SALGA WESTERN CAPE

Presentation on Financial Sustainability Study of Municipalities in the Western Cape

1 June 2012

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SALGA WC commissioned a study on the status of Municipal finances in the Western Cape and the background is

- In 2009/10 SALGA undertook a project to obtain and collect key financial information that would provide an overview of the status quo of Municipal finances in South Africa, and which included Municipalities in the Western Cape.
- SALGA Western Cape has commissioned an updated study of Municipalities in the Western Cape to ensure that this information to remain relevant and to enable SALGA to develop support mechanisms that are targeted at improved financial management at Municipalities.

The purpose of this presentation is to therefore provide a high level overview of the outcomes and recommendations on the way forward to the SALGA WC

The project entailed a high level financial analysis and other issues were also identified but will need separate studies

- Cost of compliance – financial and capacity implications
  - Increased GRAP and Other Reporting Requirements; and
  - Increased Legislative Requirements.
- Unfunded mandates and underfunded mandates (Powers and Functions), with particular reference to for example: -
  - Libraries;
  - Disaster Management; and
  - Housing.

Although the above-mentioned issues were not researched as part of this project, significant analysis will have to be performed to ascertain the impact on Municipalities

A comparison was done of the 2011 Audit Reports as compared to those issued in 2008

- The Auditor-General issued Audit Reports for the 2011 financial year to 27 of the 30 Western Cape Municipalities: -
  - 24 Municipalities received Unqualified Audit Opinions (2008: 23);
  - 3 Municipalities received Qualified Audit Opinions (2008: 3);
  - None of the Municipalities received Disclaimers (2008: 4); and
  - 3 Audits are still pending.
- Five Municipalities received an Improved Audit Opinion, whilst three Municipalities received a Regressive Audit Opinion:-
  - Both the Bergrivier and Saldanha Bay Local Municipalities improved from receiving a Disclaimer of Opinion in 2008 to receiving an Unqualified Opinion in 2011;
  - George, Hessequa and Cederberg Local Municipalities improved from receiving a Qualified Opinion in 2008 to receiving an Unqualified Opinion in 2011;
  - Overberg District and Laingsburg and Prince Albert Local Municipalities received regressive Audit Opinions, from an Unqualified Opinion in 2008 to a Qualified Opinion in 2011.

Overall there has been an improvement in the audit reports for Municipalities in the Western Cape

However, we must emphasise the relationship between the audit opinion and the financial sustainability of a Municipality

- It is important to note that even an Unqualified Audit Report is not necessarily an indicator of the absence of financial problems in a Municipality because the Audit Report does not assess:–
  - The adequacy of the Municipality's cash reserves;
  - The credibility of the funding of the Municipal Budget;
  - The allocative efficiency of the Municipality's spending priorities;
  - The quality of the Municipality's revenue management capabilities;
  - The effectiveness of Municipal spending;
  - The sustainability of the Municipality's Capital Budget and Debt burden; and
  - The nature and extent of unauthorised, irregular, fruitless and wasteful expenditure.

However, a high correlation exists between Municipalities that received either an "adverse opinion" or "disclaimer of opinion" and those identified by Treasury as being in a state of financial distress

Based on the analysis on capacity and the ability to achieve favourable audits and to implement new standards it is noted that

- 25 (83%) of the CFO positions are filled, compared to 27 (90%) in 2008 (National average of 73%).
- The majority of CFO’s that received Unqualified Audit Opinions have Bachelor Degrees, although there are instances where CFO’s have no tertiary qualifications but received Unqualified Audit Opinions.
- All Municipalities in the Western Cape implemented the GRAP Accounting Standards, with 24 Municipalities (80%) receiving Unqualified Audit Opinions in 2011 (the national average is 45%).
- The majority of the Western Cape Municipalities have the necessary capacity to implement and maintain the Standards of GRAP.
- Capacity constraints in three of the smaller Municipalities caused deterioration in Audit Opinions.
- Weaknesses have been identified in the areas of: -
  - Compliance with Legislation and Regulations (74%),
  - Performance Management (56%); and
  - Supply Chain Management (70%) where Municipalities are struggling to comply fully with the Performance and Supply Chain Regulations.

The capacity at the ailing Municipalities must be strengthened and an exercise must be done on the use of external service providers and the impact on the audit outcomes

OUTCOME OF ANALYSIS
CATEGORY A - METROPOLITAN MUNICIPALITY
(CITY OF CAPE TOWN)

The financial sustainability analysis of the Metro reveals (1/2)

- The significant increase in Investment Revenue and Government Grants in 2009 relates to funding received for spending on the 2010 World Cup infrastructure.
- The above average increase in Service Charges since 2009 is largely attributable to increases in the Electricity Tariff as a result of a high Bulk Purchase price increases from Eskom over the selected period.
- There have been substantial increases in Employee Costs above the average wage agreements, with 2009 having grown by a staggering 32%., whilst staff numbers have increased by 18% from 21,530 in 2008 to 25,390 in 2011 due to for example conversion of temporary/ contract to permanent posts and implementation of TASK Grading System.
- Bulk Purchases increased in excess of 25% year-on-year over the current reporting period, mainly as a result of the increase in the Bulk Electricity.
- Acceptable levels of Repairs and Maintenance have been maintained over the reporting period.
- Finance Charges increased substantially from 2010 onwards in relation to new borrowings.
- Distribution losses shows a worrying trend and to illustrate, a reduction in water distribution losses of 1% can result in a saving of R24m or if reduced to say 15% will realise a saving of R122m.
- The City continued to have a relatively high Net Debtors Days of 91 days in 2011, which increased from 86 days in 2008, whilst gross outstanding debtors increased from R4.7b in 2008 to R7.5b in 2011.

The financial sustainability analysis of the Metro reveals (2/2)

- The general decline in Debtors collections is confirmed by the percentage increase in the Provision for Bad Debts of 22.8% in 2011, as well as a further percentage increase of 34% as anticipated for 2012 which is above the percentage increase for revenue from Property Rates and Service Charges.
- The Budget for 2012 makes provision for a 94% payment level, compared to 96% in 2011.
- Due to the significant increase in capital related contributions towards the Accumulated Surplus, the total Cash and Investments on hand equated to 23% of the Accumulated Surplus at year-end 2011 (2008: 215%).
- Cash coverage for borrowings decreased from 129% in 2008 to only 58% in 2011 and monthly cash expenditure coverage declined from 5 months in 2008, to just above 2 months in 2011.
- The level of Capital Expenditure relative to Operating Revenue also increased significantly to a high of 30% in 2009 but has since stabilised at 20% of Operating Revenue in 2011, and remains stable for the 2012 Budget but noting that approximately 2/3 of Capital Expenditure has been for the creation and acquisition of New Assets as opposed to the Renewal of Existing Assets.
- Unsecured bonds totalling R4.2 billion are registered on the JSE and this represents 80% of the Municipality's portfolio of debt totalling R5.3 billion.

The City should review its debt management processes and long term debt (Municipal Bonds) as any changes in fiscal discipline could jeopardise cash flows and service delivery going forward

OUTCOMES OF ANALYSIS
CATEGORY B - LOCAL MUNICIPALITIES

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The financial sustainability analysis of the Local Municipalities reveals (1/2)

- The majority of the Municipalities implemented the Municipal Property Rates Act (MPRA) in 2009, therefore the significant increase in Property Rates from 2009 to 2010.
- The increase in Service Charges has on average been much higher than the CPI due to significant increases can be attributed to the increase in Electricity Tariffs.
- Government Grants also continued to increase significantly above inflation, with a high of 73% in 2009 and since then increases for both Operational Grants (mainly the Equitable Share Grant) and Capital Grants have been significantly above CPI, except for the indicative Budget for 2012 where a reduction in Capital Grants is expected.
- The significance of electricity revenue and impact of abnormal tariff increase due to the substantial increases in the bulk purchase price of electricity over the reporting period, the influence of absorbing the increases in the Municipal tariff in relation to other Service Charges has been significant.
- Revenue from Electricity Charges has increased from 41% in 2008 to 47% in 2011.
- Employee Related Costs increased substantially in excess of Bargaining Council Wage Agreements from 2009 onwards at almost double of CPI and head count grew by 10% over the reporting period.
- Bulk Purchases increased substantially due to an increase in the bulk price of electricity.
- The spending on Repairs and Maintenance was marginally lower at 6% .

The financial sustainability analysis of the Local Municipalities reveals (2/2)

- Depreciation and Amortisation continued to increase to 10% of total operating expenditure in 2011.
- Net debtors to revenue remained fairly low during the reporting period, and is close to the norm of 45 days and interestingly though is the reduction of Gross Debtors Days from 101 days in 2007 to 84 Days in 2011, indicating substantial write-offs during this period but despite the write-offs Gross Debtors still grew by 31% from R611m in 2008 to R799m in 2011.
- Cash coverage for borrowings decreased from 209% in 2008 to only 132% in 2011, whilst monthly cash coverage of expenditure continued to decline from 576% in 2008, to 369% in 2011 and ratio is still above the norm of three months, although indicative of a concerning trend that cashflow is weakening.
- The Borrowings to PPE ratio has declined from 21% in 2007 to 10% in 2011, which is mainly due to funding of Infrastructure from Grants and although there are some Municipalities in the Western Cape that are experiencing some form of financial distress, generally there remains a significant capacity at Category B Municipalities to increase borrowings in the future, as Finance Charges represents less than 3% of total operating expenditure.

An analysis should be done on an individual municipal basis and an index should be created to do comparative analysis – trend indicates declining situation but ability to borrow to fund development

OUTCOME OF ANALYSIS
CATEGORY C - DISTRICT MUNICIPALITIES

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The financial sustainability analysis of the District Municipalities reveals (1/2)

- RSC Levies abolished in 2007 was replaced by a portion of the Equitable Share and combined revenue from RSC Levies and Government Grants increased from 64% of total Operating Revenue in 2008 to 78% in 2011, further evidence that District Municipalities have become largely grant dependent as other Own Revenue has declined further to 9% in 2011.
- Employee Costs relative to total operating expenditure increased alarmingly from 17% in 2008 to 31% in 2011, whilst Repairs and Maintenance increased positively to 14% of operating expenditure in 2011.
- Grants and Subsidies paid to Category B Municipalities for Infrastructure Assets remained at 10% of operating expenditure.
- Monthly expenses are covered six times in cash, which is indicative of a very healthy margin and of the he five Category C Municipalities in the Western Cape, the Cape Winelands (R375 million) and West Coast District Municipalities (R150 million) have significant cash resources as at 2011 and are unlikely to encounter any form of financial distress in the short-to-medium term.
- The Central Karoo and Overberg District Municipalities are experiencing cashflow problems.
- Investments remained at approximately R560 million for the past 4 years and provides a source of funding to assist Local Municipalities with infrastructure backlogs.

Indications are that there is increased grant dependency and increasing cash reserves at certain Districts that could be channelled to accelerated infrastructure development

OUTCOME OF ANALYSIS
CATEGORY B1 - SECONDARY CITIES
(Drakenstein, George and Stellenbosch Local Municipalities)

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The financial sustainability analysis of the B1 Municipalities reveals (1/2)

- Secondary Cities accounts for approximately half (51%) of total revenue of Category B Municipalities and have a stronger "own" revenue base.
- The revenue mix with regards to Property Rates and Service Charges have remained fairly consistent over the reporting period but Government Grants continued to grow significantly in relation to other revenue sources. However, it is not a pronounced portion of revenue (16%) compared to all Category B Municipalities (23%).
- The encouraging trend of declining Employee Costs relative to total operating expenditure continued from 33% in 2008 to 28% in 2011.
- Expenditure on Bulk Purchases increased by 7% to 27% of total operating expenditure in 2011. This is largely attributable to the significant Bulk Purchases price increase of Electricity bought from Eskom over the reporting period.
- Again the spending on repairs and maintenance at 6% is well below the norm of 12% to 15%.
- Net debtor days remained fairly low during the reporting period, and is close to the norm of 45 days.
- Net debtors to revenue at 14% is very healthy and represents less than two month's billing.
- Gross debtors increased by 57% from R303m in 2008 to R476m in 2011 indicating increased levels of impairment.

The financial sustainability analysis of the B1 Municipalities reveals (2/2)

- Monthly cash coverage of expenditure continued to decline from 552% in 2008, to 385% in 2011.
- The ratio is still above the norm of three months, although indicative of a concerning trend that cashflow is weakening. There is however an indication that the negative trend has been stabilised in 2011.
- The trend of significant increased Capital Expenditure has continued from the prior reporting period, and correlates with an associated increase in Grant Funding.
- The level of Capital Expenditure relative to Operating Revenue has also increased significantly to a high of 35% in 2009. It has since stabilised at 21% of Operating Revenue in 2011, and remains stable for the 2012 Budget but more than 80% of capital expenditure is on the creation and acquisition of new assets and the possibility of asset stripping is becoming a real threat.
- Borrowings consists mainly of annuity type loans, for which sufficient provision is made annually.
- The Borrowings to PPE ratio has remained at constant levels throughout the reporting period, and is significantly lower than that of the City of Cape Town.
- Finance Charges as proportional to expenditure is at 3%, which leaves sufficient room to increase borrowing.

An analysis should be done on an individual municipal basis and an index should be created to do comparative analysis – trend indicates declining situation but ability to borrow to fund development

OUTCOME OF ANALYSIS
RESOURCE AND RESOURCE GAPS
CATEGORY B – LOCAL MUNICIPALITIES

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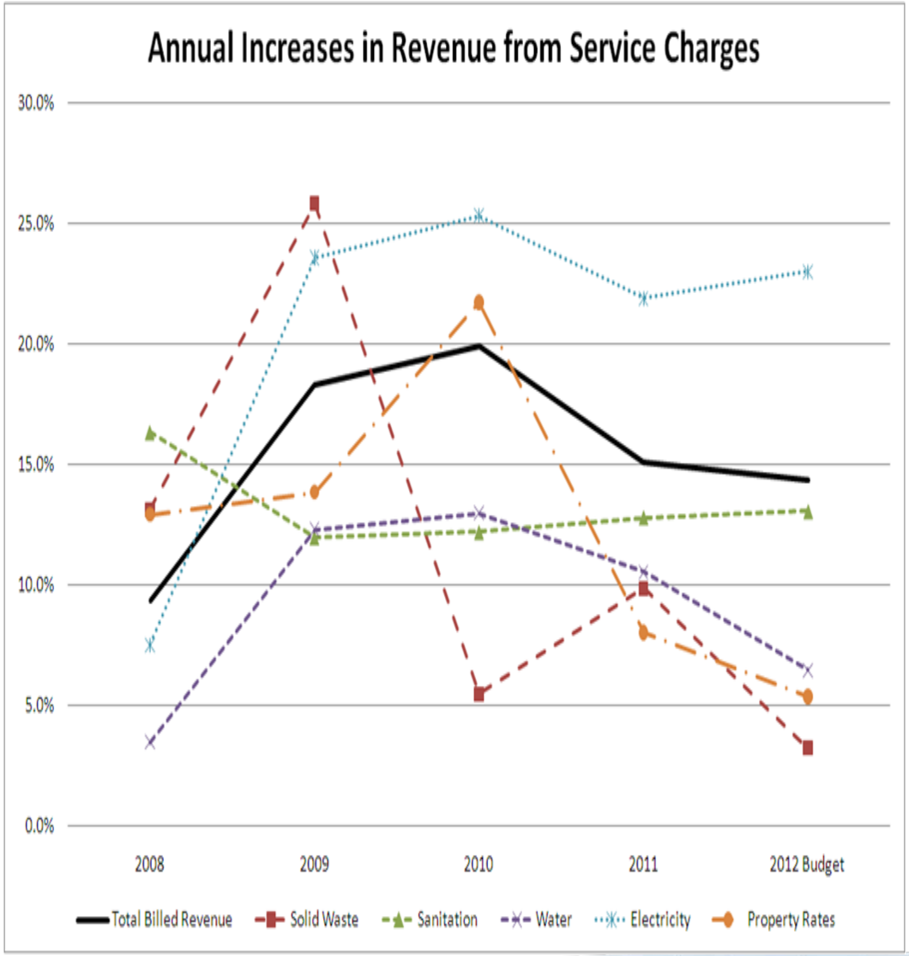
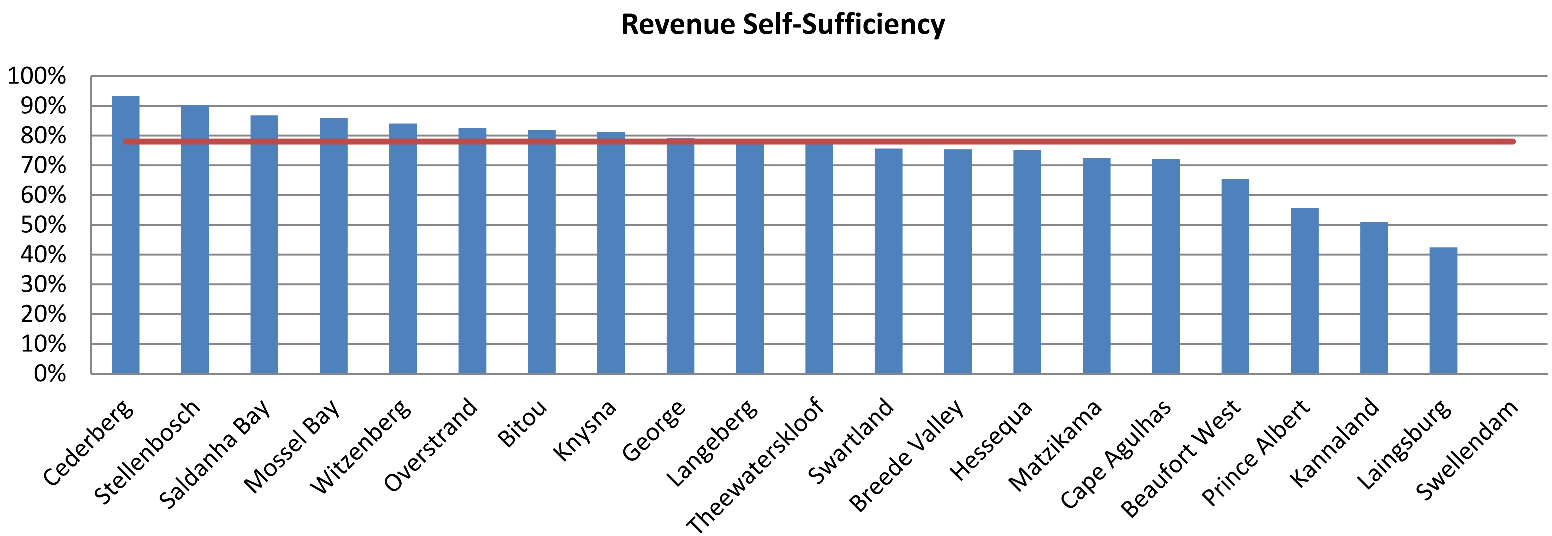
The impact of electricity on service charges and as an indicator of economic activity still represents a significant portion of revenue



- Due to the large proportion of Electricity charges (47%) in relation to other Service Charges, the total billed revenue increases followed that of Electricity.
- Service Charges from Water as well as Property Rates followed a similar trend to a large extent indicating the purchase price of bulk electricity had not been subsidised by a reduction in tariffs of Property Rates or other Service Charges.
- Except for Water in 2008, and Solid Waste in 2010 annual increases in Property Rates and Service Charges had been well in excess of inflation. What is worse is that these increases occurred during a time of economic recession and down-turn.

Continued increase of Electricity and Water well above CPI will negatively impact on affordability levels

The level of revenue self-sufficiency is high amongst the Category B Municipalities



- The majority generate more than 80% of operating income from own sources (Property Rates and Service Charges) and are thus not heavily dependent on Government Grants for operating revenue.
- The median is high at 78% with only Beaufort West, Prince Albert, Kannaland and Laingsburg Municipalities generating around 60% and below of own revenue.

Revenue from own resources makes efficient credit control and debt collection measures more important to ensure constant payment levels in excess of 90%

CONCLUSIONS AND RECOMMENDATIONS

24 April 2012

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Based on the analysis and outcomes to date, the following draft conclusion and recommendations should be noted (1/5)

NO	CONCLUSION	RECOMMENDATIONS
1	The current results as well as the improvement in audits opinion in the Western Cape as well as the cash positions of the Municipalities indicates that the Municipalities have the capacity to manage and to maintain their accounting records according to the required standards as well as comply with the increased requirements. However, the role and impact of External Service Providers in this process have not been evaluated.	The role and impact of External Service Providers be evaluated to determine reliance on external support vs internal capacity development and the impact of this on the improvement in audits at Municipalities.
2	Weaknesses have however been identified in the areas of Compliance with Legislation and Regulations (74%), Performance Management (56%) and Supply Chain Management (70%) where Municipalities are struggling to comply fully with the Performance and Supply Chain Regulations.	SALGA and Municipalities should place emphasis on enhancing capacity at the relevant Municipalities, inclusive of training and provision of resources.
3	The abnormal increases in Electricity Tariffs and Employee Costs had significantly changed both the Revenue and Expenditure mix of Municipalities over the reporting period.	Tariffs must be structured to include the true costs of services in order not to compromise on repairs and maintenance in order to protect the asset base of Municipalities.

Based on the analysis and outcomes to date, the following draft conclusion and recommendations should be noted (2/5)

NO	OBSERVATION	RECOMMENDATIONS
4	The rise in Employee Costs in excess of inflationary adjustments is having significant impact on tariff increases and is likely to be unaffordable in future. The increase in Employee Related Costs in excess of Bargaining Council Wage Agreements as a result of Municipalities implementing the TASK job grading system, creating additional positions on the organisational structure and converting temporary posts into permanent posts, as well as the appointment of additional Staff in non-service delivery positions poses a threat to the future financial sustainability of all Category Municipalities.	➢ A detailed analysis must be undertaken to determine the reasons for this trend and steps be taken to address/curtail this; ➢ Increases in salaries to be kept in line with Bargaining Council agreements; ➢ An expansion of the workforce should be limited to an expansion in service delivery, with related revenue increases to fund new appointments; ➢ The cost of compliance relative to increase in salary costs must be investigated against service delivery imperatives rather than just for the sake of receiving clean audits; and ➢ An investigation to be done on the use of shared services amongst Municipalities to curtail costs and administration where appropriate.

Based on the analysis and outcomes to date, the following draft conclusion and recommendations should be noted (3/5)

NO	OBSERVATION	RECOMMENDATIONS
5	Distribution losses continue to be above the norm, putting added pressure on sustaining acceptable levels of Repairs and Maintenance and Revenue growth.	The reasons for all distribution losses must be investigated and plans be implemented to reduce distribution losses to acceptable norms, which will free up funds for increased spending on repairs and maintenance to say 12-15% of operating expenditure.
6	Government Grants have continued to contribute substantially to the Revenue base of Municipalities in order to expand service delivery, and has on average increased at a rate higher than CPI.	➢ A larger portion of Capital Grants be earmarked for the Renewal of Existing Assets in order to protect the asset base or Municipalities; and ➢ An increased reliance on “own” revenue be pursued rather than an overt reliance on Government Grants.
7	The ability of Local Municipalities to borrow to fund growth and capital expenditure is evident from the fact that Finance Charges are a low percentage of Total Expenditure, coupled with sufficient cash reserves to increase borrowings in order to fund growth and Capital Expenditure.	➢ The significant increases in asset values be leveraged to finance further expansion through increased borrowings; and ➢ Debt collection be vigorously implemented to ensure that external loans can be serviced at all times, and must also be linked to updated Indigent Registers to separate the customers that cannot pay from those that do not want to pay.

Based on the analysis and outcomes to date, the following draft conclusion and recommendations should be noted (4/5)

NO	OBSERVATION	RECOMMENDATIONS
8	The significant surplus cash investments of the Cape Winelands and West Coast District Municipalities should be evaluated against the backlog of infrastructure needs of Local Municipalities in its area of jurisdiction.	There should be increased allocations to Local Municipalities for accelerated infrastructure development.
9	Whilst not investigated, indications are that Unfunded and Underfunded Mandates are likely to undermine service delivery and sustainability at Municipalities and that current Grant allocations are probably inadequate in this regard.	➢ A workshop should be set-up to finally address and conclude on all under and un-funded mandates; and ➢ All powers and functions should be reviewed as part of this workshop/investigation.
10	There is good oversight by National Treasury but no direct linkage/relationship to Local Government and the realities on the ground.	➢ National Treasury should share their best practices and oversight models with Municipalities (eg. 1 page financial assessment); ➢ A comparative analysis needs to be done between B1, B2 and B3 Municipalities in the Western Cape; and ➢ There should be a focus on non-financial indicators as well, i.e. Good Governance.

Based on the analysis and outcomes to date, the following draft conclusion and recommendations should be noted (5/5)

NO	OBSERVATION	RECOMMENDATIONS
11	The importance of electricity supply as a source of revenue and credit control measure is noted, yet some Municipalities have no control over areas supplied by Eskom.	A study should be done on the possible transfer of the electricity function to Municipalities in those areas currently supplied by Eskom, specifically noting the disestablishment of the Regional Electricity Distributors (RED's).
12	The implementation of GRAP and increased capital spend in certain areas has led to an increase in the asset base of Municipalities.	The long term infrastructure plans should be reviewed to ensure adequate provision "for new" vs "replacement" assets coupled with a sustainable financing strategy.

THANK U!