# REPUBLIC OF KENYA
# THE NATIONAL TREASURY AND PLANNING

**Statement on Fiscal Risks Arising from the State Corporations Sector**

In line with the Government's mandate to establish, develop and implement policies that advance prudent financial management, the National Treasury has recently undertaken the task of identifying and quantifying the fiscal risks arising from the State Corporations (SC) sector. The key objective of the exercise is to determine the amount of fiscal exposure from the SC sector, which can migrate to the national budget and negatively impact the economy. The exercise will enable the Government to develop appropriate measures to mitigate these risks and determine the policy choices that will help reduce the potential impact on the exchequer.

The key fiscal risks to Government that emanate from the State Corporations in Kenya are defined by three broad and interrelated groups:

- Expenditure and revenue risk from unforeseen developments such as higher operating expenses or lower sales that reduce the net profit or increase losses.

- Liquidity risks and arrears accumulation, which are a consequence of adverse revenue and expenditure developments and uncompensated public service obligations where entities are unable to raise revenues or recover costs. These may result in a call on Government – in case the SC fails to have sufficient working capital – to finance short-term obligations, whereby debts continue to accumulate, become uncollectible, or are written off.

- Direct and contingent liabilities of which the Government may have an explicit legal obligation (such as a loan, guarantee, or contractual obligation as part of an investment project) or an implicit obligation, such as supporting an SC facing liquidity problems, given the strategic importance that it plays in the economy.

Kenya has 248 State Corporations, out of which 46 are commercial enterprises, and 201 are non-commercial entities. A high number of commercial state corporations are concentrated in the transport and energy sectors, performing strategic functions. In FY2019-2020, these commercial enterprises accounted for 85 percent of total revenues and 89 percent of total liabilities in the SC sector. Non-commercial SCs include universities and vocational training colleges, water development agencies and national hospitals. These entities have strong social mandates to deliver core services to the citizens and are heavily dependent on Government transfers.

The high number of SCs and the high concentration of a few large companies make it important to monitor SCs fiscal risk exposure and ensure they are performing well financially and are sustainable.  The concentration of large companies in strategic sectors, their inter-linkages with Government and amongst themselves raises the importance of oversight and effective monitoring.

## Financial Analysis

A recent financial analysis of 18[1] major state corporations highlighted the weak financial performance of these entities and their high levels of indebtedness, arrears, and contingent liabilities. The selection of the SCs for this analysis was based on their size and strategic importance to the economy and society, and so by definition hold a high implicit risk to Government in that many of them are too big to fail. In a no reform scenario, their estimated financial shortfall or liquidity gap stands at KSh. 382 Bn. over the next five years, a sizeable amount that reflects the SC sector's financial challenges. The liquidity gap analysis was based on a set of conservative assumptions which presupposes that entities' operations will in FY2021-22 be affected by the COVID-19 pandemic to the same degree as FY2020-21 and that their financial health is fully restored during the five-year evaluation period.

In contrast, the fiscal risk analysis estimates the Government's exposure at a "worst case" scenario, where SCs are unable to fulfill their obligations otherwise explicitly or implicitly guaranteed by the Government.

## Fiscal Risk Analysis

The analysis of the fiscal risk parameters of the 18 major state corporations found that these the risk primarily relate to the liquidity challenges resulting from unfavorable revenue and economic performance. The analysis revealed that 11 of these SCs are loss-making, and 11 reflect a high liquidity risk, implying that they are unable to service short-term obligations when they fall due. Subsequently, 14 SCs have accumulated sizable arrears, totalling KShs. 211 Bn. (2.2 percent of GDP).

[1] The evaluation included following SCs: Kenya Ports Authority (KPA), Kenya Pipeline Corporation (KPC), Kenya Airports Authority (KAA), Kenya Electricity Generation Company (KenGen), Kenya Power and Lighting Company (KPLC), Kenya Railways Corporation (KRC), Kenya Broadcasting Corporation (KBC), East African Portland Cement Company (EAPCC), Postal Corporation of Kenya (PCK), Kenya Post Office Savings Bank (KPOSB), Kenyatta National Hospital (KNH), Kenya National Examinations Council (KNEC), Athi Water Works Development Agency (AWWDA), Kenya Wildlife Service (KWS), Jomo Kenyatta University of Agriculture and Technology (JKUAT), Moi University (MU), Kenyatta University (KU), and the University of Nairobi (UON).

The total fiscal risk exposure (as presented in the table below) includes all the SCs with significant risk exposure and excludes those SCs that have the capacity to sufficiently manage the risks and mitigate any exposure to the Government.

The maximum gross fiscal exposure of the 18 SCs is estimated at KShs. 436.2 billion (4.5 percent of GDP). This estimate represents the potential cost to Government in the event the SCs defaulted on guaranteed and commercial debt (and required immediate repayment), all contingent liabilities materialized, and all entities failed to repay arrears. There is, however, a very low probability of all components occurring at once or all SCs defaulting on their obligation simultaneously or within the same time frame.

Estimated total fiscal exposure of the 18 major SCs FY2019-20 (Ksh. Millions)

| | Ksh. millions | | | | |
|---|---|---|---|---|---|
| Group | Guaranteed Debt | Commercial debt (non-guaranteed) | Contingent liabilities | Arrears | Maximum fiscal exposure |
| Profitable strategic | 42,738 | 11,898 | 5,040 | 3,200 | 62,876 |
| Unprofitable strategic | 51,900 | 53,800 | 7,100 | 132,500 | 245,300 |
| Marginal strategic role | 0 | 1720 | 42,694 | 33,800 | 78,214 |
| Service provider | 0 | 4,847 | 3,418 | 41,523 | 49,788 |
| **Total** | **94,638** | **72,265** | **58,252** | **211,023** | **436,178** |
| **Percent of GDP** | **1.0** | **0.7** | **0.6** | **2.2** | **4.5** |

**Mitigation Measures**

The analysis of the liquidity risks for the 18 SCs suggests the following liquidity management options based on the potential fiscal risks they pose. These include:

(i) reform measures to boost revenues and rationalize spending;
(ii) new concessional borrowing;
(iii) deferred repayments for on-lent loans;
(iv) debt to equity swap;
(v) some combination of these measures.

All entities have considerable scope to implement measures that would improve their financial performance and efficiency. To address the liquidity challenges, different reform options will be required, which are specific to the entity.