Briefing Note: Government Guarantee

Introduction

Eskom and the Government of the Republic of South Africa, represented by the Department of Public Enterprises and National Treasury, have been engaged in lengthy negotiations on the Government Guarantee. The purpose of the Guarantee is to demonstrate the Government's explicit support of Eskom by assisting Eskom in the Capital Expenditure Program.

The challenge faced by the negotiating parties was to create a Guarantee which would go beyond an ordinary guarantee to improve the condition of both Guaranteed and non-Guaranteed Lenders.

Although, all parties involved in the negotiations had this common goal, innovative thinking was required to translate these intentions into a workable instrument. The end result is a lengthy and complex document, which notwithstanding, did achieve all the shared goals of the parties.

This Briefing Note was put together to serve as a guide to the salient features of the Guarantee and to clarify the intention behind certain clauses in the Guarantee. It is not, in any way, to be considered a binding legal document.

Mechanics of the Guarantee – General Overview

Eskom and the RSA Government will enter into a Guarantee framework agreement which will delineate the duties and responsibilities of the parties involved and include details such as fees. Under this framework agreement, individual guarantees will be executed, containing the detailed rights of the relevant beneficiaries.

Eskom will pay Government a guarantee fee on the aggregate guaranteed amount at agreed intervals.

Apart from the Eskom's local Bond Issue (DMTN Program) which has already been approved, should Eskom wish to apply the Guarantee to a particular Liability, the processes detailed below will have to be followed:

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Eskom firstly needs to apply to Government for any eligible liability to be guaranteed. Certain information needs to be submitted for assessment by the Government, including pricing and term. The Framework Agreement stipulates that the maximum principal amount to be guaranteed may not exceed a certain annual limit of R 30 billion per annum (negotiable with the Government). The Government will grant these Guarantees at its sole discretion.

Once the Guarantee has been approved with all the underlying conditions met, the beneficiary will be given an unconditional, first-demand Guarantee.

Should Eskom default or anticipate default on such guaranteed debt, the Government may either step-in and assume the payment obligations of Eskom, or it may pay the full amount owing - together with breakage costs and other related costs. Any amounts paid out under the Guarantee, would constitute a claim by the Government on Eskom. This claim is seen as a loan and would become subject to the terms and conditions identical to those of the Government Subordinated Loan already signed between Eskom and the Government in December 2008.

As with the Government Subordinated Loan, the rights of the Government under the Guarantee are subordinated to all other unsecured and unsubordinated creditors. In essence, upon the unlikely event of liquidation, the Government would stand at the back of the queue.

Default on the Guarantee will only take place should one of two events occurs – Eskom defaults on the payment terms of the Subordinated Loan to Government (after the lapse of a thirty day grace period) or the occurrence of an insolvency event in relation to Eskom.

Should Eskom default on payment terms of the Subordinated Loan, the Government may, at its discretion, institute any one of the following actions:

- Declare all the Subordinated Loans due to the Government to become due and payable
- Institute proceedings for the Winding up of Eskom
- Cancel the unutilized portion of the Guarantee

Rights of the Government

There are three payment rights generated under the Guarantee for the Government:

- The payment of a fee on the utilized portion of the Guarantee
- The right to reclaim any amounts paid as a result of the step-in feature(prior to liquidation)
- The right to reclaim and amounts paid after default (both prior to and following liquidation)

Assistance on Three Levels:

1. The first stage of assistance occurs *before* a payment has been missed – Eskom can request the Government to `step-in' and make a payment which Eskom foresees it will be unable to make.
2. The second stage of assistance occurs when a payment has been missed - Eskom would be in default and the Lender would have issued a demand. At this point Eskom would be still solvent. The guarantee now functions as an ordinary guarantee.
3. The final stage occurs at liquidation - the Government's rights to reclaim the amounts paid under the Guarantee are subordinated to those of all other Lenders.

Step-in Feature of the Guarantee:

One of the more unusual features of the Guarantee is the 'step-in' option (clause 11.1.4 read together with 20.18). The two clauses effectively state that Eskom is obligated to inform the Government if it anticipates being unable to make a payment of any Guaranteed debt - the Government will then, subject to its discretion, intervene and pay on behalf of Eskom .

The intention behind these provisions is to enable Eskom to call on the Government in anticipation of default in order to prevent defaulting on a contract. The step-in solely refers to payment obligations of Eskom - the Government will not assume any corresponding rights. The Government, at its discretion, will pay either the whole amount together with any applicable breakage costs (does not apply to the DMTN Program) or the relevant interest payment. Should it choose to do the latter, the Government reserves the right to transfer the obligation back to Eskom once Eskom has recovered from whatever event(s) has caused it to seek relief on a payment.

The Loan Agreements and Bonds Papers will have clauses inserted to the effect that a failure to pay by Eskom will not constitute a default. Clause 12 further highlights the intention of both parties to ensure that all debts are serviced - by directing Eskom to pay non-Guaranteed debtors, before utilizing resources to pay Guaranteed debtors.

All amounts paid by Government are converted into `loans' which will adopt identical terms and conditions to the Loan already executed between Eskom and Government in December 2008 (definition of "capital outstanding" in clause 2.2.22 and "subordinated loan" in clause 2.2.100, read together with clause 15).

Prevention of Cross-Defaults

In order to prevent cross-defaults from occurring, the Guarantee has stipulated that, the Government stepping in to make an interest payment will not be construed as a default event (11.1.4) – to be inserted as a standard condition in all future contracts and via convention of Noteholders with the DMTN program.

With this clause built in, Eskom's other loans will not be triggered by the Government step-in, avoiding any negative consequences.

Subordination of Rights of the Government

The intention to subordinate the rights of the Government to all other counterparties was one of the earliest established decisions. The subordination of the Governments rights, takes place on two levels:

1) Deferral of right to repayment

In accordance with the step-in facility, Eskom may call on the Government when in distress to make a payment on its behalf – there are no fixed prerequisites beyond the fact that Eskom must be in a weak position and for whatever reason is unable to make payment(s).

Once paid, these `rescue' payments are converted into a loan, which generates interest and would need to be serviced by Eskom.

However, should Eskom be in a truly weak position where either a `mandatory deferral event" occurs (2.2.71 – occurs when the Interest Multiple is equal to or less than 2.5 or the leverage ratio is equal to or less than 12.5) or Eskom is in breach of the `solvency condition' (16.2), then:

- Eskom will not pay interest on such a Loan to the Government should the mandatory deferral event occur on 1 April of any relevant year (15.3)
- Eskom need not pay any Guarantee fee for the period that the situation persists, nor will a fee accrue during such time (13.3.)

Thus, while Guaranteed Lenders have access at to a new cash-pool, being that of the Government - a benefit immediately accrues to non-Guaranteed Lenders as Eskom's own cash-flow is relieved of the obligation to service any amounts to either the Government or Guaranteed Lenders – freeing up the cash flow for the servicing of debt to non-guaranteed Lenders.

2) Subordination of Claim at Liquidation

The Government's rights to reclaim any amounts paid to counter-parties at liquidation have been subordinated to those of other Lenders (s16). The effect of this is that Guaranteed Lenders debt will always be serviced, whilst freeing up Eskom assets for the servicing of non-Guaranteed Debt.

First-demand Guarantee

The Guarantee document was aimed at delivering efficient and rapid relief to the Guaranteed counterparties - this was achieved by shaping the guarantee into a first-demand guarantee. Clause 14.2 states that the Government must immediately pay upon demand by the counterparty, without any obligation to verify.

Conclusion

To sum up the features of the Guarantee:

1. It is an unconditional, first-demand guarantee
2. The Governments right to repayment is deeply subordinated
3. It serves to free up Eskom's cash flow for servicing non-Guaranteed debt
4. Cross-default risk has been addressed

Credit risk has become one of the primary concerns of Lenders and Investors globally. The Guarantee was created to address this need as far as possible, by extending security directly to Guaranteed Lenders, whilst still offering assurance to non-Guaranteed Lenders that their investments stand a greater chance of being serviced in the event of Eskom facing financial distress.