Caught in a vicious circle

Unless municipalities change the way they plan, build and finance infrastructure, argues TIAN CLAASSENS, they'll continue to lurch from one 'emergency' to the next, with dire consequences for service delivery.

There are typically four steps along the road to a service-delivery emergency common to the situations where municipalities have found themselves caught in a vicious circle of emergencies:

Step 1: Underestimating the real cost

One of the most common causes is failing to correctly estimate the 'all-in' or true total cost of delivering a municipal service. For example, according to business principles, a municipality should thoroughly understand the 'all-in' cost of supplying water, from source to delivery point, including all relevant overheads such as cost of billing, collection, and provision for bad debts. Only then can water tariffs be set to ensure that the water business operates at the required level of surplus.

If setting the price is one side of the coin, the other is collecting the money from consumers ('the cost recovery rate'). As important as setting the tariff higher than the all-in cost, is the need to have a reasonably high cost recovery rate.

With proper insight into demand patterns, a municipality can also use the tariff structure to achieve strategic goals such as cross-subsidisation and demand management. The former will strive to make water more affordable for poorer households, while the latter should serve to defer new capital expenditure, which again supports affordability. In cases where the tariffs needed to achieve a target surplus level that would be unaffordable to the broad municipal community, the municipality could request financial assistance from the fiscus.

Thus, the first step towards the vicious circle includes cases when:

- The municipality does not know what its all-in cost is, or does not calculate it correctly.
- The tariff charged is substantially below the all-in cost.
- Critical elements of the all-in cost, for example maintenance, are significantly understated.
- The cost recovery rate is substantially below the target set when the tariff was determined.

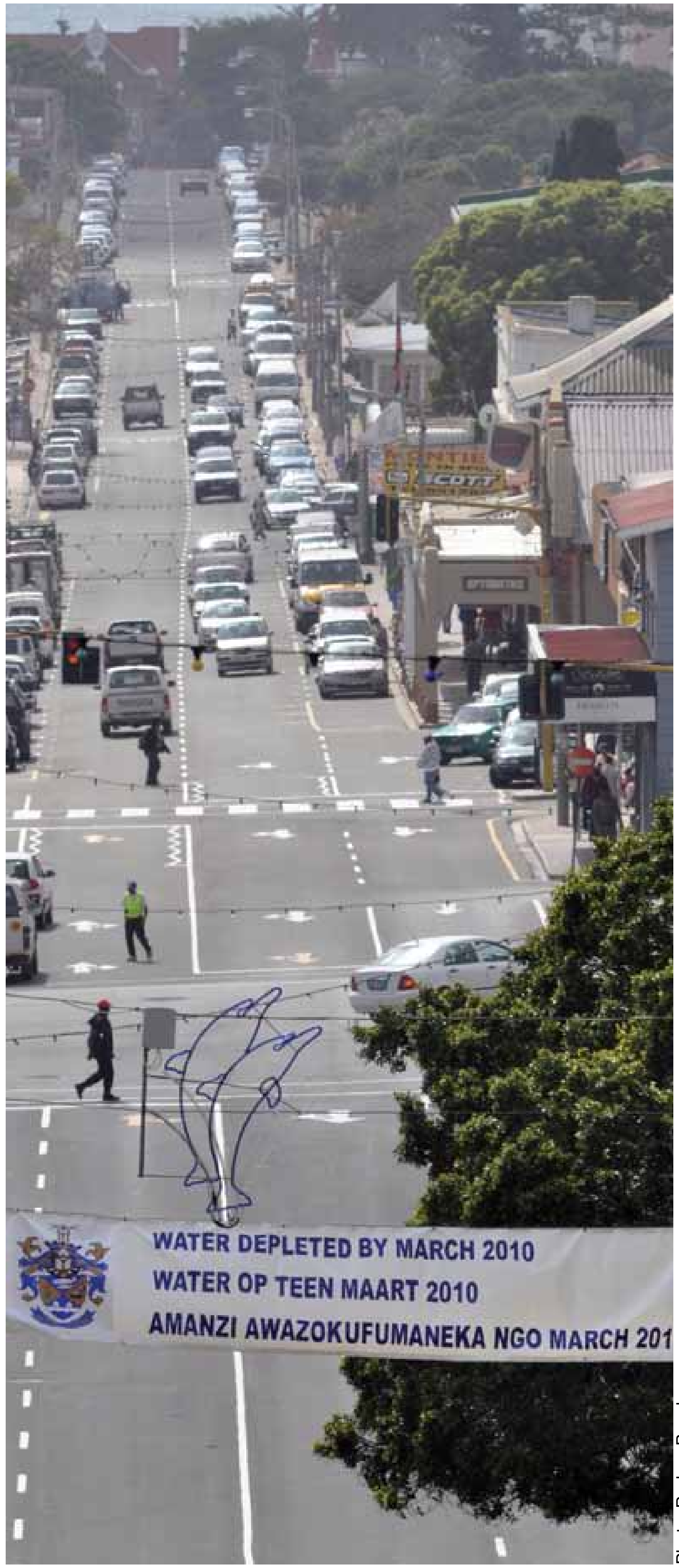

Photo: Rodger Bosch

A banner across the main road in Mossel Bay highlights the vulnerable situation many coastal towns find themselves in.

Step 2: Funding operations from cash reserves

In the situation described, the service is probably operating at a loss or vulnerable if a risk event, such as a sudden breakdown of equipment, will trigger a loss-making scenario. This loss would then have to be funded from cash reserves, or other sources such as grants received. This isn't sustainable and over a period of time erodes the financial position, or balance sheet, of the municipality.

Other factors can also play a role. One such factor is political resistance to adjusting tariffs to help reduce or eliminate losses. A second example is the failure of neighbouring municipalities to exploit regional opportunities to develop or share resources, which would result in benefits through economies of scale, sharing and diversification of risk.

Step 3: Not developing new infrastructure

As the financial health of a municipality deteriorates, its ability to develop new infrastructure, and upgrade and maintain existing infrastructure is steadily eroded. Service levels start to drop, bad debts rise and there's more unaccounted-for water through increased losses and leaks. The cost recovery rate declines further. This accelerates financial decline and a loss of municipal capacity.

What is not always recognised is the approach of a crisis or emergency. This may result from a breakdown in infrastructure, leaving large areas without water, to which the municipality is unable to respond. It may be caused by a relatively mild drought when resources are being over-utilised beyond acceptable norms because the municipality hasn't been able to fund and develop new resources. Or an existing resource may be polluted by a severe sewage spill, with the municipality unable to treat water to the safe drinking standards. It may be nothing to do with water supply or service, where funds have been diverted to another service or crisis. These are all situations experienced in different municipalities.

In these circumstances, the crises are 'self-made' and inevitable. It may be argued that a drought is not 'self-made', which may be true of a 1-in 50 or 100-year event. But in less severe instances, the crises stem from the inability to develop a new, or extend a current, resource when use exceeds acceptable levels or to declare and effectively enforce water restrictions at the beginning of a drought period or when the source becomes over used.

Step 4: Seeking disaster funding

Municipalities typically use a crisis to motivate for urgent and drastic financial interventions and assistance. A looming human, social and economic disaster becomes the focus, rather than the way in which the municipality has contributed to the crisis. Thus emergency schemes are proposed and motivated and funded through disaster funding by the fiscus.

Because it's an 'emergency', solutions are chosen not for their long-term sustainability, cost effectiveness or regional impact, but rather on the basis of how quickly they can be implemented. Little attention is paid to the all-in cost in relation to the tariff, nor to the cost recovery rate, and the impact of the new scheme on these critical parameters. With the crisis mitigated and the status quo maintained, the municipality is firmly on the way to developing the next crisis.

How this works in practice

Consider the southern Cape, where towns such as Sedgefield, Knysna, Mossel Bay and George faced looming disasters because of their inability to plan and implement infrastructure. In one municipality after another, a disaster scheme was motivated by the Western Cape regional office of the Department of Water Affairs and financed through the fiscus. But the following questions should be answered:

- Did these municipalities thoroughly review their costs and tariffs or significantly improve their 'cost recovery rate' as part of the emergency scheme?
- Did they ensure that the emergency scheme was sustainable in the long run?
- Did they explore regional integration opportunities?

In some cases, the disaster may have been staved off but only until the next crisis hits. With its coastal neighbours caught in the vicious circle of emergencies, the next town likely to apply for disaster funding is Oudtshoorn. Situated in a relatively dry region prone to drought, this municipality charges R3.50 in its lowest price tier for potable water, with an average tariff of around R6. With probable high unaccounted-for water and a relatively low cost recovery rate, its water services business is likely to be operating at a loss – highly likely if one looks at the tariff structure for sanitation. A crisis is looming. But should the municipality be bailed out or should the Department of Water Affairs issue an early warning to get their house in order?

There are other examples. After more than a decade of dysfunction in the Madibeng Municipality, which includes the Hartebeespoort Dam, the government has asked Rand Water to implement an emergency scheme to deliver potable water. Now this area, situated right on the banks of the dam, will source its water from Lesotho. Surely, this cannot be the appropriate solution?

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What can be done?

The critical question is how this circle of emergencies can be broken. There are two simple steps. The first is to go back to basics and ensure that the fundamentals are in place. The second is to finance the required infrastructure, and everything needed to ensure the fundamentals are put in place, through a mechanism that will enforce the discipline necessary to keep those fundamentals in place – commercial debt.

The following facts provide a convincing case:

- Government simply does not have enough money to rehabilitate those municipalities with the greatest needs and those facing impending disasters.

- In spite of their weak financial positions, most municipalities would be able to project-finance the required infrastructure to avert the disasters and set them on the road to financial recovery and sound service delivery.
- Commercial project financiers would critically interrogate a proposed infrastructure solution to confirm its affordability and sustainability, as well as the risk profile. They would only finance the infrastructure if the municipality could clearly demonstrate that its tariffs exceed the all-in cost of the service by a reasonable margin.
- A municipality would have to show that it had the capacity to operate and maintain the infrastructure on a best-practice basis and the capacity to collect its revenue and maintain a suitable cost recovery rate. This would have to be on a sustainable basis.
- In spite of having to pay interest and service the debt, most municipalities would not have to increase tariffs dramatically. Enhanced cash flows from increased cost recovery, wider service delivery, reduced losses and increased efficiencies would, in many instances, be sufficient to service the debt. An exception would be a municipality like Oudtshoorn with its grossly unrealistic tariffs.
- In instances where a municipality can show that the all-in cost of a service makes it unaffordable to a section of its population, government can provide financial assistance needed to restore affordability.

In short, commercial lenders are better at managing risks on an ongoing basis because that is how they make money. In this way they enforce strict discipline on their borrowers. Government should make use of this in the case of municipalities.

Currently, every time disaster funding is made available to a municipality to deal with a self-made crisis an opportunity is lost to rehabilitate that municipality. Through commercial debt finance, a municipality can not only access funding to implement the infrastructure to avert the obvious looming disasters, but more importantly the necessary strict discipline will be imposed over the term of the debt, perhaps 20 years, ensuring that the vicious circle of emergencies is broken.

Many municipalities shy away from funding their infrastructure through commercial debt, citing the impact on affordability, loss of control and other issues. The question can be asked whether these are the real reasons for their reluctance or rather the prospect of the strict discipline that will accompany a commercial loan. As long as there is alternative funding available from the fiscus, they will continue to shy away.

Photo: John Robinson

Municipalities should make use of commercial debt finance to fund infrastructure that is required to avoid disaster.

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