Guidance Note: Metro preparations for the introduction of trading services infrastructure financing reforms, starting in 2024/25 with water and sanitation.

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Title:	**GUIDANCE NOTE: METRO PREPARATIONS FOR THE INTRODUCTION OF TRADING SERVICES INFRASTRUCTURE FINANCING REFORMS, STARTING IN 2024/25 WITH WATER AND SANITATION**
Purpose:	To provide guidance to metropolitan municipalities preparing for the introduction for trading services (starting in 2024/25 with water & sanitation) of a performance-based incentive grant component of the Urban Sector Development Grant, as set out in the Division of Revenue Bill, 2024, page 232, with reference to allocations set out in Schedule 4, Part B, page 44.
Target audience:	Metro officials responsible for city management, trading services and shared services management (engineering, financial and administrative)
To be read together with:	• Division of Revenue Bill, 2024 (as published in GG No. 50099 on 8th February 2024); • Explanatory Memorandum, Annexure W1, p108 (Urban Settlements Development Grant), p121 (improving efficiency of urban utility services); • USDG framework, p231 (infrastructure financing reforms); • Schedule 4, Part B, p44 (USDG allocations); and • Resource document A: Developing and implementing municipal water business turnaround strategies.

1. Introduction and background:

1.1 The Explanatory Memorandum (Annexure W1, p121) for the Division of Revenue Bill, 2024 indicates an intention to explore the introduction into the USDG of a performance-based incentive grant component for trading services, starting in 2025/26 with water and sanitation services, and rolled out to other trading services in subsequent financial years.

1.2 The USDG framework on page 232, under the heading Water Financing Component indicates that to qualify for the incentive grant component: (metro) municipalities must submit the following to the Transferring Office and the National Treasury:

- A council approved water turnaround strategy by **31 July 2024**;
- A roadmap on institutional reforms for improved management and governance by **30 September 2024**; and
- A water and sanitation business and investment plan that is consistent with the water services development plan by **30 September 2024**.

1.3 The purpose of this Guidance Note is to assist Accounting Officers to prepare this documentation by elaborating on their rationale and purpose, indicating what will be sufficient for the metro to qualify for the incentive grant component, how they will be assessed, and overall timeframes.

2. Scope and application:

2.1 Trading services are services for which consumption charges are levied and determined with the intention to make a surplus (profit) on the delivery of the services[1].

2.2 The surplus (after maintenance costs) is required to provide firstly, for capital investments and other business improvements, calculated the long-term viability; and secondly, for contributions to the rates and general account. The primary source of metro capital funding are the surpluses (profits) of metro trading services, and/ or metro property taxes. The USDG is only supplementary.

2.3 Trading services are services for which service charges are levied[2]: water and sanitation, electricity, solid waste management. The charges are based on consumption (in the case of electricity and water); or approximations or proxies in the case of sanitation and solid waste.

2.4 Among metro municipalities, trading services have varying functional scopes: in water, sometimes including water resources as well as reticulation; and in electricity, increasingly having to include generation as well as distribution.

2.5 Institutional forms and vehicles of delivery also vary: in most cases the services are provided by departments/ directorates, but other models include municipal-owned entities[3], internal business units[4], and distributed functionality. Sanitation/ wastewater is usually though not always managed with water services.

2.6 The fundamental long-term objective of a municipal trading service is to sustainably provide universal access to essential services. This is critical for the social and economic development of the people, businesses and institutions of the city, including its city government.

2.7 Unlike for other municipal services, the most important source of trading service revenues are their own service charges, which should in principle be set and managed to make a surplus. The particular importance of trading services is that in metropolitan areas, especially in water and sanitation and in electricity distribution, trading surpluses should be able to generate real (cash) operating surpluses to fund their own capital and maintenance spending; and thereafter potentially also contribute to the cost of other municipal services.

2.8 The extent to which this is in fact achievable will of course vary by service and by metro. Trading service surpluses depends on factors such as management efficiency (cost of services provided, affordability of tariffs charged; collection efficiency, etc); the need for medium- and long-term investments (and the cost of capital); the profile of commercial, institutional, and household consumers (and the scale and efficacy of service subsidies provided); the state of the local economy, etc. Electricity and water trading services have traditionally been more able to generate surpluses than solid waste; and metros with larger city economies, and with more commercial and affluent households should be better able to generate surpluses than metros with weaker city economies and relatively less affluent consumers.

2.9 Nevertheless, the starting point must be that trading services in metro areas are expected to be sustainable based on their own service charges. They should not in the first instance assume that they can rely upon property tax revenues to achieve sustainability. Furthermore, even smaller metros with relatively weaker customer bases can and should, in the name of sustainable universal service access, be seeking to generate surpluses by better management of service delivery, cost containment, billing and collection, and maintenance and investment.

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[1] For example, see https://commons.laws.africa/akn/za-wc015/act/by-law/2015/tariff/eng@2015-06-12.pdf or https://archive.opengazettes.org.za/archive/ZA-EC/2017/provincial-gazette-ZA-EC-vol-24-no-3859-dated-2017-06-12.pdf

[2] Municipal gas services and fresh produce markets are examples of services for which similar principles apply: these are not the subject of the current reforms.

[3] Examples of municipal-owned entities include CP, JW, and CENTLEC and ERWAT (only for wastewater)

[4] eThekwini W&S was once an example of an internal business unit, though no longer.

2.10 The reforms will therefore ultimately be applicable to all metro trading services. Qualifying trading services will have access to the performance-based incentive grant component of the USDG, and associated funding.

2.11 The reforms will start in water and sanitation, and only metro water and sanitation units must generate strategies, roadmaps and plans (in municipal 2024/25), to be eligible to participate in incentive grant funds to be allocated for the (municipal) 2025/26 financial year.

2.12 The reforms will thereafter be systematically rolled out to electricity and to solid waste management.

3. Rationale and purpose:

3.1 It is well-established that widespread and long-term under-investment in metro bulk infrastructure[5] has been associated with declining service delivery and financial performance of trading services[6], to the extent that infrastructure failures now threaten city social and economic performance (Annexure W1 p121). Metro trading services performance is generally inconsistent with sustainably providing universal access to essential services.

3.2 The long-term failure to allocate sufficient necessary capital funding (or, correspondingly, to adequately maintain infrastructure, ensure that costs are contained, tariffs reflect full costs incurred, subsidies if any are well-targeted and allocated, and collections are very high) reflects institutional and governance arrangements which are blind to the distinctiveness and importance of trading services.

3.3 Many metros have not adequately recognised the special characteristics and role of trading services, or how they should be managed. Their structure and governance are such that decision-making authority (such over capital investment and tariff decisions), and key parts of operational performance (such as supply chain management and billing and collection) may be diffused over multiple units. Full financial statements for the individual trading services are seldom available, and the financial relationship between the trading service and the metro is opaque.

3.4 The wide latitude allowed to municipalities in the use of USDG funds has therefore regrettably been associated with long-term under-investment in categories (notably bulk infrastructure) that are essential for the long-term economic and financial viability of municipal trading services and therefore the whole municipality. The grant's framework is therefore being amended to emphasise the importance of spending on both new and existing bulk infrastructure (Annexure W1, p 108).

3.5 These generic institutional challenges apply to most metro water and sanitation, electricity distribution and solid waste management trading services, and the current reform initiative seek to directly address them.

3.6 Metro electricity trading services will need to go further, however: they also need to confront the changes in the markets for power (an increasingly open and competitive market; changes in technology mix, customers generating their own power, business model changes (energy to network), and possibilities for municipalities to generate power themselves). Metro electricity trading services may require (1) improved security and efficiency of supply mainly through least cost electricity system planning for generation (2) Distributed Energy Resource Management Systems (DERMS) implementation plans, and (3) Demand-side management and energy efficiency, including installation of Solar PV at municipal buildings, etc.

[5] This refers to the larger elements of city water infrastructure, and should not be confused with bulk water supply infrastructure commonly provided by Waster Boards

[6] For example, see https://commons.laws.africa/akn/za-wc015/act/by-law/2015/tariff/eng@2015-06-12.pdf or https://archive.opengazettes.org.za/archive/ZA-EC/2017/provincial-gazette-ZA-EC-vol-24-no-3859-dated-2017-06-12.pdf

3.7 Metro solid waste trading services have their own specific characteristics. Analytically, solid waste services have characteristics of public as well private goods (failure to provide services has public and well as private consequences), so there is more reason to fund part of solid waste costs from property tax revenues. Tariffs may also be less directly consumption-related; and the potential surplus is also less clear, though should not be assumed to be negative. Solid waste also occupies a relatively smaller share in total city finances. Nevertheless, metro waste management services should also be managed and treated as trading services, at least seeking to ensure that service charges cover costs (to the extent possible without compromising public services), to minimise un-warranted reliance on property tax funding. Properly run waste collection trading services are also likely to have significant positive economic and social benefits.

4 Trading services reform initiatives:

4.1 The well-established facts of general (although not universal) performance decline in metro water and sanitation and other trading services have now enabled the convergence of several reform initiatives:

4.2 In water and sanitation:

- Metros have started developing water and sanitation turnaround strategies to address challenges, with specific focus on institutional and governance reform; and
- DWS is implementing a programme to properly separate authority from provider in water services, and to license the providers.

4.3 In electricity:

- Some metro electricity department initiatives are seeking to transition to electricity distribution and generation markets fundamentally different from their traditional experience;
- Some metro electricity departments and metro CFOs have been concerned and constrained by declining electricity revenues and ensuing electricity sector dependence on property rates, and noting the applicability of the W&S diagnostic to their circumstances, have started seeking similar solutions; and
- DMRE is implementing initiatives on industry transition and distribution viability.

4.4 In alignment with these initiatives, National Treasury:

- will now require full separate annual financial statements for each metro trading services, in addition to those of the metro as a whole, consistent with the *m*SCOA Specimen AFS;
- is seeking concessional infrastructure funding which can be used to leverage private funding and structured for impact; and
- is restructuring conditional grants to increase impact.

4.5 The grant reforms are intended to:

- increase investment in trading services by leveraging grant finance with loan finance, linked to improved operational and financial performance of service providers;
- catalyse changes in structure, management, and governance of trading service businesses, to support improvements in operational, technical and financial performance;
- promote professional management with single point of management accountability for trading services in cities, suitable managerial autonomy and the technical skills necessary to manage an effective service; and
- promote and ensure full financial transparency, including by making the financial relationship between the utility and the municipality explicit.

5 Overall metro water services diagnostics and theory of change:

5.1 This following diagnostic was developed in the metro water and sanitation sector with DWS and NT. Many aspects have been noted to also apply to other trading services. However, to support the sector leading the trading services reform, the remainder of this Briefing Note is applicable to water and sanitation only.

5.2 The high-level diagnostic points will of course apply differently and to varying degrees in each metro. If they have not already done so, metros should use these points to review the performance (i.e. conduct a self-assessment) of their own water and sanitation services, to establish a realistic starting point for reform.

5.3 Water and sanitation services are recognisably caught in a self-reinforcing downward spiral (with an increasing pace of decline) involving long-term and substantial under-investment in maintenance, rehabilitation and new infrastructure (very large investment gaps); unsustainably large debtors, very large, costly and increasing operating inefficiencies, leading to widespread, long-term, and serious declines in the reliability and quality of services.

5.4 The root causes of this, and concomitant interventions are:

National level

At National level root causes include:

- evident weaknesses in the regulatory environment (such as separation of water services authority from water services providers, and licensing of providers), given the widespread/ long term performance declines;
- it has also become apparent that infrastructure grants such as USDG are not providing the leverage originally intended, for metros to invest in trading services (both existing and new bulk and network infrastructure), and hence are not achieving sufficient impact (not clear that metros are prioritising clear cut budgeting plans for trading services under the USDG); and
- Residual unresolved issues regarding the application and interpretation of the MFMA and its associated supply chain management regulations to enable infrastructure procurement to speed up and smoothen delivery.

To address the root causes, the following national interventions are being developed and implemented:

(a) NT will be requiring increased transparency of financial performance, financial position and cash flow per metro trading service, as well as the overall municipal AFS, for the 2024/25 and subsequent financial years. Full and accurate *m*SCOA implementation will facilitate this;

(b) NT is restructuring conditional capital grants to increase investment in water services by leveraging loans with grant finance; catalyse changes in utility structure, management and governance, promote professional management with single point of management accountability, ensure full financial transparency, etc. Metros will be engaged in this reform and supported with further guidance. Implementation will start in the 2025/26 financial year, based on strategies, plans and engagements prepared in 2024/25;

(c) NT is also working with DFIs to provide concessional finance on a results basis, to be implemented from the 2025/6 FY onwards; and

(d) DWS is implementing regulatory changes, including requiring proper separation of water services authorities from water services providers, and licensing of providers, to be implemented from the 2025/6 FY onwards.

Metro level

The challenges facing most metro water and sanitation businesses are highlighted by applying a 'seven-box framework' for successful utilities. Adapted from international experience[7], the seven box framework (see Figure 1) stresses the importance of connecting (a) customer service and trust (because service delivery depends upon customer trust and satisfaction) (b) sound finances (necessary to maintain and invest in assets), (c) asset maintenance and operations and (d) investing in new assets; all mutually-reinforcing, and carried out by (e) properly motivated and skilled staff, underpinned by effective support systems.

Effective utility operations also have two further important requirements (i.e. seven in all), however: (f) sound governance and a supportive enabling environment; and (g) leadership and management with the vision, strategy and execution capacity required to achieve the outcomes required.

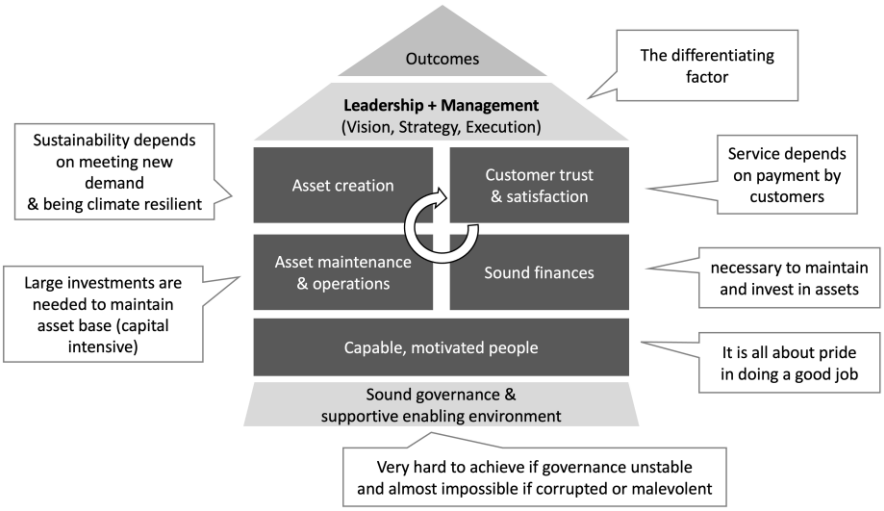

Figure 1. 7-box framework for successful trading services

With fundamentals in place, effective utilities tend to be those which put the customer first; are open to learning; benchmark against the 'best in class'; set strategic goals, and measure progress; establish effective management in core areas; make progress through continuous improvement; and communicate effectively and build trust.

The use of this framework highlights the areas in which metro governance of its water and sanitation services often undermines their long-term viability, to the detriment of both services and finances.

At metro level, the root causes include:

- the politics of budgeting, tariffs and credit control has meant that capex allocations to water and sanitation services have long been far too low to ensure viability; that tariff structures are often inappropriate and generally not cost-reflective; and that cash flows are compromised;
- important water and sanitation services issues (including their fundamental long-term viability as well as long-term capital planning and investment in renewal, repairs and maintenance) are often hidden when management and oversight are both driven by short-term and municipal-level rather than utility perspectives;
- decline in presence of professional and capable staff to not only manage the utilities but also to lead in decision-making and navigating dynamic political and social contexts;

[7] See, for example, Baietti A. Kingdom, W. & Van Ginneken M. 2006. Characteristics of well performing Public Water Utilities: World Bank Water Supply and Sanitation working Note No. 9.

- essential components of utility value chains (meter management, billing, collection), and support services (finance, SCM, HR, fleet) are provided centrally as a shared service, such that they are not driven by and do not adequately support utility priorities, a misalignment which reduces utility performance, autonomy on investment decisions and management accountability at the same time; and
- lack of utility-level financial transparency, especially regarding balance sheets and cash flows, due to municipal aggregation. Given the condition of the assets and the poor conversion of revenue into cash, these statements are critical for utility management and analysis.

Metros are addressing their root causes by developing and implementing the following:

(a) administrative and governance reforms within or in relation to the metro, to establish or clarify the single point of accountability for water and sanitation services, including support services;

(b) operating interventions including capacity enhancement, and a capital programme to address the most urgent inefficiencies and infrastructure needs, as part of a long-term transformative turnaround programme; and

(c) financial transparency reforms, including the publication and auditing of complete annual financial statements and transparent, well-defined relationship between water services and corporate finance.

Given that they are to reverse long-term declines, trading services turnrounds are necessarily multi-year efforts which require strong commitments, focussed attention and phased implementation. In broad terms, to improve trading utility performance and increasingly access to private capital funding and expertise (essential given constraints on government infrastructure grants), metro trading services should move in this direction, calibrated to circumstances and starting points.

Difficult context

Important though they were, specific events and processes of the last few years, whether socio-economic (such as the impact of covid-19 and covid restrictions; or theft, vandalism, construction mafias, etc.), political (such the events of July 2022; or fragile Council coalitions), or environmental events (such as floods and droughts) are treated as part of `Difficult Context' rather than as underlying causes: they are challenges to which trading services need to be resilient.

6 Preparation and approval of strategies, road maps, and business and investment plans:

6.1 In order to prepare for the introduction of the restructured infrastructure grant framework in 2025/26, and to help ensure a smooth transition to the new grant structure is smoothly achieved, metro municipalities should before the end of the first quarter of (municipal) 2024/25:

- Note the intentions of the grant reform (set out in Sections 2 and 3 above);
- Conduct a self-assessment of the long-term service delivery and financial performance of their water and sanitation services (some metros have already completed this step); and
- Prepare a Turnaround Strategy (some metros have already completed this step); an Institutional and Governance Reform Road Map, and Business and Investment plans for water and sanitation services, based on the results of their self-assessment.

6.2 The following subsections outline the expected characteristics and features of each of these.

Water Services Turnaround Strategy

Since any water services turnaround strategy is likely to involve addressing institutional and governance weaknesses as well as urgently necessary capital investments (such as to addressing sanitation failures or NRW, for example), Water Services Turnaround Strategies should:

(a) Recognise and document the facts of long-term poor services performance (in investment, revenues, operations (all aspects, including NRW, cash recoveries);

(b) Applying the seven-box framework for effective utility management, and taking account of the intentions of the grant reform (see Figure 1 above), recognise and document the institutional and governance reasons for such long-term poor performance;

(c) Outline programmes and measures, including institutional and governance changes, and capital investment and operational business plans;

(d) No standard format is required, but care should be taken to address all of the following:

- Long-term track record of water and sanitation service delivery and financial performance;
- Historical and current self-assessment of water and sanitation governance and decision-making;
- Outline an overall water and sanitation turnaround strategy;
- Outline the institutional and governance changes to be made to address any shortcomings;
- Outline how management capacity to lead the turnaround will be obtained;
- Outline immediate/ emergency water and sanitation business plans, investment plans, project plans, financing plans which collectively would initiate the turnaround;
- Outline key risks and mitigations; and
- Implementation (short-, medium- and long-term) timelines.

The Turnaround Strategy should be approved by Council and submitted to the National Treasury by **31 July 2024**.

Resource Document A (Developing and implementing municipal water business turnaround strategies) is provided to support metros in developing Turnaround Strategies.

Institutional and Governance Reform Road Map

At metro level the Institutional and Governance Reform Road Map is in many ways the heart of the reform process. It is necessary to address fundamental metro-level weaknesses in water and sanitation service performance as well as to address new national regulatory requirements.

Derived from the overall water and sanitation services turnaround or business improvement strategy, the road map should:

(a) Within the varieties of metro institutional arrangements, show a clear path and timelines (short-, medium- and long-term) to establish a single point of management accountability, including effective and functional HoD control of all W&S operations and W&S support functions; and HoD responsibility for performance and compliance;

(b) Demonstrate how the management capacity (technical, systems, change leadership, additional to current) to support the single point of management accountability to execute the turnaround, will be acquired;

(c) Show a clear path and timelines to establish governance arrangements which protect and re-enforce water services focus on and accountability for long-term performance;

(d) Rapidly achieve transparency standards: produce a complete AFS (statements of financial position, performance and cash flow) for water services separately:
- Correctly allocate shares of equitable share and conditional grants, other revenues and cash to trading services; and
- Specify contributions to the rates account after true operating surpluses (i.e. after scaled-up maintenance and investment).

(e) No standard format is required, but care should be taken to address:
- The administrative and management changes required to establish the single point of management accountability: steps to be taken and associated timelines;
- The governance changes required to establish and protect the single point of management accountability: steps to be taken and associated timelines;
- The changes required to achieve full financial transparency: steps to be taken and associated timelines; and
- The need for management capacity augmentation and development to execute the turnaround; approach to fulfilling the requirements, steps to be taken, associated timelines.

The Institutional and Governance Reform Road Map be submitted to the National Treasury by **30 September 2024**.

Business and investment plans

Business and investments plans matching and supporting the Turnaround Strategy should cover commercial plans (customer relations, billing, collection, financials), tariff structuring, specific and prioritised engineering projects organised into a capex programme (3 to 5 year plan, 10 year perspective), HR capacity enhancement, and project plans (with business case, costings, funding, proof of ability to spend/implement).

They should credibly demonstrate plans for:

(a) An overall path towards water and sanitation services operational effectiveness and financial solvency;

(b) sharply increased capital spending on immediately urgent capex (sanitation improvements, NRW reduction, etc), accompanied by increased allocation of USDG funds (metro prioritisation of utility capital investment requirements);

(c) Addressing commercial and social challenges (billing and collection, etc);

(d) increased use of private and development finance and expertise, (to supplement declining public sector resources);

(e) additional management capacity necessary to support project implementation alongside the institutional and governance change, given the challenges and forces to be faced;

(f) No standard format is required, but care should be taken to address:
- Commercial plans to address billing and collections, priorities, etc;
- Capital spending plans, why they are urgently critical, and project plans and associated funding plans;
- Private sector contributions of finance and expertise;
- Management capacity to execute the plans; and
- Projections on how collectively the plans will return the utility to solvency.

The capex funding plan should transparently specify existing debt levels, projections for the future, and the funding gaps after city budget allocations to W&S.

These business and investment plans can contain smaller specific project finance proposals, but should also be prepared at a W&S sector level.

Water and Sanitation business and investment plans consistent with the turnaround strategy should be submitted to the National Treasury by **30 September 2024**.

7 Processing of metro submissions:

7.1 Metro submissions will be reviewed by a team from national departments, which will engage the metro on any details and issues.

7.2 Submissions will be reviewed against data already known to the team, the seven-box framework, and the realism and plausibility of diagnostics, road maps, extent of political and administrative will and support. A template for review of submissions will be shared with metros.

8 Conclusions: next steps:

8.1 For metros, the immediate next steps and forthcoming deadlines are:

1	Review the long-term service delivery and financial performance of water and sanitation services, and confirm or develop a turnaround (performance enhancement) strategy, for Council approval.	Submit with confirmation of Council approval to NT by 31 July 2024.
2	Prepare corresponding Institutional & Governance Reform Road Map	Submit to NT by 30 September 2024.
3	Prepare corresponding business and investment plans	Submit to NT by 30 September 2024.

9 Contact for queries or support:

9.1 If Metros require further information or support in relation to the contents of this Guidance Note, they should direct their enquiries to:

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Chief Director: Local Government Budget Analysis
01 April 2024

ANNEXURE A – RESOURCE DOCUMENT