

Memo values Recalculated

*not assessed owing to inadequate information at the time

ELEMENTS ASSESSED IN RELATION TO THE MEMO

- Best And Final Offer (BAFO) prices
- Escalations from April 2013 to March 2014 (A)
- Original Transnet Engineering (TE) scope (B)*
- Forex adjustment from April 2013 to March 2014 (C)
- Batch price adjustment for reduction of batch size (D)
- Additional TE scope (B)*
- Cost to fix escalation to end of contract (E)
- Cost of hedging (F)
- Contingencies (G)

Exception

Comfortable

*not assessed owing to inadequate information at the time

OPINION ON A REASONABLE ETC (ALLOWING FOR TE COSTS)

	Business Case	May 2014 Memo	Assessed value
Locomotive price	30.476	29.355	29.355
A - Backward escalation	-	2.362	1.392
B - Original TE scope	-	1.707	1.707*
C - Forex adjustment	0.066	3.031	3.031
D - Batch price adjustment	-	2.754	-
	30.542	**39.209**	**35.485**
B - Additional TE scope	-	0.883	0.883*
	30.542	**40.092**	**36.368**
E - Forward escalation	2.534	6.726	3.472
F - Forex hedging	3.292	2.729	2.729
	36.368	**49.547**	**42.570**
G - Contingencies	2.232	4.955	2.809
	38.600	**54.502**	**45.379**

R15.9 bn (41%)

R6.8 bn (18%)

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OPINION ON A REASONABLE ETC (WITHOUT TE COSTS)

	Business Case	May 2014 Memo	Assessed value
Locomotive price	30.476	29.355	29.355
A - Backward escalation	-	2.362	1.392
B - Original TE scope	-	1.707	-
C - Forex adjustment	0.066	3.031	3.031
D - Batch price adjustment	-	2.754	-
	30.542	**39.209**	**33.779**
B - Additional TE scope	-	0.883	-
	30.542	**40.092**	**33.779**
E - Forward escalation	2.534	6.726	3.472
F - Forex hedging	3.292	2.729	2.729
	36.368	**49.547**	**39.980**
G - Contingencies	2.232	4.955	2.809
	38.600	**54.502**	**42.789**

R15.9 bn (41%)

R4.2 bn (11%)

BEST AND FINAL OFFERS - LOCOMOTIVE PRICES

Base price of locomotives considered **reasonable**

	CNR	GE	BT	CSR	Assessed value	Memo
Number of locos	232	233	240	359	1,064	
Price per loco - CFET	40,500,000	25,624,560	30,955,000	34,380,000		
Price per loco - BAFO	28,124,169	24,311,700	29,049,486	28,890,000		
Total	**6,524,807,208**	**5,664,626,100**	**6,971,876,640**	**10,371,510,000**	**29,532,819,948**	**29,355,532,740**

SAVING OF R6.5 BILLION AS PER MEMO

Narrative	R' bn
Update of business case for updated economic factors	5.39
Risk Mitigation - Forex and Escalation	9.45
TE Scope	2.59
Contingencies	4.95
Lower capital acquisition cost of the locomotive obtained through the competitive tender and negotiation process	-6.5

- Table 1 of the memo attributes a R6.5 bn saving in capital acquisition cost to a competitive tender and negotiation process.
- Savings in capital acquisition costs amounted to R0.18 bn.
- R6.5 bn (in fact R9.2 bn after allowing for batch price adjustment cost of R2.7 bn); not a saving

ESCALATION COSTS - APRIL 2013 TO MARCH 2014 (A)

	CNR	GE	BT	CSR	Assessed value	Memo
Escalation costs	271 298 194	296 357 446	322 025 602	502 783 516	1 392 464 758	2,362,018,104

- Escalations were higher than our computation of R1.4 billion by R0.9 billion.
- Escalations over the period need not have attracted a risk premium (a premium for the uncertainty in the escalations) as they were already realized.
- R2.4 billion considered **unreasonable.**

TRANSNET ENGINEERING SCOPE (B)

- The figures (totaling R2.6 billion) were taken as per the memo.
- The figures could not be verified to the extent required in order to draw a conclusion owing to the information available at the time

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FOREIGN CURRENCY ADJUSTMENT - APRIL 2013 TO MARCH 2014 (C)

Forex adjustment costs **reasonable**

	CNR	GE	BT	CSR	Assessed value	May 2014 Memo
Forex costs	873 510 172	420 068 328	946 017 946	931 797 725	3 171 394 171	3 030 660 144

BATCH ADJUSTMENT vs BREAK PRICING (D)

- Sections 3.1 on the RFP relating to the acquisition of 465 Diesel and 599 Electric locomotives, read as follows:

  "Transnet requires flexibility in exercising options for the acquisition of the Locomotives. These options may include suspending or postponing the delivery of the Locomotives until a later date or changing quantities. ***Transnet however does not expect to pay a price premium should it exercise any of these options.****"*

- ***Break pricing, however, applies to terminating orders*** and assumes one had invested in fixed costs for the whole order. A cost of R2.7 bn was computed based on the break pricing schedule provided however, no contract had been agreed for a break pricing fee to be levied on Transnet.

- R2.7 bn therefore considered to be an **unreasonable** cost.

ESCALATION COSTS - ACCELERATED DELIVERY PERIOD (E)

This cost reflects the impact of inflation over the revised delivery schedule.

	CNR	GE	BT	CSR	Assessed value	Memo
Forward escalation costs	737 004 876	703 352 320	839 332 716	1 192 406 552	3 472 096 465	6 725 748 499

This additional cost was difficult to justify as a risk premium and considered **unreasonable.**

FX HEDGING COSTS - ACCELERATED DELIVERY PERIOD (F)

Foreign currency hedging costs considered **reasonable**

	CNR	GE	BT	CSR	Assessed value	Memo
Forex hedging costs	683 581 291	365 072 815	610 499 668	766 459 449	2 425 613 224	2,729,046,496

CONTINGENCIES (G)

Contingency costs of R4.95 billion considered **excessive** on the basis of inflated costs.

	CNR	GE	BT	CSR	Assessed value	Memo
Contingency costs	616,598,575	551,931,043	659,236,824	968,143,531	2,795,909,974	4,954,775,590

OVERALL CONCLUSION

- We opine that a reasonable Estimated Total Cost of acquisition, would have been R45.4 bn, an increase of R6.8 bn allowing for TE's scope. The excess of R9.1 could not be justified.

- Assuming the Market Demand Strategy and Corporate Plan were realistic and targets reasonable…

  - Were the assumptions to the variables in the Business Case reasonable?

    No evidence to suggest that there not

  - Was R38.6 billion a reasonable amount for the ETC put forward in the Business Case?

    No evidence to suggest it was not

  - Were the reasons put forward (in totality) for the increase in ETC by R15.9 reasonable?

    On the basis of the information assessed, No

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THE PROCUREMENT OF 100 LOCOMOTIVES

EVALUATION OF R969 MILLION INCREASE IN ESTIMATED TOTAL COST

28 May 2019

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R969 MILLION INCREASE IN ETC

- Reasons for the increase in ETC from R3.871 billion to R4.84 billion
- Opine on a reasonable increase in ETC

FINDING

- A reasonable Estimated Total Cost of acquisition, would have been R4.1 billion, a (5.9%) increase of R229 million on the original ETC of R3.871 billion.
- The excess of R740 million could not be justified.

REASONS PUT FORWARD FOR INCREASE IN THE MEMORANDUM

- Update of Business Case for economic factors (**R495 mil vs R194 mil**)
- Scope change – locomotive design changes (**R347 mil**)
- Risk Mitigation – Forex & Escalation (**R371 mil vs R300 mil**)
- Contingencies - @10% (**R440 mil vs R373 mil**)
- Discount negotiated – (**R247 mil vs R209 mil**)

ELEMENTS ASSESSED IN RELATION TO THE MEMORANDUM

- Base price of 20E locomotive
- Forex adjustment from May 2013 to March 2014 (A)
- Escalations from May 2013 to March 2014 (B)
- Modification costs and duties (C)
- Cost to fix escalation (D)
- Foreign currency hedging (E)
- Contingencies (G)

OPINION ON A REASONABLE ETC

	May 2014 Memo	Recalculated
Price per locomotive as of May 2013	34.34	30.95
Impact of exchange rate to contract date	3.69	0.43
Impact of inflation to contract date	1.26	1.50
Modification costs (and duties)	3.47	3.47
Cost to fix escalation	2.63	1.92
Foreign exchange hedging	1.08	1.08
Discount negotiated	-2.47	-2.09
Final contracted price per locomotive	**44.00**	**37.27**
Contingencies	4.40	3.73
ETC per locomotive (plus contingencies)	48.40	41.00
ETC for 100 locomotives (plus contingencies)	4 840	4 100
Original ETC	3 871	3 871
Increase in ETC	**969.28**	**229.44**

25%

5.9%

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MNS-AC-38

Thank you.

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PART C

COMMISSION OF INQUIRY INTO STATE CAPTURE

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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 <u>excluded</u> 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

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	CNR	GE
	232 (50%)	233 (50%)
	CNR 1st 20 from China	GE 1st 6 from USA
by March 2015	0	0
by March 2016	20	34
by March 2017	87	126
by Oct 2017	84	73
by February 2018	42	
Locomotives will be manufactured at a peak tempo of 12 per month.		

Delivery Schedule - Electric locomotives	Bombardier	CSR
	240 (40%)	359 (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.		

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)

Table 2

Diesel + Electric [illegible]	[illegible]
Grand Total [illegible]	[illegible]
3 064 [illegible]	[illegible]%

Best and Final Offer per Board submission excluding Hedging & Escalation		29 333 832 740	
Adjusted for changes to:		9 594 929 113	
Escalation up to signature date (from close of tender to Mar 14)	A	2 392 013 104	8.0%
Add back original TE scope removed for BAFO purposes	B	1 706 643 360	5.8%
Forex adjustment to spot rate at 17 March 2014	C	3 030 660 144	10.3%
Batch pricing adjustment for reduction of batch size to 40 % / 60 %	D	2 754 402 335	9.4%
Best and Final Offer updated for economic and other factors		39 209 256 683	
Adjustments for:			
Additional TE Scope	B	883 172 732	3.0%
New Price including TE scope		40 092 429 415	
Cost to fix escalation to end of contract	E	6 725 743 499	16.8%
Cost of Hedging	F	2 729 045 496	6.8%
Estimated Total Cost including Hedging and Escalation		49 547 224 410	
The ETC above excludes the cost of any options, variations capital spares, initial spares, tools and test equipment. Add approximately a further 10 % at least to cover this cost	G	4 954 775 590	
Proposed Estimated Total Cost including Hedging, Escalation, options, spares, tools and test equipment		54 502 000 000	

Table 2

		Diesel + Electric Grand Total 1 064	%
Best and Final Offer per Board submission excluding Hedging & Escalation		29 358 832 740	
Adjusted for changes to:		9 994 929 119	
Escalation up to signature date (from close of tender to Mar 14)	A	2 362 018 104	8.0%
Add back original TE scope removed for BAFO purposes	B	1 706 643 360	5.8%
Forex adjustment to spot rate at 17 March 2014	C	3 030 660 144	10.3%
Batch pricing adjustment for reduction of batch size to 40 % / 60 %	D	2 754 402 335	9.4%
Best and Final Offer updated for economic and other factors		39 209 256 683	
Adjustments for: Additional TE Scope	B	883 172 732	3.0%
New Price including TE scope		40 092 429 415	
Cost to fix escalation to end of contract	E	6 725 748 499	16.8%
Cost of Hedging	F	2 729 046 496	6.8%
Estimated Total Cost including Hedging and Escalation		49 547 224 410	
The ETC above excludes the cost of any options, variations capital spares, initial spares, tools and test equipment. Add approximately a further 10 % at least to cover this cost.	G	4 954 775 590	
Proposed Estimated Total Cost including Hedging, Escalation, options, spares, tools and test equipment		54 502 000 000	

BACKWARD LOOKING ECONOMIC AND OTHER FACTORS THAT HAVE IMPACTED THE PRICE:

24. The estimates and assumptions on which the 1064 business case was based have changed substantially since approval was obtained from the Transnet Board in April 2013.

25. In addition a number of parameters have materially changed since issue of the tender, approval of the Investment by the Transnet Board and the contract negotiation process. These are summarised in Table 3 below:

Table 3

	Business Case	Tender Stage	Negotiation/ Contracting Stage	% movement
Rand to the US Dollar	9.13	8.98	10.72	19.4%
Rand to the Euro	n/a	11.86	14.87	25.4%
Local CPI	n/a	100%	106.10%	6.1% *
Local Hot rolled Steel plates Index	n/a	100%	112.90%	12.9% *
Local PPI	n/a	100%	107.50%	7.5% *
Chinese Equivalent CPI Index	n/a	100%	102.50%	2.5% **
US Equivalent CPI Index	n/a	100%	101.33%	1.3% **
Euro Equivalent CPI Index	n/a	100%	102.05%	2.1% **

* Index movements calculated from Dec 12 to Jan 14
** Index movements calculated from May 13 to Mar 14

Item C of Table 2

a. Foreign exchange rates. The Rand has depreciated by 19.4 % against the US Dollar since the tender stage. Similarly the Rand has also depreciated by 25.4 % against the Euro over the same period. The spot rate of exchange used in the business case to calculate the base price of the locomotive was 9.13 Rand to the US Dollar, as compared to the spot exchange rate as at contract signature date of 10.72 Rand to the US Dollar, an increase of 17.4 %. This has impacted the expected price of the locomotive as per the business case and ultimately the ETC as approved by the Board.

Consequently the additional 10.3 % per C in Table 2 is reasonable.

Item A of Table 2

b. Labour cost increase. The cost of labour required to build the locomotives has increased locally within South Africa and globally over this period, as indicated within the CPI/PPI indices listed in Table 3 above and as evidenced by the higher than CPI wage settlement that Transnet entered into at 8.5 % for a 2 year period. Due to the tender localisation requirements, Transnet Engineering (TE) will assemble the locomotives and consequently local labour will be utilised for the assembly.

c. Material cost increase. A significant component of the locomotive is steel. The price of steel is impacted by the steel commodity price of which the trading currency is in

US Dollars and secondly thereby foreign exchange deterioration as well. The local index for hot rolled steel plates has deteriorated by approximately 12.9 % since December 2012, which is indicative of the level of increase in the price of steel.

d. Inflation. Local Producer Price Index (PPI) has increased by over 7.5 % since December 2012 thereby affecting the price of locally sourced products required for the build of the locomotives. Foreign equivalent indices also increased over this period. This together with the foreign exchange deterioration indicated above has resulted in the price of imported components for this project increasing.

e. Statistics SA report that the headline CPI annual inflation rate in April 2014 was 6.1 %, further explained in the Business Day article "CPI breaches Reserve Bank target" dated 22 May 2014.

f. 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 8 %.

g. Consequently the net impact of 8 % on the locomotive price due to the change in economic conditions as per item A of Table 2 is reasonable.

FORWARD LOOKING ECONOMIC FACTORS AND MEASURES TO MITIGATE FINANCIAL RISK THAT HAVE IMPACTED THE PRICE:

Forex (Item F of Table 2)

26. The Financial Risk Management Framework (FRMF) approved by the Board of Directors (BOD) does not permit Transnet accepting forex exposure on committed transactions.

27. The South African Reserve Bank (SARB) also does not permit SOC's to accept open exposure on foreign currency contracts.

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

29. Sensitivities indicate that a 5 % devaluation of the Rand could impact the total ETC by approximately R 3.07 billion if left unhedged.

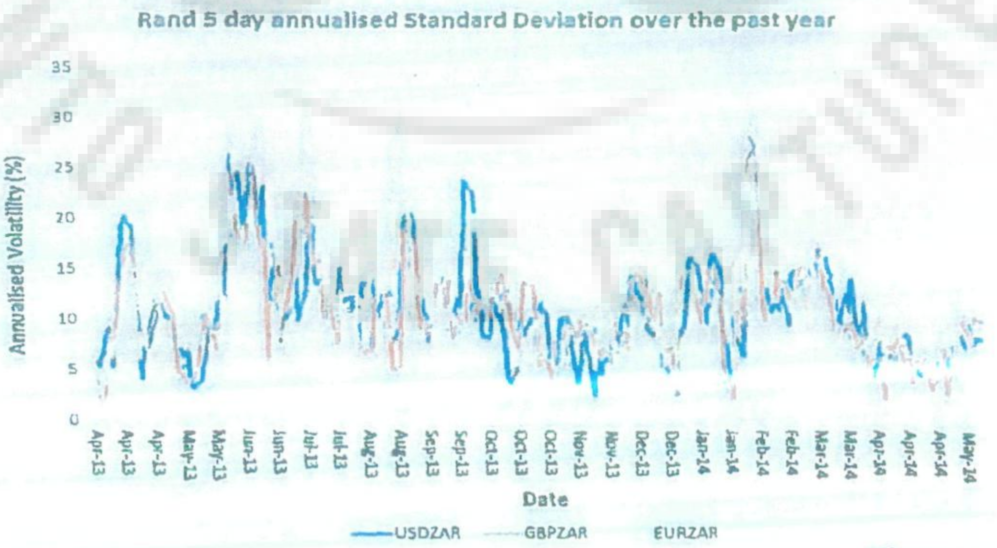
30. Consequently the cost of foreign currency hedging to mitigate and protect the Company against foreign currency devaluation is an inherent cost of the transaction.

31. Costs related to forex are influenced by market forces which are not within managements control and therefore were not included in the ETC for the business case submission. The impact of these forex related costs would only be known once the contract was negotiated and finalised as they are based on market conditions and sentiment at the time.

32. The cost of fixing the forex exposure is impacted by currency volatility and time or duration of the exposure.

33. The recent volatility in the foreign exchange rate of on average up to between 15 & 20 % directly impacts the transaction cost as can be seen in Table 4 below:

Table 4



34. In addition the ZAR currency is one of the most volatile and fragile currencies in the world. This view is substantiated by the ZAR currency being termed as one of the "fragile five" by economists and financial markets (refer diagram below).

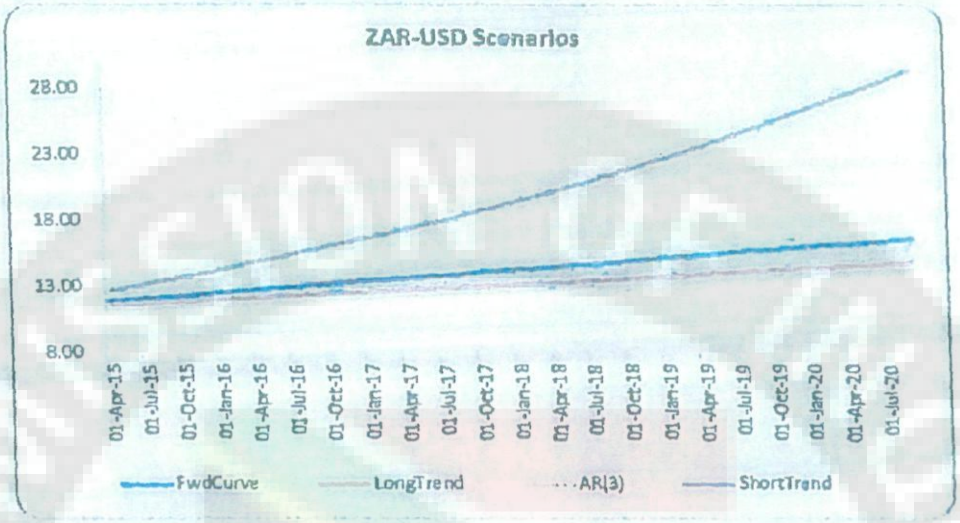
35. Business Day reported on 18 March 2014 that the Rand is in for a "Rocky ride" for the rest of the year (Refer article "Rocky Ride forecast for 'still to expensive' Rand)

36. The generally held consensus view is that due to the twin deficit of the RSA budget and the current account, and the weak economic outlook supports Rand devaluation in the medium to long term.

Table 5

37. A historical regression analysis conducted by Regiments Capital indicates that the ZAR currency is on a trend of devaluation as indicated in Table 5 above.

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 6.8 % 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

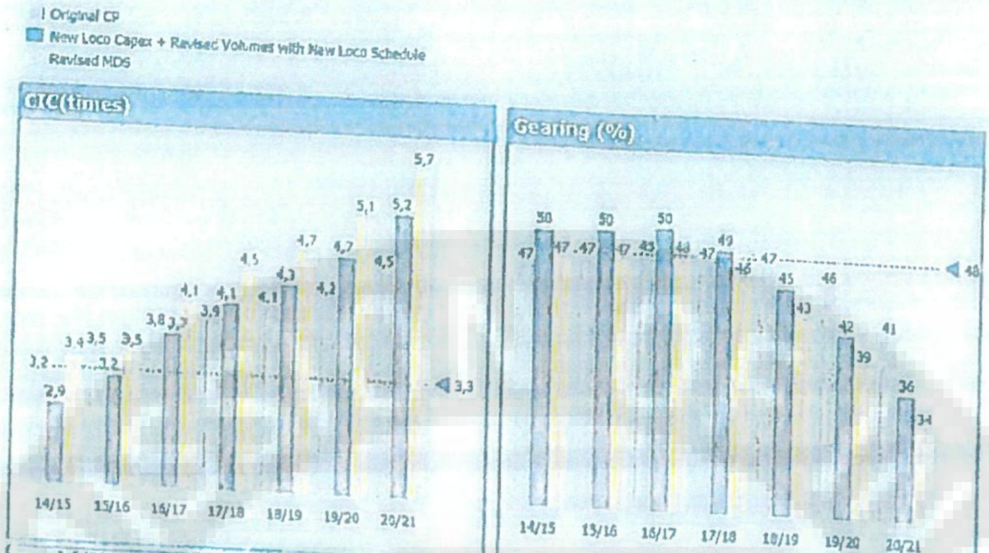
	Rand million								
	ETC	13/14	14/15	15/16	16/17	17/18	18/19	19/20	20/21
Budget per Corporate Plan	41 468	-	315	4 188	8 344	9 123	9 420	8 382	1 696
Contracted	49 547								
Add 10 % for options, variations, tools, spares etc.	4 955								
Expected	54 502	4 824	6 308	6 597	18 618	16 970	1 185	-	-
Difference	-13 034	-4 824	-5 993	-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:



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 exclusion 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:

Anoj Singh
Group Chief Financial Officer
Date: 22/05/14

Recommended by:

Siyabonga Gama
TFR Chief Executive
Date: 2014.05.21

Recommended by:

Brian Molefe
Group Chief Executive
Date: 23.5.14