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REPUBLIC OF KENYA

REPORT OF THE INTER-MINISTERIAL COMMITTEE ON

NZOIA SUGAR COMPANY

ESTABLISHED UNDER THE AUTHORITY OF THE
PUBLIC INVESTMENTS COMMITTEE OF THE NATIONAL
ASSEMBLY.

SEPTEMBER 1995

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MINISTRY OF AGRICULTURE, LIVESTOCK DEVELOPMENT AND MARKETING

REHABILITATION AND EXPANSION OF NZOIA SUGAR COMPANY

The Fifth Report of the Public Investments Committee on the Accounts of State Corporations, 1994 recommended that an Inter-Ministerial Committee be established to investigate the mismanagement of funds during the Phase I and II factory rehabilitation and expansion and that the following be the Terms of Reference:-

1. Investigate the tendering system of the rehabilitation and expansion.

2. Look into the feasibility study of the project and linkage between consultant and contractor.

3. Events leading to abandonment of the project by Arkel International of United States of America.

4. Suggest ways of completing the rehabilitation and expansion from 3000 TCD to 7000 TCD.

5. Look into ways of increased sugar cane development as raw material to cope with the expanded capacity of the factory.

6. Investigate delays in payments to farmers and how to solve the matter in line with the contractual undertakings.

7. Suggest ways of restructuring the financial position of the company particularly in regard to the loans portfolio.

8. Investigate the financial mismanagement of the company with a view to instituting immediate prosecution and recovery of the money. This is particularly in relation to Phase I and II factory rehabilitation and expansion.

9. Investigate the contract variation price of US$8,702,400 and Kshs.18,000,000 which was done without Board of Director's approval.

10. Look into any other matters that might have caused financial and administration problems facing Nzoia Sugar Company.

Pursuant to the above, the Government appointed the Inter-Ministerial Committee comprising of the following members:-

	Name	Status	Institution
1.	Mr. C. M. Nzau	Chairman	MOALD&M
2.	Mr. E. M. Gichohi	Secretary	"
3.	Miss B. W. Gathirwa	Member	Treasury
4.	Mr. C. S. Barasa	"	"
5.	Mr. P. O. Obado	"	Auditor General (Corporations)
6.	Mr. P. W. Sikolia	"	"
7.	Mrs. H. W. Nyagisere	"	Office of the President
8.	Mr. E. O. Awilly	"	Kenya Sugar Authority
9.	Mr. D. P. Nyongesa	"	"
10.	Mr. S. N. Karanja	"	Criminal Investigations Department
11.	Mr. D. K. Ameyo	"	Attorney General.

The Inter-Ministerial Committee discharged its responsibilities by perusing documents pertinent to Nzoia Sugar Company that are in possession by various Government institutions including the Ministry of Agriculture, Livestock Development and Marketing, The Treasury and Kenya Sugar Authority. Members also visited the Company premises in Bungoma District and in addition to scrutinizing documents, interviewed key officers of the Company and observed factory production of sugar and related technical problems.

The following persons gave verbal evidence before the Committee:-

	Name	Status	Institution
1.	Mr. P. Nakitare	Chairman	Board of Directors
2.	Mr. F. Waswa	General Manager	NOCO
3.	Mr. R. Fwamba	Ag. District Agricultural Officer	Bungoma District

4.	Mr. C. Amatha	Crops Officer	NSC
5.	Mr. M. O. Were	Managing Director	NSC
6.	Dr. N.C.O. Keya	Agricultural Manager	NSC
7.	Mr. F. W. Makete	Ag. Financial Controller	NSC
8.	Mr. B. Masake	Factory Manager	NSC
9.	Mr. S. A. Chunge	Purchasing Manager	NSC
10.	Mr. L. Nyambok	Production Manager	NSC
11.	Mr. G. Mulokori	Agricultural Services Manager	NSC
12.	Mr. B. Bwibo	Boilers Engineer	NSC
13.	Mr. H. A. Mukolwe	Engineering Manager	NSC
14.	Mr. D. Munyasi	Planning & Project Manager	NSC
15.	Mrs. H. Kibanani	Chief Chemist	NSC
16.	Mr. W. Khausi	Personnel & Training Manager	NSC
17.	Mr. F. T. Wabuke	Former Managing Director	NSC
18.	Mr. D.S. Eshitemi	Former Managing Director	NSC

The Inter-Ministerial Committee hereby submits its special report to the Auditor-General (Corporations) for the ultimate submission to the Parliamentary Public Investments Committee as so directed.

INTRODUCTION

Nzoia Sugar Factory was commissioned in 1978. It was designed and built by a French firm called Fives Cail Babcock (FCB). The factory was designed for a crushing capacity of 2,000 TCD.

The factory is located in Bungoma District of Western Province in a well endowed agricultural area of Kenya. Its catchment area is the most ideal for sugar cane production. The area receives good rainfall and its temperatures are suitable for excellent cane growth. Nzoia therefore is situated in the most ideal agronomical zone with great potential to produce sugar economically.

The factory however, has not performed well since inception and today is encumbered by so many operational, financial and managerial problems to the point of bankruptcy. Initially the company was financed through heavy commercial borrowing and low equity capital base by the owners. Over the years, poor factory performance on account of inappropriate technology has led to very high tonne-cane to tonne-sugar ratio and hence increasing losses. The situation was further compounded by increased borrowing to finance operational costs and a stalled ambitious expansion programme that was intended to raise the initial production from 2000 TCD to 7000 TCD.

Nzoia Sugar Company is a viable project but its current problems are basically historical. If these can be solved then the full potential of the Company will be realized. One major hindrance to success has been the lack of continuity in management at the top level. The rapid turn-over of the Chief Executives throughout the years has made it impossible for the conceptualization of managerial strategies and their ultimate implementation. It is also vital that these appointments be filled by persons of unquestionable integrity, professional qualifications with business acumen and be allowed reasonable periods of time to realize the ultimate objectives of their plans.

The issues raised by the Public Investment Committee that were investigated by the IMC fall under ten specific terms of reference (TOR) but may also be classified as:-

(i) issues that relate to past performance in all areas;

(ii) the current status of affairs and;

(iii) recommendations regarding what should be done to improve matters.

In addressing itself to these matters, the IMC endeavoured to analyse problems as posed under the TOR. The IMC probed Nzoia at a time when a major Study was being undertaken by the Agricultural Sector Management Programme II under the Ministry of Agriculture, Livestock Development and Marketing and when the policy of privatization is on the drawing board.

The observations and recommendations of this Report were reached through a unanimous agreement of the members after receiving various reports and/or evidence from various organizations and individuals. The Committee hopes that the findings and recommendations of this Report will appropriately be considered within the overall policy framework of the sugar industry for future development.

EXECUTIVE SUMMARY

Since its inception in 1978, NSC continued to perform below the break-even point. The income realized was not enough to cover the production and overhead costs. This is what led the GOK to appoint an Inter-Ministerial Committee to look into ways of expanding the production capacity. The Committee proposed an expansion of the factory from 2,000 TCD to 3,000 TCD. The committee also recommended an expansion of cane development to match the expanded factory capacity. Among other bidders, Arkel was awarded the contract to carry out the Feasibility Study and thereafter the implementation of the study on a turn-key basis at an estimated cost of US$ 23,687,000 and Ksh. 379,000,000.

M/s Arkel contracted M/s F.C. Schaffer as the project consultant. Immediately thereafter, the two differed and parted company. Subsequently, M/s Apcone, a local industrial Consultant was awarded the consultancy. Before completion of Phase I expansion, the Government requested Arkel to look into ways of expanding the factory's capacity to 7000 TCD. The Government decided to embark on the Phase II project whereby M/s Arkel were awarded the contract at a cost of US $ 66,759,900 and Ksh. 203,242,320. This Contract price was later on varied upwards by US $ 8,702,400 and Ksh. 16,845,000. The project faced various problems which culminated in its abandonment by Arkel. This led to an arbitration process and later on to amicable settlement out of Court.

Arising from the above background, the Committee made the following observations;-

1. The tender procedures were not followed in awarding the contract to Arkel for both Phase I and II expansion programmes.

2. Phase II Expansion was introduced before the completion of phase I which was faced with a lot of implementation problems, and had not been commissioned. The 3,000 TCD has never been attained todate.

3. Whereas Arkel International Inc. as a contractor was supposed to work alongside with the projects industrial Consultants, the contractor did not heed the professional and technical advice given by the two consulting firms i.e M/s F. C. Schaffer and Apcone Industrial Consultants. These strained relationships affected the implementation of the project.

4. Whereas cane development was included in the Expansion programme, no effort was made to expand and improve the growing of cane in the area. Agricultural machinery for cane haulage though procured, did not improve cane transportation due to unsuitability.

5. Notwithstanding the fact that the contract contained a clause providing for the supply of spare parts, very little was supplied.

6. Nzoia Sugar Company has breached its contractual obligations to its outgrowers and has not paid farmers promptly when such payments fall due. The amount owing to the farmers todate is approximately Ksh.300 million.

7. Most of the factory equipment was sourced from various countries which has made their synchronization difficult. This among others, has led to the factory's poor performance.

8. The contractor abandoned the site before installation of most of the equipment for Phase II as a result of which the projected factory capacity has not been realized. The equipment now lies idle on site and is subjected to severe deterioration.

9. The Company has a very poor capital base. It was financed with too much debt and very little equity and it is operating with a negative working capital and negative shareholders' equity.

10. Handling of finances in the company has not been in accordance with the generally accepted financial regulations and procedures. Financial decisions have been made haphazardly leading to financial misallocation. It was also observed that procurement procedures are not followed.

11. Nzoia Sugar Company's technical staff did not have the necessary expertise to handle the installed equipment. Whereas members of the Management Technical Assistance group were supposed to train the local staff, there was confusion due to linguistics problems and their technical competence was questionable.

12. The Company's human resources requirements have not been identified to match the Company's broad goals and objectives. There has been high turnover among senior management staff including the Chief Executives.

Among others the following were the major recommendations:-

1. Due to its socio-economic and political role, it is important that NSC continues to perform in operation. This calls for the financial restructuring of the company to render it a viable enterprise. This will entail the Government taking over external and internal loans and injecting into the company more working capital. Once the company attains a stable financial position, NSC should pay other creditors including the farmers.

2. A competent professional firm should be appointed through competitive bidding to carry out verification of the current machinery and equipment yet to be installed in the factory with the ultimate goal of completing the already started rehabilitation and expansion programme.

3. For the factory to operate effectively and efficiently, it is necessary to have a proper back up system and adequate stocks of spare parts. These should be procured through competitive bidding as opposed to single sourcing/selective tendering.

4. This Committee recommends that a professional firm should be appointed to assess the usefulness of the existing vanguard tractors currently at the company's machinery yard. It is also recommended that the company should make effort to procure local tractors for loading the vanguards.

5. The three major factors i.e cane availability, cane haulage with the necessary infrastructure and the factory technological capacity must be synchronized for optimum output.

6. The Committee recommends that Police investigations be instituted in matters of criminal nature. In cases of wrong decisions surcharge proceeding should be meted against officers who were responsible for such decisions.

7. It is the view of the Committee that the settlement agreement be enforced by the Government.

8. A competent team of experts should carry out and determine manpower requirements for the company with a view to ascertaining the company's manpower needs against its envisaged expansion. The company should have a deliberate training programme for its staff. Minimisation of transfers of chief executives and senior staff is recommended.

9. Even if the ultimate objective is privatization, it is essential to undertake immediate major financial restructuring in order to make the Company sellable.

TOR 1: INVESTIGATE THE TENDERING SYSTEM OF THE REHABILITATION AND EXPANSION.

1.0 TOR 1: THE TENDERING SYSTEM OF THE REHABILITATION AND EXPANSION

1.1. Early in 1985, the Government identified the need to address the deteriorating performance of Nzoia Sugar Company (NSC). An Inter-Ministerial Committee was appointed and mandated to study the Company's position and recommend appropriate measures to be taken in order to bring the Company into a sound financial footing. On 7th February 1985 the Inter-Ministerial Committee recommended remedial measures which included the following:-

(i) *Synchronization of Nzoia Milling and processing capacities;*

(ii) *Expansion of Nzoia factory capacity from 2,000 to 3,000 tons of cane per day, (TCD); and*

(iii) *Rehabilitation and expansion of cane fields to cater for the current and projected capacities.*

The recommendations by the Inter-Ministerial Committee were presented to the Government for consideration after which the Government approved:-

(i) *That the factory be rehabilitated and the capacity be expanded from 2,000 TCD to 3,000 TCD;*

(ii) *That the S.G.V. Group of the Philippines be appointed as consultants with specific terms of reference to evaluate the machinery and equipment required for the expansion to ensure that the approved capacity of 3,000 TCD was attained at the end of the expansion;*

iii) *That an amount of Kshs.53 million (being part of equity participation) be availed by the Government to the Company to finance cane development programme to provide the then shortfall in raw materials and engage the expanded capacity.*

(iv) *That purposeful measures be put in place to train Kenyans with a view to making it possible for them to take over the management of the sugar industry.*

The S.G.V. Group of Philippines had earlier been appointed as consultants to the Kenya Sugar Authority (KSA) to offer technical assistance and consultancy services under the Sugar Rehabilitation Programme covering Muhoroni, Miwani, Chemelil and Ramisi Sugar Companies. Prior to embarking on implementation of the Government decision it was reconsidered and decided that additional consulting firms should be invited for the purpose of competitiveness. The invited firms, therefore were:-

(i) *S. G. V. Group of Philippines;*
(ii) *Booker Agricultural International of UK;*
(iii) *Tate & Lyle Technical Services of UK;*
(iv) *Arkel International Inc. of USA.*

It is on record that the three additional consulting firms were proposed by the Ministry of Agriculture to the Office of the President arising from their prior involvement in the Sugar Industry worldwide. Authority to invite the four consulting firms was given by the Office of the President, consequent upon which the firms were invited to quote as per specific Terms of Reference as listed here below;

As stated above the objective of the study was for the rehabilitation and expansion of the factory capacity from 2,000 to 3,000 TCD and programme its implementation taking note of the planned agricultural development in terms of Nzoia's requirements of machinery for land preparation and sugarcane transportation to ensure adequate supply of sugarcane to meet the expanded capacity of the factory.

1.2 On 30th July, 1985 the Ministry of Agriculture sent letters inviting bids from the four firms, with a tender closing date of 30th September, 1985. The bids were received and passed over to the Kenya Sugar Authority and Nzoia Sugar Company for independent evaluations. The Kenya Sugar Authority carried out the evaluation on 10th October, 1985 while Nzoia Sugar Company did its evaluation on 17th October, 1985. For fair evaluation, the following guidelines were adopted:-

(i) *Experience in the field of study i.e. Sugar industry;*

(ii) *Work plan and methodology;*

(iii) *Personnel for the study;*

(iv) *Proposed costs and duration of the study.*

In terms of financial costs, two aspects were considered i.e.

(i) *The fees to the consultancy firm;*

(ii) *The reimbursable local costs.*

Both KSA and the NSC concurred in their independent evaluations that ARKEL International Inc. of the USA was the most appropriate firm to undertake the consultancy. Under the signatures of the Chief Executive, Kenya Sugar Authority and the General Manager, Nzoia Sugar Company, the evaluation Report was submitted to the Ministry of Agriculture with the recommendation that ARKEL International Inc. be appointed to undertake the Study.

On receipt of the recommendations from the Kenya Sugar Authority and Nzoia Sugar Company, the Permanent Secretary - Ministry of Agriculture considered the cashflow constraints of Nzoia Sugar Company and hence requested ARKEL International Inc. and Tate & Lyle who had been rated the second best overall to propose funding for the Study. The two firms responded as follows:-

(a) *Tate & Lyle.*

They had approached the Commonwealth Fund for Technical Cooperation for funding and while CFTC had expressed interest in the proposal, there was no firm commitment that funds would be available.

(b) *Arkel International Inc.*

They confirmed that they had made arrangements for the necessary off-shore funding and that should they be awarded the full implementation of the project, they would waive the fees and expenses related to the Feasibility Study. Subsequently, Arkel confirmed that the funding of the Study would be sourced from the United States Trade Development Programme by way of Grant to assist in financing the cost of Arkel services for the Study.

1.3 A Grant Agreement between the Government of Kenya and the United States of America was signed on 27th August, 1986 (for US$55,000) specifically stating "to provide the Grant under the terms of this Agreement not to exceed US$55,000 to assist in financing the cost of services required for proposed feasibility study on a proposed rehabilitation of Nzoia Sugar Mill, " and further " that the funding provided under this grant will be used to finance United States Dollar/local currency costs for professional and technical services to be performed by a United States firm in preparing the aforementioned study." A letter of offer was issued by the Ministry of Agriculture in September, 1986 to Arkel to undertake the feasibility study . The Ministry's letter was explicit with regard to the mode of funding for the Study. Arkel was informed that the cost of the Study would be financed through a grant from the Trade Development Programme of the United States of America. In turn Nzoia Sugar Company Limited would provide adequate transport for the consultants for local travelling. Further, the Kenya Government would need to approve all documents for payments presented to enable Arkel obtain payments under the US Trade Development Programme Grant. The consultant was required to complete the Study and submit their Report by 31st December, 1986. Pursuant to the above, Arkel International Inc. submitted its preliminary Report on 24th November, 1986. In their forwarding letter the firm revisited their earlier request to be awarded the implementation of the *entire* project. The firm had gone a step further to make arrangements for financing through Equator Bank of Hartford Connecticut (US).

On receipt of the preliminary Report the Ministry of Agriculture referred it to the Kenya Sugar Authority for detailed comments. The Kenya Sugar Authority and Nzoia Sugar Company officials looked into the Report and invited the consultant for further discussions.

A joint meeting was held on 26th November, 1986 and according to records (under MIN.5/86) all parties present agreed with Arkel's proposals on funding the project under consideration. In response to this position, the Ministry of Agriculture referred the matter to the Treasury, proposing that the project be implemented on a Turn-key basis by Arkel International Inc. of the United States.

1.4 The Permanent Secretary Treasury vide his letter Ref.No.ZZ.130/05/26 dated 24th March, 1987 concurred with the views of the technical teams as conveyed by the Ministry of Agriculture. The Permanent Secretary particularly made special praise of the financial package. He further directed that a high powered Inter-Ministerial Committee comprising of Nzoia Sugar Company, Kenya Sugar Authority, Ministry of Agriculture, Treasury and Attorney-General under the chairmanship of Treasury be constituted to start negotiations with Arkel International Inc. with immediate effect. It is necessary to note here that the decision to enter into negotiations with Arkel was taken by the Government and communicated to NSC. The letter further proposed that the Cabinet be appraised as necessary. The Inter-Ministerial Committee was given three (3) basic Terms of Reference which were as follows:-

(a) *Discuss and negotiate with ARKEL on the entire financial package regarding the proposed rehabilitation and expansion of Nzoia Sugar Company.*

(b) *Discuss and negotiate with ARKEL on the implementation of the rehabilitation and expansion project.*

(c) *Discuss and negotiate with ARKEL on the provision of consultancy services to oversee the implementation of the rehabilitation and expansion project.*

The Committee identified four(4) key areas which were to be addressed as follows;

(i) *Consultancy/Supervision,*
(ii) *Supplies/Procurement,*
(iii) *Construction/Installation,*
iv) *Financing.*

The Committee sought guidance as to whether or not it was Government's intention for Arkel to undertake action on the four(4) areas. Of particular concern were:-

(a) *Conflict of interest if Arkel were to undertake all the four key areas.*

(b) *Lack of checks and balances,*

(c) *Want of price competitiveness; and*

(d) *Want of independent advice and supervision.*

The Committee was of the opinion that it was not in the interest of Nzoia Sugar Company and the Government for one firm to undertake all the functions. The Committee therefore made the following recommendations:-

(i) *Arkel be retained as consultants and ensure supervision during the implementation period.*

(ii) *Arkel be commissioned to arrange financing for the project.*

(iii) *That procurement and construction be on a Turn-key basis by a reputable contractor appointed through International competitive bidding.*

1.5 During the same period the Attorney-General gave legal opinion over the same matter. In his letter Ref.No.5699/270 dated 9th July, 1987 and addressed to the Ministers for Finance and Agriculture, the Attorney-General advised that "A consultant ought not to assume the role of a contractor to implement the proposals contained in his consultancy. What is even more objectionable is for the same consultant to assume supervision of his own proposals. In my considered view it would not be in the best interest of the Government to have one firm implement all the phases of this project". This letter was copied to the Head of the Public Service. In response to the Attorney-General's legal opinion, the then Minister for Agriculture expressed his variant views and affirmed he "saw" nothing wrong in the consultant who did the Study assuming the role of a contractor to implement the proposals provided he is competent and well equipped to do so." After various exchange of correspondences between the Treasury, Ministry of Agriculture and the Attorney-General, it appears from available records that a decision was reached to award the contract to Arkel International Inc. and consequently a formal contract was signed on 27th August, 1987.

The Attorney General, Hon. Justice Matthew Mulli in his letter Ref.No.5699/699 dated 3rd September, 1987 addressed to Hon. E. W. Mwangale the then Minister for Agriculture and copied to Prof. G. Saitoti then Minister for Finance, the Attorney-General cleared the draft Agreement from the legal point of view for signature.

1.6 The Permanent Secretary, Treasury in his letter Ref.No.ZZ.130/05 dated 3rd September, 1987 to the Permanent Secretary, Ministry of Agriculture conveyed Treasury approval. Because of the value of this letter, we hereby quote it in full. "Reference is made to your letter No.SVG/44A Vol.XIII of 2nd September, 1987 in connection with the above. In view of your confirmation that the proposal by the Arkel International Inc. as contained in the Agreement has been found to be the most cost effective and most competitive available in the international market, Treasury authority is hereby granted to you to facilitate appropriate signing of the agreement."

A notable anomaly was that the Attorney General was clearing this agreement on 3rd September 1987 when indeed it had already been signed by all the parties on 27th August, 1987 (8 days earlier). The Committee also noted that on the same date, 3rd September 1987, Treasury conveyed authority to the Ministry of Agriculture to go ahead and facilitate the signing of the Agreement. The Committee noted that Arkel submitted their final feasibility study Report which, in summary proposed a rehabilitation and expansion of the factory to 3,000 TCD. The project was to be implemented on a "turn-key" basis at an estimated cost of US$23,687,000 and Kshs.379,000,000. The project was also to entail provision of agricultural and cane haulage equipment, technical assistance and 100% financing for the project. In addition, Arkel proposed to extend the training of local NSC's staff.

1.7 Overall, Arkel's feasibility Study indicated that the project was economically and financially viable with an Internal Rate of Return (IRR) of 34%. It is also on record that while Arkel International Inc. were finalizing the credit arrangements, Exim Bank on behalf of Equator Advisory Services, proposed 85:15% ratio sharing of the eligible US dollar costs. The equivalent of the 85% was US$19,992,000. The 15% equivalent was to be raised by local Banks, i.e EADB and NBK, the total of which amounted to US$3,528,000. The reimbursable local costs were to be met entirely from local finance sources.

1.8 After the agreement was signed, Parliament was dissolved shortly thereafter to pave way for the 1988 General Elections. The necessary Parliamentary approval for the Government to guarantee the borrowing by NSC to finance the project could not therefore be obtained. Immediately this gave rise to the delay in effecting the following stages crucial to the implementation of the credit agreement:-

(a) *Conclusion of an appropriate credit agreement to finance the project.*

(b) *Establishment of letters of credit by the Purchasers (Nzoia Sugar Company).*

(c) *Receipt by the contractor (Arkel) of the required 15% down payment.*

(d) *Receipt by the Purchaser of any Bonds required (by the Purchaser) in respect for work to be carried out by the contractor under the contract.*

1.9 The project implementation became effective on 3rd November, 1988 after a delay of sixteen (16) months. Due to the delay as already explained, the contract price was varied upwards by US$437,069 and Kshs,18,052,087. This variation was formally approved by the Board of Nzoia Sugar Company Limited.

TOR 2: LOOK INTO THE FEASIBILITY STUDY OF THE PROJECT AND LINKAGE BETWEEN CONSULTANT AND CONTRACTOR.

2.0 TOR 2 : RELATIONSHIP BETWEEN CONTRACTOR & CONSULTANT

2.1 Before implementation of the project started, Arkel entered into agreement with F. C. Schaffer for the latter to be the Project Director. This appointment which was made on 15th April, 1988 gave the Project Director responsibilities which included the following:-

(a) *The appointment and control of all senior Technical and Management personnel involved in the implementation of the project.*

(b) *Overall engineering design, procurement and implementation of the project.*

(c) *Proper utilization of the funds allocated to this project.*

(d) *Any other responsibility appertaining to the foregoing responsibilities.*

Both the Contractor and the Project Director opened an Escrow Account in their joint names and were mandated to be the only signatories to the single Dollar and single Shilling Account. In the contract document, the term contractor is used in reference to Arkel International Inc., while the term Project Director is used in reference to F. C. Schaffer & Associate Inc. In our view, the project direction agreement between the two firms would appear to have transferred contractual obligations from Arkel International Inc to F. C. Schaffer altogether in complete disregard of the Purchaser's rights in the main agreement. Thus the project now fell into the hands of a third party implementer who had no direct contractual obligations with the Purchaser. Neither the Government nor Nzoia was involved in this decision. It was a unilateral assignment of her obligations by Arkel.

2.2 Immediately after the agreement was signed, misunderstandings between the two parties seem to have occurred. The bone of contention was the role of the project Director vis-a-vis the contractor in particular with regard to procurement and proper utilization of funds. Utilization of the funds was at the center of misunderstanding between the two parties as each of them had their own respective interpretation of the contract. Consequent upon this, F. C. Schaffer in their letter of 21st October, 1988 to the General Manager, Nzoia Sugar Company requested to withdraw as project Director. The variance in opinions as explained hereabove appears to have extended to all other parties concerned and various meetings were held to look into ways of reconciling the warring parties. The consensus of the majority of interested parties was that M/s Arkel International had a legal right under the contract, to hire a project Director of his choice.

The matter reached its climax in London in November 1988 when the then Minister for Agriculture, put an urgent request to the President of F. C. Schaffer & Associate (Mr. Francis C. Schaffer) to withdraw from the project. This is duly attested by a letter dated 30th November, 1988 from F. C. Schaffer to the Hon. Minister. It will be noted that the two firms agreed to release each other from the project direction agreement on 23rd November, 1988 . At this point M/s F. C. Schaffer disappeared from the scene.

2.3 A special Nzoia Sugar Company Board meeting was convened on 14th December, 1988 which was attended by the two Permanent Secretaries of the Ministry of Agriculture and Treasury in person. The following resolutions emerged:-

(a) *The Government and Nzoia Sugar Company recognized Arkel International Inc. as the contractor and therefore there was to be no reference to F. C. Schaffer and Associates in relation to implementation of the project agreement.*

(b) *Nzoia Sugar Company was to immediately appoint an independent engineering consultant to undertake verification of equipment during fabrication, shipping and installation on site. A British firm - W.L.P.U. - Engineering consultants was proposed.*

(c) *The project agreement should be amended to provide further safeguard in the following:-*

(i) *Performance Bond obligation be 10%;*

(ii) *Arkel International be required to give a guarantee that equipment will perform after installation.*

The above amendments were to be effected as conditions subsequent to the operational date.

2.4 The Committee noted that while the decision was being made to have Arkel proceed without the services of F. C. Schaffer, Kenya Sugar Authority became very concerned about the technical capability of the resultant dismembered Arkel. In their detailed letter Ref. No.KSA/C/67/3 dated 21st December, 1988, the KSA advised as follows:-

(a) *That a competent consulting Engineer be appointed to act as the Purchaser's representative;*

(b) *That the contractor should provide a performance guarantee Bond of 10%;*

(c) *That the output and extraction warranties be based on realistic technical parameters.*

2.5 Early in 1989 the Board of Directors of Nzoia Sugar Company rejected the appointment of the WFPU (the British engineering consulting firm) as the project engineering consultants on the grounds that the firm's prices were very high. The required appropriate engineering competence was also lacking. The Board instead approved that the Company's Engineering staff be used and that the management engage ONE consultant on advisory basis. On 22nd May, 1989, the Board of Directors advised Nzoia Management to advertise locally the requirement for the consultant and emphasized that payments would be made in Kenya shillings. In response to the advertisement, the following firms submitted their bids:-

1. *Carl Bro Kenya Ltd.*

2. *Kaburu Okello and Partners,*

3. *Apcone Industrial Consultants,*

4. *Shacko and Partners, and*

5. *G. M. Engineering Services.*

Of the five, Apcone was rated all round competitive and was awarded the consultancy. Consequently, a formal contract was signed between Apcone and Nzoia Sugar Company to formalize the latter's appointment on 5th September, 1989. The local advisory engineering Consulting firm - APCONE Industrial Consultants submitted their first Report on 20th December, 1989. In their Report, the consultant expressed their dissatisfaction with the Study conducted by Arkel with regard to some specific areas. This indicated an early signal of the emerging differences between the Purchaser's Consultant (Apcone) and the Contractors (Arkel).

2.6 Apcone's second Report was submitted in April, 1990 and covered the period 15th December, 1989 to 15th April, 1990. It reflected further continued differences between the Consultant and Contractor. The report indicated that Apcone's professional/technical criticisms were met with emotional, verbal arguments and physical threats by Arkel International as perceived and expressed by Apcone consultant. The consultant concluded his Report by suggesting that Arkel, the Contractor required more Technical staff on site for improvement of machine installation and commissioning. This was not done satisfactory. This strained relationship was continued in the Phase II Project.

TOR 3: EVENTS LEADING TO ABANDONMENT OF THE PROJECT BY ARKEL INTERNATIONAL OF UNITED STATES OF AMERICA.

3.0 TOR 3: PHASE II EXPANSION AND THE ABANDONMENT OF THE PROJECT BY ARKEL.

3.1 In February, 1989, the Ministry of Agriculture requested Arkel International Inc. to examine the possibility of expanding the factory capacity "to somewhere in the region of 6,000 to 7,000 TCD depending on the feasibility of doing so". Arkel responded and submitted the feasibility study for Phase II expansion programme in June, 1989. At the time that this Report was received, expansion to 3,000 TCD had not yet been achieved and even as at July 1991 (two years later), the project consultants still reported that the factory had attained a mere 2,400 TCD at peak levels of production. At that time (i.e. 1991), Arkel International Inc. still had a large number of faults to rectify on new equipment as stipulated in the contract agreement between Nzoia Sugar Company and Arkel. The achievement of the targeted 3,000 TCD therefore, was still hanging in the balance due to these inadequacies. This expansion to 7,000 TCD according to this Committee, appears to have been ambitious, premature, and overstretched.

3.2 The step-by-step expansion strategy of raising to 3000 TCD , then to 4000 TCD and then to 6000 TCD was abandoned and the direct expansion to 7,000 TCD was adopted. Once again without resorting to an open competitive tendering process the Government prepared to award Arkel implementation of the Phase II expansion programme as recommended in their <u>own</u> feasibility study. The Government gave its express approval for the award to Arkel on 19th July, 1990. In pursuance of this approval, the then Permanent Secretary Ministry of Agriculture conveyed approval to the Nzoia Sugar Company management to start implementing the extension programme.

In September 1990 Arkel entered into a formal contract with Nzoia Sugar Company to expand the factory capacity to 7,000 TCD at a contract value of US$66,759,900 and Kshs.203,242,320. This agreement which was referred to as Phase II factory expansion programme, was supposed to be completed by December, 1994. It should be noted that Apcone was mandated to continue its role as the purchaser's (Nzoia Sugar Company) Industrial Consultant.

3.3 Incorporated in the main contract was also the construction of the non-sugar production support facilities amounting to Kshs.102.6 million. To be constructed were staff houses, clinic, community hall and a school. Under the contract NSC was mandated to formulate specifications and subsequently identify the contractor to undertake the construction works. Contrary to this contractual provision, in September, 1991, Arkel agreed with Nzoia SC and the former appointed a contractor to carry out the works, at the negotiated cost of Kshs.72.0 million. Previous to this NSC had appointed M/s. Busuru and Partners as the Project Architectural consultant on the basis that this firm was on site.

NSC awarded it the responsibility of overseeing these construction facilities. The Committee noted that this award was not competitively done. NSC asked M/s Busuru & Partners to identify suitable construction companies and seek quotations from them. Thus the responsibility was passed over from NSC to the firm. It is worth noting that thereafter through selective quotations, M/s Shiv Contractor was awarded the contract. At the time of submitting its bids, Shiv Construction Company had quoted Kshs. 85,525,101 which was later negotiated downwards with the management and the consultant firm to Kshs. 72,200,000.00. The list of firms which had quoted were:-

NAME OF FIRM	AMOUNT(Kshs.)
1. SHIV CONSTRUCTION Co. Ltd.	85,525,101
2. ELDORET BUILDING Co.	87,495,190
3. N.K. BROTHERS & Co.	88,140,925
4. TRISHOL CONSTRUCTION Co.	89,143,200
5. JINA RAMJI CO. LTD	90,976,645

Although M/s Shiv Construction Company was the lowest, this Committee did not understand the justification or rationale for entering into negotiations to lower the price as quoted. Arising from the disagreement between M/s. Arkel International Inc., and Nzoia Sugar Company, M/s. Shiv construction Company abandoned the site in June, 1993 after they had been paid Kshs. 9,388,114. The structures remain uncompleted to date.

3.4 In 1991, the Nzoia Sugar Company management, headed by the new Chief Executive, held a meeting with Arkel and Apcone arising from which the new diffusor technology was adopted. It is pointed out that the Milling Tandem encompasses many milling rollers, mill bearings, couplings etc, while the diffusor is a simple enclosed tank used for simple extraction by diffusion, hence reducing the maintenance costs on operations.

Arising from the change of technology as stated above, Arkel submitted a variation in contract price of US$8,702,400 and Kshs. 16,845,000. This contract variation did not contain detailed component by component breakdown. Also built to this variation was a provision for contingency amounting to US $1.0 million. This Committee was not satisfactorily informed on how the amount was to be dispensed. This variation was signed by the then Chairman, Nzoia Sugar Company Mr. Fred Wafula and the then Managing Director Mr. Donie Eshitemi. This amendment which was signed before Board approval, in addition to financial implications, had far reaching technological implications as well. This concern was raised by Kenya Sugar Authority, as the technical wing of the Government, in their letter Ref.No.KSA/CONF/67/1A/62 dated 8th June, 1992. In that KSA's letter, the following issues were raised:-

(i) *The technological variation from milling tandem to diffussor must have had variance on performance guarantee parameters as given under Article No.16 of original contract. This legal aspect had not been addressed to accordingly.*

(ii) *There had been no submission of the revised equipment list to go along with the changed technology.*

(iii) *The Kenya Sugar Authority expressed their fears that the proposed improvement of the factory management through the use of expatriate staff under the Technical Management Agreement should not be construed to sideline local technical staff at the time who were performing those functions. Further more the duration of the expatriate staff should be reduced from the proposed three(3) years to upto a maximum of one (1) year.*

(iv) *The technical management assistance programme must have a definite training programme for the local counterpart.*

Available records indicate that this variation was referred to the Board for ratification. It was deferred pending provision of more detailed information from management. This was never done. Further more, the necessary Government approvals and guarantees for the additional financing were not obtained as required by law. The variation, therefore, remains unenforceable.

3.5. EVENTS LEADING TO TERMINATION

The foregoing background demonstrates that there were major issues of differences between Arkel and NSC as we start Phase II expansion. It has been observed that Arkel had been weakened by the departure of Schaffer & Associates. We have also observed that financing for the amendment was not to be forthcoming because of the lack of Parliamentary and Government approvals to finance the amendment. With this in mind, the Committee found out that the two parties could not implement Phase II of the programme.

The Committee also observed that there was a Management and Technical Assistance Agreement which was concluded in March 1992 where a team of twelve personnel had been agreed to assist in the technical Management of the Company. This was done without the prior approval of the Board and the necessary financing arrangements. The entire team was recruited from Panama and their main language of communication was Spanish. During its visit to the Company premises, this Committee was informed of the very acute confusion in communication that arose due to linguistic problems. The technical competence of the Panamanians was questionable. Upto the beginning of 1993 the controversy between Arkel International Inc. and Nzoia Sugar Company continued as to who should be responsible for meeting payments for the Management Technical Assistance (MTA) to the Company. In addition to the above, Arkel had not received part of the down payment amounting to US$6 million under the Phase II Expansion agreement. Besides this, Arkel complained that the arrears due to them from the Escrow Account was not forthcoming to fund the local construction costs. Consequently on the 5th July, 1993 Arkel served Nzoia Sugar Company with a letter to terminate the contract. This letter which reflects the climax of the conflict between the two contracting parties raised the following cardinal points which were referred to the Managing Director, Nzoia Sugar Company:-

(a) *Nzoia is in arrears of US$6 million plus interest payable under the down payment provision of the Phase II Expansion Contract.*

(b) *In addition to the above, Nzoia is in arrears in the sum of US$1,305,360 in respect of the down payment due to amendment No.1 to the contract.*

(c) *Nzoia has yet to accept (although suitable financing has been arranged and offered) the 85% financing required for amendment No.1 to the contract.*

The conclusion of this communication from Arkel International Inc. clearly stated that "In the circumstances Arkel International now has no alternative but to treat the contract as having been terminated by you as a consequence of the foregoing serious and fundamental breaches of the contract". On the 13th July, 1993 Arkel physically abandoned the site and started demobilizing. They removed from the site project construction equipment like the cranes, dumpers, welding machines, concrete mixers, transport vehicles etc. Nzoia Sugar Company through the National Bank of Kenya formally asked Exim Bank to extend a letter of credit to 30th June, 1994 and also write direct to the Exim Bank seeking extension of the letter of credit. Exim Bank through Arkel, replied that it would not extend the letter of credit because it had closed all programmes in the country.

3.6 The Permanent Secretary Treasury invited Arkel to a meeting on 26th August, 1993 with a view to resolving the issue at stake. Arkel declined to attend the meeting. On 26th August, 1993 to the Permanent Secretary, Ministry of Agriculture wrote to Arkel informing them of payments that had already been made by the Government towards down payment off arrears as follows:-

DATE	AMOUNT (IN US$)
02/08/93	500,000
09/08/93	1,000,000
12/08/93	500,000
TOTAL	2,000,000

He re-invited Arkel for a meeting in Nairobi on 9th September, 1993 "To finalize all pending issues on this contract once and for all". On 7th October, 1993, the Permanent Secretary repeated his invitation to Arkel for a meeting. Eventually a series of meetings took place from 28th October, 1993 to 11th November, 1993 when Arkel abandoned the meetings deliberations. During the meeting Arkel was represented by their lawyers Mr. Hamish Keith, Mr. Fritchie and Mr. George Knost (the son of Arkel's chairman). Consequently on 25th November, 1993 Nzoia Sugar Company sent a notice to Arkel declaring a dispute in line with the provisions of the contract which provided that where parties fail to amicably resolve any dispute, the same shall be referred to arbitration. Arkel did not react.

On 24th December, 1993, Kenya Sugar Authority wrote to Arkel inviting them to resume negotiations by 6th January, 1994. No response was received from Arkel. The Managing director, Nzoia Sugar Company wrote to Arkel on 3rd January, 1994 informing Arkel that Nzoia was prepared to perform their obligations under the contract. Arkel did not oblige. The contract required that each party would perform even when there is a dispute. On 11th January, 1994 Nzoia sugar Company wrote to Arkel expressing its disappointment at Arkel's unwillingness to discuss and find amicable solution to the issues at stake. Nzoia further gave Arkel seven (7) days to respond or else Nzoia would proceed to arbitration in accordance with the provisions in the contract. Arkel did not respond. Arkel wrote to the Ministry of Agriculture Livestock Development and Marketing on 18th January, 1994 expressing doubt on the success of the negotiations and instead proposed meeting in London. On 21st January, 1994 Nzoia gave Arkel a formal notice of arbitration as required.

No response was received from Arkel. Consequently, on 9th March, 1994, as required by law Nzoia Sugar Company cancelled the contract pursuant to article 29.7 of the contract on the grounds that Arkel had abandoned the site when the contract required parties to continue performance during the arbitration process. Arkel acknowledged receipt of the cancellation on 15th May, 1994. It is pointed out that at the time, the position regarding the claim by Arkel was US $ 6,987,093 and Kshs. 10,862,505.00 which was alleged to be in respect of the following:-

	US $
(i) Unpaid down payment	4,000,000
(ii) Interest on unpaid down payment	1,436,208
(iii) Unpaid amount on invoices from EXIM Bank L.C	245,525
(iv) Amendment No 1. down payment	1,305,360
Total US $	**6,987,093**
(v) Unpaid amount due on Construction work	Kshs 10,862,505

3.7 On 3rd May, 1994, Arkel wrote to the Kenya Sugar Authority suggesting a meeting in London between one (1) Government and one (1) Arkel representative. On 25th May, 1994, Nzoia Sugar Company engaged Freshfields Advocates of Paris to handle the arbitration matters on their behalf. On 13th July, 1994, a detailed notice of Arbitration was served on Arkel. As the arbitration process was going on, at the request of the United States Government through its Embassy in Nairobi and the Government of Kenya, the two parties agreed to settle the issues out of the Judicial system as follows:-

(a) *That Arkel has agreed to release to Nzoia all the equipment on site to enable Nzoia contract with any other contractor to complete the project on receipt of 1st instalment of what is due to them.*

(b) *That Arkel has agreed to surrender the equipment at H. Young to the latter on condition that H. Young agreed to release same to Nzoia upon Nzoia paying the balance of the price.*

(c) *That Arkel will assist Nzoia trace and recover all equipment for which part payment had been made and assist in the release once the balance of the price is paid.*

(d) *That Nzoia will pay Arkel the outstanding down payment of US$4 million.*

(e) *That Arkel agrees in the spirit of compromise to accept US$1 million as interest in lieu of US$1,550,000 ; and*

(f) *That Arkel agrees to reimburse Nzoia Kshs. 16.7 million previously over paid.*

3.8 The decision to attempt an out of arbitration settlement was based on the following considerations;-

(a) *Nzoia chances of succeeding in the arbitration was no more that 50 % as advised by the Paris lawyers retained by Nzoia Sugar Company;*

(b) *The cost of financing the arbitration was highly prohibitive given Nzoia Sugar Company's cash flow constraints; and,*

(c) *Nzoia Sugar Company would never have access to the equipment on site until the arbitration process was over.*

At the time of this Report an out of arbitration settlement agreement had been signed between Nzoia Sugar Company and Arkel specifying, inter alia;-

(i) That Arkel would be paid US$ 5.0 million representing the outstanding US$ 4.0 million, interest thereon and all other claims raised under the MTA;

(ii) That as a result thereof, Arkel was to release the entire equipment for Phase II to Nzoia Sugar Company; and,

(iii) That Arkel pays Nzoia Sugar Company an amount of Kshs. 16.7 million which was an over payment on local costs.

Although it was a term of the agreement that US$ 5.0 million would be paid in two installments (at the end of July and at the end of October, 1995), Nzoia Sugar Company had not by the 14th of September, 1995 paid the first installment.

It was the understanding of the negotiating Committee that the funds to pay Arkel would be made available by the Kenya Government. The consequences of continued breach by Nzoia Sugar Company are grave to the Company.

TOR 4 SUGGEST WAYS OF COMPLETING THE REHABILITATION AND EXPANSION FROM 3000 TCD TO 7000 TCD.

4.0 TOR 4: SUGGESTIONS ON COMPLETION OF PHASE II

4.1 The historical problems in NSC's factory, some of which are the technical parameters which were raised by the project consultant (Apcone) were not achieved even at the time Arkel abandoned the project. A successful Rehabilitation and Expansion programme should therefore be started somewhere between the end of Phase I and the beginning of Phase II. The first step in this regard is to ensure that a sustained output of 3,000 TCD is achieved. The current machinery and equipment will need a thorough overhaul in the factory maintenance programme and, where necessary, to procure and instal standby units. These will form the initial basis for further expansion. When this is done, the installation of the equipment supplied under Phase II project should commence. However, an independent firm should be contracted to verify the equipment on site and that which is yet to be delivered.

4.2 In view of the doubts cast on the benefits of the diffusor technology, the verifiers should additionally be requested to give professional advice on the adoption of this technology vis-a-vis the conventional milling tandem. It is recommended that this verification be undertaken under an open competitive and transparent tendering system for further factory expansion. With the resultant verification it will therefore be clear whether or not there will be need for supplementary equipment and machinery for further expansion to the targeted 7,000 TCD. It is the view of this Committee that in order to avoid the pitfalls of the past, the tendering for the installations as recommended in verification Report should be done separately and again through international competitive bidding system. This will ensure that the first contract on verification will be completely divorced from the second contract on actual installation and commissioning and thus safe-guarding the conflict of interests.

TOR 5: LOOK INTO WAYS OF INCREASED SUGAR CANE DEVELOPMENT AS RAW MATERIAL TO COPE WITH THE EXPANDED CAPACITY OF THE FACTORY.

5.0 TOR 5: PROPOSED SUGAR CANE DEVELOPMENT PROGRAMME

5.1 At the time of compiling this Report, the area under cane was 17,000 Ha of which 14,000 Ha were in the outgrower's zone and 3,000 Ha in the Company's Nucleus Estate. Assuming an average sugarcane yield of 70 tons/ha, about 28,000 hectares of cane will be needed by the Company to be able to have enough cane to operate at 7,000 TCD continuously for about 260 days per annum. This demand will require additional land development of about 11,000 hectares. During its visit to Bungoma District, the Committee was assured that there is enough additional land to meet this requirement. To realize this overall development programme, attention must be given to the procurement of agricultural equipment. However the Committee observed that under Phase I and II, the management in 1990/91 decided to procure agricultural equipment which the Committee finds absolutely inappropriate. Vanguard tractor and trailer units manufactured in the United States of America, were delivered to the factory without considering the following factors:-

(i) *The Tractor/Trailer Unit weight of about 14 tons (without cane load of about 10 tons) was absolutely incompatible with the type and size of feeder road in Nzoia. Their usage resulted in actual destruction of these roads.*

(ii) *The machinery cannot be used to haul cane across the existing small narrow bridges;*

(iii) *Due to factors (i) and (ii) above, the machinery's usefulness in hauling cane from the interior cane fields is hampered. This has led to under-utilization of the machinery.*

(iv) *The Vanguard tractors have a gear system which is electronic, as opposed to the conventional mechanical gear system. There are no trained mechanics to handle this. Spare parts are not available locally. The unit price of the electronic gear system as quoted recently, ex-USA, is Kshs. 400,000.*

(v) *The back-up service is non-existent as there are no local agents in Kenya. As a result minor mechanical and electronic faults are not attended to, hence the majority of the Vanguard tractors are now lying idle at the factory/agricultural machinery yard.*

(vi) *The weigh-bridge could not accommodate the Vanguard tractors/Trailers owing to their huge size. This caused additional expenditure in expanding the weigh-bridge.*

(vii) *Training of the local members of staff to operate the tractors was altogether overlooked.*

All these factors render this equipment mechanically inappropriate, and financially and economically unviable. The Committee was not surprised therefore that previous efforts to dispose of some of the units on-as-is-basis proved futile.

5.2 While taking cognisance of the above, the Committee strongly recommends that, in order to avoid repetition of the past mistakes, it is imperative that appropriate agricultural machinery and equipment with tested and proven performance in our local environment are procured for the completion of the project. In addition to the aforegoing, the necessary development of the support infrastructure, including improvement of the existing road network will have to be undertaken in addition to the creation of new bridges etc. This will further entail improvement of research on overall cane development. During this Committee's interaction with Government officers and outgrowers representatives in the District, it was clear that farmers were very enthusiastic to grow more cane if only the right signals are given. In view of the substantial amount of land to be put under cultivation, it is necessary that farmers' credit facilities should be enhanced. This may be achieved through the Sugar Development Fund or any other sources considered more appropriate. The Committee feels that the expansion of the factory capacity through a rehabilitated and expanded programme as discussed under TOR 4 above must be appropriately and timely synchronized with the cane availability. This is important to avoid a situation where the factory has the capacity without the corresponding raw materials and vice-versa as has been experienced in the past.

In conclusion, therefore, the Committee is of the strong view that the three major factors i.e cane availability, cane haulage with the necessary infrastructure and the factory's technological capacity must be handled concurrently and be conceived as one complete package.

TOR 6: INVESTIGATE DELAYS IN PAYMENTS TO FARMERS AND HOW TO SOLVE THE MATTER IN LINE WITH THE CONTRACTUAL UNDERTAKINGS.

6.0 TOR 6: DELAYED PAYMENTS TO FARMERS

6.1 The factory from its inception has had varied operational and financial problems. These have led to production below the break-even-point. As a result, this has affected revenue realization. The debt situation of the Company from inception has made it difficult for the Company to operate profitably consequently, the Company's management has had problems in adequately meeting expenditure commitments as they fall due. Payment to farmers is a competing item in the allocation of the inadequate cashflow of the Company. The Committee noted that there appeared to be less priority attached to payments to cane farmers as compared to payments in favour of other commitments. The comparative value of sugar sales visa-vis the cane cost reflects such a poor overall performance that it will need a complete operational overhaul for the Company to be able to service farmers' debt promptly. For example, in 1993/94, the net sales of sugar amounted to Kshs. 695,328,136 while the cost of sugar cane alone used was Kshs. 460,521,484. With this scenario, it is obviously difficult to meet the farmers' obligations especially when other demands on the cash available have also to be met.

6.2 As at 30th June, 1995, the outstanding debt due to farmers was Kshs. 296.9 million - and this dates back to July 1994. The contract between the cane outgrowers and NSC stipulates among other things that a farmer has to be paid for his cane within 30 days after harvest. This, therefore, shows very clearly that the Company is in perpetual breach of its contractual obligations to the outgrowers.

6.3 Having appreciated the totality of the problems facing this Company, the Committee is of the view that payments to farmers cannot be handled singularly. This serious problem must be addressed to within the wider context of the total improved factory operations, financial management and restructuring of the Company.

TOR 7: SUGGEST WAYS OF RESTRUCTURING THE FINANCIAL POSITION OF THE COMPANY PARTICULARLY IN REGARD TO THE LOANS PORTFOLIO.

7.0: TOR 7: FINANCIAL RESTRUCTURING OF THE COMPANY

7.1 Nzoia Sugar Company is currently insolvent in that the Company is completely unable to meet its financial obligations as they fall due. Current liabilities completely out weigh current assets and the Company has made losses year after year since inception. Current accumulated losses have soared to Kshs. 3.5 billion (as at 31st March, 1995), consequently, these losses have completely wiped out the shareholders' funds resulting in a negative position of Kshs. 2.6 billion. The Company's long term loans and accrued interest have reached Kshs. 6.64 billion. The overdraft with the National Bank of Kenya has reached Kshs. 753 million. This level of overdraft is excessive given the overall poor performance of the Company. The project was financed with too much debt and little injection of equity which led to the poor gearing of the project in the initial stage. Currently, the Company's gearing ratio is beyond the acceptable commercial limits. In addition to this, dues to creditors including cane farmers have reached Kshs. 634.3 million. Of these, farmers are owed Kshs. 296.9 million in arrears dating as far back as July,1994.

7.2 The Committee noted that the situation has been addressed by the Government over the years without reaching a satisfactory conclusion. As at 22nd August, 1994 it was considered by the Government that the financial restructuring of the Company may not be meaningful due to the uncertainties surrounding the future of the Company's expansion programme. Instead, privatization of the whole sugar industry (Nzoia Sugar Company included) was considered by the Government. This, notwithstanding, the Committee is of the view that Nzoia Sugar Company's performance calls for the financial restructuring of the Company and render it ultimately a viable enterprise.

7.3 Overall, Nzoia Sugar Company plays a very important socio-economic role in terms of:-

(a) Rural industrialization

(b) Employment creation

(c) Income generation

(d) Improvement of the living standards of the area

(e) Improvement of health and education standards and facilities

(f) Injection of cash into the economy

(g) Contribution to the Exchequer in the form of duties and taxes.

In terms of public investments, Nzoia Sugar Company is among the leading enterprises in Western Province and its consequential political dimensions cannot therefore be overlooked. Considering the agronomic and climatic advantages of the area in terms of sugarcane growing, Nzoia sugar zone is rated the best in the whole country. It is inconceivable, therefore, that such a well endowed enterprise can be abandoned altogether for anything else. The Committee cannot visualize any better alternative enterprise. It should not be forgotten that in Kenya in 1995 the estimated consumption of sugar is in the region of 580,000 MT per annum against the estimated production of about 400,000 MT per annum, leaving a deficit of 180,000 MT. At current prices, in order to meet the shortfall, the country is losing the scarce foreign exchange to the tune of Kshs. 6.12 billion per annum to import sugar.

7.4 The Associated Sugar Company, Ramisi of the Coast Province, was closed in April, 1988. Experience shows that such collapse of a rural enterprise has adverse socio-economic and socio-political consequences and any repeat of such abandonment should be avoided at all costs. It is a well known fact that there is a great public demand that the factory (Ramisi) be revived. With the increasing population and the consequential rise in demand for sugar consumption therefore, priority should be given to the improvement of the existing sugar industrial enterprises. Towards this goal, the survival of Nzoia Sugar Company must be accorded top priority, for the current and future generations.

7.5 There are four (4) critical areas which must be addressed to bring Nzoia Sugar Company to a viable commercial level of operation. These include:-

(a) *Working capital,*

(b) *Cane development,*

(c) *Factory rehabilitation and expansion, and*

(d) *Loans portfolio.*

7.5.1 WORKING CAPITAL

The unaudited Company's balance sheet as at 2nd April, 1995 shows a negative working capital to the tune of Kshs. 3,340,531,567. Obviously this magnitude of negative working capital must be corrected. The Committee therefore proposes that there should be an increase in the authorized share capital from the existing Kshs. 600 million to adequate levels to be subsequently determined in order to generate the needed working capital. This should be subscribed over a reasonable period of time. The Committee also observed that the current authorized share capital amounts to Kshs. 600 million out of which only Kshs. 532 million have been paid up leaving a balance of

Kshs. 68 million as unpaid share capital by the Government. There is therefore urgent need for the Government to pay up the outstanding call-up share subscription.

In view of the current Government policy of divestiture as stated in the Policy Framework Paper of 1992 and revised in October, 1994, it is not feasible that the Government will continue to be the effective majority shareholder. Consequently, this Committee is of the view that the Government should in the first instance, intervene and facilitate the urgently required cleaning-up of the Company's balance sheet to make it a bankable document. Along these lines, the Government should continue its equity participation and inject the necessary working capital as already recommended and address itself positively to the current loans' burden. At the same time the Government should consider inviting local and off-shore equity participants after this clean up exercise. It is the view of this Committee that implementation of the above proposals will be in the right direction towards realization of the long term policy goal of privatization of the Company.

7.5.2 CANE DEVELOPMENT

The detailed aspects of cane development have already been discussed under TOR NO.5. With regard to the necessary financial requirements, it will be necessary to provide, at current prices, funding for:-

(i) *Cane development at the cost of Kshs. 165 million per annum for the next 3 successive years totaling to Kshs. 495. Million. These funds are expected to develop an additional 11,000 Ha of cane which will yield adequate cane to supply the expanded factory's capacity up to 7,000 TCD.*

(ii) *Agricultural equipment for both land development and cane haulage at the cost of Kshs. 99 million per annum spread over the next 3 successive years (amounting to Kshs. 297 million).*

(iii) *Road improvements and the associated infrastructure at the estimated cost of Kshs. 12 million per annum for the next 3 successive years totaling to Kshs. 36 million.*

In total, it is initially estimated that Kshs. 828 million would be required for cane development to match up the envisaged expansion of the factory's capacity upto 7,000 TCD.

7.5.3 FACTORY REHABILITATION AND EXPANSION

For the factory rehabilitation and expansion, it will be prudent to acquire the services of competent engineering consultants to verify and determine the necessary estimated cost for completion of the rehabilitation and expansion to the expected factory capacity. The Committee is least qualified to cost this area however, at the moment, it is estimated by NSC that this would cost about Kshs. 1.012 billion.

7.5.4 LOAN PORTFOLIO

The Committee noted that the Company is heavily indebted both internally and externally as follows:-

(i) Long term loans Kshs. 6.54 billion

(ii) Bank Overdraft Kshs. 0.175 billion

(iii) Other creditors including cane farmers, Kshs. 0.634 billion.

These total to Kshs. 7.35 billion on loan portfolio. Of the long-term loans i.e (i) above the details are as follows:-

INTERNATIONAL LENDERS (Kshs.)			
LENDER	**PRINCIPAL SUM**	**INTEREST ACCRUED**	**TOTAL (KSH)**
1. EXIM BANK (PHASE 1 &II)	3,231,543,057	421,904,015	3,653,447,072
2. OPEC	17,109,358	12,603,885	29,713,243
3. EADB	179,737,461	61,710,716	241,448,177
SUB TOTAL	**3,428,389,876**	**496,218,616**	**3,924,608,492**
LOCAL LENDERS (Kshs.)			
LENDER	**PRINCIPAL SUM**	**INTEREST**	**TOTAL LOAN**
1. NBK	121,258,157	-	121,258,157
2. IDB	15,088,266	1,626,521	16,714,787
3. MoF	1,451,707,185	339,078,869	1,790,786,054
4. MoA	170,482,657	90,124,168	260,606,825
5. PBC	178,152,185	179,291,586	357,443,771
6. KSA (SDF)	141,500,000	33,000,000	174,500,000
SUB TOTAL	**2,078,188,450**	**643,121,144**	**2,721,309,594**
GRAND TOTAL		***6,645,918,086***	

(ii) The overdraft of Kshs. 0.753 billion includes NBK's compounding of its other loans to NSC to the overdraft account of the Company. The authorized Bank overdraft of the Company currently stands at Kshs. 175.5 million. Efforts are being made by the Company to convert the overdraft due to NBK to long term loan.

(iii) **OTHER CREDITORS (INCLUDING CANE FARMERS)**

CREDITORS	Kshs.
NOCO (farmers)	296,865,316
Trade Creditors	161,307,335
Statutory Deductions	163,272,858
Others	12,806,550
SUB TOTAL	634,252,059

After examining the current position of the loans, this Committee recommends as follows:-

(i) All International loans be taken over by the Government.

(ii) All local Bank loans (NBK, IDB) be taken over by the Government.

(iii) Government cash injection and loan serviced through Ministries of Finance and Agriculture be written off. The full amount as at mid 1995, being Kshs. 1,712,392,879.

(iv) The farmers' arrears of Kshs. 296,865,316, the Post Bank Credit loan of Kshs. 178,152,185 and the SDF (KSA) loan of Kshs. 174,500,000) all totaling to Kshs. 649,517,501 to be met by NSC.

On the authorized Bank overdraft of Kshs. 175.5 million in addition to the other compounded loans from the NBK, the Committee recommends that these be taken over by the Government. As already explained, the excess should be appropriately reflected under local loans portfolio. This Committee strongly recommends that urgent action by the Government on these proposals be taken to stem escalation of the banks' interest.

TOR 8: INVESTIGATE THE FINANCIAL MISMANAGEMENT OF THE COMPANY WITH A VIEW TO INSTITUTING IMMEDIATE PROSECUTION AND RECOVERY OF THE MONEY. THIS IS PARTICULARLY IN RELATION TO PHASE I AND II FACTORY REHABILITATION AND EXPANSION.

8.0 TOR 8: FINANCIAL MISMANAGEMENT

8.1 The Committee having scrutinized all the evidence available found this TOR difficult and delicate to handle. In order for prosecution to be contemplated, the element of criminality must be established. Management decisions which may appear to be wrong might not necessarily be criminal. In order to pin down an individual for prosecution, it is important to establish that the elements of a specific criminal offense exist. As already explained in previous paragraphs, Nzoia Sugar Company in itself acted as an end receiver of instructions from authorities external to itself. It is evident that key Government institutions were involved in the conceptualization and implementation of phases I & II Rehabilitation and expansions of Nzoia Sugar Company. Initially NSC referred its matters to the parent Ministry (Ministry of Agriculture). The Ministry of Agriculture referred matters of policy nature to the Office of the President, matters of financial nature to the Treasury and matters pertaining to legal aspects to the office of the Attorney-General.

8.2 In most cases, this Committee was satisfied that the channelling of all matters relating to phases I and II Rehabilitation and expansion were appropriately adhered to by the Company. However, notwithstanding the above, there are certain matters that appear to have been done without recourse to the established procedures. On these matters, the Committee wishes to comment as follows:-

(i) *The Phase I Contract was signed by the pertinent parties before getting the necessary legal advice from the A-G.). This is an obvious anomaly but it appears possible that the necessary consultations within Government were done.*

(ii) *The Phase I contract was signed before the capacity to raise the 15% down payment was confirmed. This led to a 16-month delay giving rise to escalation of the original project cost. (see para.1.9). This Committee feels that the Government machinery should have been more cautious.*

iii) *The then Chairman and the Managing Director of the Company signed a contract variation price (TOR 3, para. 3.4) of US$ 8,702,400 and Kshs. 16,845,000 without the necessary Government approvals. However when Mr. Eshitemi appeared before this Committee, he alleged that he had been directed to sign the the document by the Government. However no documentary evidence was availed to this Committee in support of this allegation. When summoned to appear before the Committee, the former Chairman Mr. Fredrick Wafula did not oblige. The Committee was not therefore able to receive comments on this matter from him.*

During his tenure of office the then Chairman failed to regularize his earlier signing of the contract price variation possibly to cover his exposure to scrutiny. Later in November 1994, Mr. Fredrick Wafula swore an affidavit in support of Arkel and to discredit NSC and the Kenya Government. By inference therefore, *the Committee is of the view that Mr. Wafula acted with fraudulent intentions.*

(iv) *The procurement of the agricultural machinery was definitely improper and unsuitable for the purpose. When he appeared before this Committee, Mr. F.T. Wabuke the then MD confirmed that he had personally visited the USA for the purpose of ascertaining the suitability of the machinery. The Contract specifications with regard to the Horse Power was between 75 HP and 100 HP. Contrary to this Mr. Wabuke (who was responsible for Phase I implementation) placed an order leading to subsequent delivery of tractors of 146 HP whose unsuitability has already been discussed (see para. 5.1). Despite this unsuitability, the Company insisted on a re-order of similar machinery in Phase II expansion programme.*

Mr. D.S. Eshitemi (who was responsible for Phase II implementation) appeared before the Committee and indicated that he saw nothing wrong with the tractors but denied having placed any order during the Phase II Expansion Programme. This Committee is of the view that the procurement of the tractors and their implements was improper. Both former Managing Directors failed to give this matter the necessary professional attention which it merited. They are, therefore, personally responsible for the resultant financial losses.

(v) *During the early stages of the Phase I implementation, Arkel prepared an invoice for US$ 675,084 for spare parts whose details were not submitted. The Managing Director declined to process the invoice contrary to instructions from the Chairman Mr. F. Wafula. Mr. Wabuke told this Committee that this was one of the reasons that led to his transfer from NSC to Mumias Sugar Company. The chairman ensured that invoices were promptly paid by the incoming MD. Both the spare parts and their records have not been produced for verification by the Committee. When Mr. Eshitemi appeared before this Committee, he stated that he could not recollect the pertinent details over this issue. This Committee recommends immediate police investigations with a view to ascertaining the truth of the matter and thereafter take the necessary action within the Law.*

(vi) *In 1994, the Public Investment Committee observed that as per the contract for phase II project between Arkel and NSC, an escrow account was opened with a local bank and credited with Kshs. 19.2 million. It was not clear to this committee as to how much money passed through this account. Although the NSC management jointly with Arkel was a signatory to this account, the details regarding the transactions of this account would appear to have remained unknown to them. As the P.I.C. noted during its sitting in 1994, M/s Busuru Consulting firm were paid Kshs. 7.0 million. The fee note against which this payment was made was not supported by the necessary certificate of completion at that stage. The PIC instructed the Chief Executive, NSC to submit all the necessary documents on the matter to the Auditor-General (Corporations) by 5th*

November, 1994. By the time of compiling this report the IMC was informed that this information had not been provided to the Office of the Auditor-General (Corporations)

(vii) *On 13th January 1993 Nzoia Sugar Company applied for a loan of Kshs. 230 Million to finance expansion operation of the Company from the Post Bank Credit. On 13th March 1993 a formal agreement was signed between the Company and the Post Bank Credit for Kshs. 300 Million. On 25th January 1993, Treasury issued a letter of awareness to Post Bank Credit giving "Treasury no objection" for the sum of Kshs. 230 million on terms and conditions agreed between the bank and the NSC. Todate bank statements available indicate that the Company has withdrawn Kshs. 178,835,804.85. The following payments were made prior to signing of the agreement:-*

Date	*Cheque No.*	*Amount (Kshs.)*
19/02/93	*181801*	*10,000,000*
25/02/93	*181802*	*10,000,000*
22/03/93	*(Direct Transfer)*	*12,402,525.60*

The first two cheques were in favour of Post Bank Credit while the Direct Transfer was in favour of Wambugu & Co. Advocates as legal fees.

After signing the agreement, the following payments were made:-

Date	*Cheque No.*	*Amount (Kshs.)*	
22/03/93	*803*	*20,000,000*	
26/03/93	*804*	*40,000,000*	
01/04/93	*805*	*50,000,000*	
15/04/93	*806*	*30,000,000*	
18/05/93	*807*		*cancelled*
18/05/93	*808*		*cancelled but cheque leaf missing.*
19/05/93	*809*	*57,470,289**	

** not in Bank statement*

Cheque No.181808 for Kshs. 57,470,289 payable to Arkel/NSC Escrow Account of Barclays Bank does not appear in the Bank Statement and the cheque leaf is *missing. Cheque No.181809 of a similar amount is missing from the statement and the cheque leaf is also missing from the cheque book. Except for cheque No.181804 paid to Arkel, the other cheques according to information available from the counter-foils were paid to Post Bank Credit. The Committee was unable to establish the rationale behind this mode of payment.*

The Committee observed that both former Chief Executives of Nzoia Sugar Company (Mr. Wabuke and Mr. Eshitemi) including the acting Financial Controller appeared reluctant to give information regarding this Account. Given the nature of handling of this Bank account, the Committee is of the view that the matter should be handed over to the Police for further investigations.

The Committee recommends that:-

(a) Police investigations be instituted in matters set out in paragraphs (iii), (v), (vi) and (vii)

(b) That the officials involved in the financial losses set out in paragraph (iv) herein be surcharged.

TOR 9: INVESTIGATE THE CONTRACT VARIATION PRICE OF US$8,702,400 AND KSHS.18,000,000 WHICH WAS DONE WITHOUT BOARD OF DIRECTOR'S APPROVAL.

9.0 TOR 9: VARIATION OF PHASE II CONTRACT PRICE

9.1 TOR 9: is appropriately covered under TOR 3: (Para 3.4) of this Report.

TOR 10: LOOK INTO ANY OTHER MATTERS THAT MIGHT HAVE CAUSED FINANCIAL AND ADMINISTRATION PROBLEMS FACING NZOIA SUGAR COMPANY.

10.0 TOR 10: ANY OTHER FACTORS THAT HAVE CAUSED FINANCIAL AND MANAGEMENT PROBLEMS

10.1 NSC has faced a multiplicity of problems since inception which may be classified as follows:-

(a) Problems that are external to the Company, and

(b) Problems that are internal to the Company itself.

10.1.1 External Factors

(i) NSC was conceived as a purely commercial Public Enterprise but was by and large supervised by various Government institutions. Unlike a typical Public limited liability Company it has had to contend with typical Government bureaucracies.

(ii) There has been high turnover of the Chairmen, the Chief Executives and the Directors to the detriment of the management of the Company. In most cases on their first appointment these persons have not had any requisite experience and qualifications in the sugar industry. They are also not retained long enough after gaining experience to serve the Company.

(iii) The Permanent Secretaries who are the substantive Directors have delegated their responsibilities to their junior staff who may not be in a position to effectively articulate policy issues. These officers are also frequently changed. This Committee recommend that the Permanent Secretaries do attend in person Board meetings at least twice a year.

(iv) Certain technical and administrative officers with known poor past performance in public enterprises have been recycled and imposed on sugar companies instead of being laid off altogether. This compounds the culture of bad management in addition to demotivating the existing staff. Nzoia Sugar Company has its unfair share of these postings in the departments of finance, factory management and general administration. This scenario needs to be reviewed.

(v) The Company has employed excess staff who are of dubious credentials because of political and other connections. There is currently excess establishment which is above the approved levels and this burdens the Company's payroll. Sometimes these employees have joined the Company with salaries personal to themselves which they would not have otherwise merited.

(vi) Installed machinery and equipment have been sourced from various countries and have not been technically synchronized. Procurement of spare parts have been a consequential problem.

(vii) NCS is currently placed in Category C of the State Parastatals. This does not augur well for the recruitment of properly qualified staff at senior cadres. Subject to ability to pay this Committee recommends enhancement in status with regard to the categorization of the Company so as to attract well qualified personnel.

10.1.2 **<u>Internal Factors</u>**

(i) There is on the whole no teamwork spirit among the managers as each manager appears to operate on his own. The Committee observed through interviews the tendency for struggle for recognition and direct personal gain in the handling of the Company resources.

(ii) There is a general care-free attitude in the commitment of huge sums of money without recourse to rigid procedures. This mental attitude of "I can get away with it" has resulted in misplacement and misuse of the Company resources.

(iii) Un-coordinated and inconsistent supply of cane to the factory leading to shortages of cane in some periods and excess in others.

(iv) In the factory, technical flows have led to periodical breakdowns reducing the efficiency of the factory performance.

(v) Poor procurement procedures have led to the procurement of machinery, delayed delivery of critical spares and purchasing of unnecessary parts. The Company has no tendering procedures in place. This Committee recommends complete compliance with procedures in place.

(vi) Foreign spare parts have been procured under direct source from one local Company called Thermis of Nairobi acting on behalf of its overseas principal (FCB). When the Company's financial position improves, this Committee recommends that procurement through this same local agent be discontinued. This is because of the possibility of abuse in the absence of competitiveness in procurement.

(vii) The responsibilities of the Chairman vis-avis those of the Chief Executive appear to have been a cause of conflict due to misperception of their individual roles. When these conflicts become evident, the Committee recommends prompt Government decision to separate the two.

(viii) It is evident that some chief executives have withheld information to the Board of Directors and vice versa. This Committee recommends a more dedicated commitment, increased thoroughness in analysis of issues, transparency and accountability in the dispensation of all Board matters. The Committee further recommends the need to expand the Board of Directors to include farmers' representation to the Board after restructuring the Company.

(ix) The Company lacks a training programme for its staff. This coupled with lack of a clear cut manpower development programme has led to frustration of some staff and has resulted in high turnover of technical staff.

(x) Recruitment of most employees is localized . Poor management techniques and bad inter personal relationships have come into play, and have created pettiness among staff and grouping loyalties towards individual key people in the Company. This Committee recommends a review in the recruitment policy and any other necessary adjustments to give this Company a national outlook.

(xi) Failure by the Company to remit as necessary statutory deductions against staff salaries have led to low morale among the staff.

(xii) The relationship between farmers and the Company has been strained through the latter not remitting some of the deductions from cane proceeds e.g. farmers credit cooperatives deductions.

(xiii) The Mollases produced by the Company has not been adequately quantified prior to marketing. The value of the sales of this by-product has remained questionable upto date. This Committee recommends putting in place the necessary control mechanisms to ensure proper accountability.

(xiv) Diffusor was originally in use for beet sugar extraction. Cane diffussor technology is commonly in use in South Africa but it is understood that in India it has not been well adopted. Further more, the cane diffussor technology has not been known to be in use in the United States and, therefore, Arkel International had no technical knowhow on the diffusors construction/operations. Under the future Phase II expansion programme, this matter should be handled carefully.