**AGENDA ITEM 2.2**

**REPORT ON THE ENGAGEMENTS RELATING TO THE 59 MUNICIPALITIES THAT WERE OWING ESKOM AND THE WATER BOARD’S ARREAR DEBT AND WHOSE MARCH ALLOCATION OF EQUITABLE SHARE WAS WITHHELD**

**PURPOSE:**

1. To brief the PC on the status of the municipal debt due to creditors (particularly, Eskom and the Water Boards); and debt owed to municipalities by provincial and national departments, and to report on the progress to date.
2. Furthermore, the purpose of this report is to provide a summary of the outcomes from discussions held with 59 municipalities whose equitable share allocations were withheld due to their failure to settle amounts owed to Eskom and the Water Boards. The purpose of these discussions was to agree on suitable support as well as intervention programmes to improve financial management, municipal service delivery, governance and institutional arrangements.

**BACKGROUND:**

1. The withholding of local government equitable share (LGES) allocations was an extraordinary step taken by National Treasury after persistent failures by municipalities to honour debts owed to Eskom, the Water Boards and other creditors delivering services to municipalities. This action followed years of engagements and warnings to municipalities to pay for services provided. It has become a common practice in certain municipalities that current invoices and outstanding debt to Eskom and the Water Boards are not prioritised for payment.
2. Four broad objectives of implementing the process of withholding the equitable share allocations are summarised below:
* To address the growing culture of non–payment by municipalities and understand why municipalities are not able to pay creditors on time and conform to the 30 day MFMA requirement[[1]](#footnote-1);
* To understand the root causes of municipality’s failure to pay its creditors and why municipalities find themselves in an unfavourable financial positions;
* To address managerial failure of Eskom and non-implementation of its credit control policy. Financial distress in Eskom and the Water Boards leads to poor credit ratings, which in turn will results in the increase of cost of borrowing for the national government; and
* To institutionalise the above-mentioned measures across all spheres of government.

**DISCUSSION:**

1. National Treasury adopted an approach to assist with the recovery of outstanding amounts from the top municipal debtors for Eskom and the Water Boards’ as this will have the greatest impact in reducing the overall debt owed by municipalities. Based on engagements which National Treasury has had with Eskom and Water Boards over the past years, a number of municipalities have payment agreements with bulk suppliers in place. However, in most cases these agreements were not affordable and thus not adhered to.
2. It has become a common trend among certain municipalities that current invoices and outstanding debt to creditors and in particular bulk supply creditors (Eskom and the Water Boards) are not prioritised for payment. In order to address the culture of non-payment to bulk supply creditors and ensure compliance with Section 65(2)(e) of the MFMA, the National Treasury has institutionalised a process to compel municipalities to honour their payment arrangements. This process is aimed at enforcing municipalities to implement their credit control policies and improving financial management in municipalities.

**Approach:**

1. On 6 March 2015 National Treasury issued correspondence encouraging municipalities to:
* settle their current accounts with Eskom and Water Boards; or
* conclude debt repayment arrangements with Eskom and Water Boards; and
* ensure that their political leadership is made aware of their Eskom debt obligation by requesting a Council resolution supporting the repayment arrangement.
1. Municipalities were advised to respond by the 13th of March 2015 or risk having the March 2015 tranche of their equitable share withheld. In addition, municipalities were advised to request assistance with the development of a financial recovery plan from the Municipal Financial Management Act (MFMA) Implementation unit of National Treasury.
2. The number of municipalities affected by this process was 59; 49 of which owed Eskom the largest amounts and 10 municipalities owing the largest amounts to the various Water Boards. In some of these cases, municipalities owed both these creditors significant amounts. The March 2015 tranche of the equitable share payments were withheld from these 59 municipalities. The affected municipalities are listed in **Appendix A**.

**Progress to date:**

1. To date, the following progress with municipalities can be reported on:
* National Treasury has met with 45 of the 59 municipalities;
* A total of 58 municipalities have received their full equitable share tranche for March 2015;
* The one municipality that did not receive any funds is Renosterburg local municipality. In the case of Renosterburg Municipality, the agreement with Eskom is still waiting to be signed.
* Of the R2.08 billion total equitable share withheld, R2.04 billion has been released;
* NT, COGTA and SALGA have assisted municipalities in negotiating and signing repayment agreements as follows:
	+ - Of the 59 municipalities affected, 51 municipalities required signed Eskom agreements and to date 48 municipalities have signed, and
		- Of the 59 municipalities affected, 14 municipalities required signed Water Board agreements and to date 12 municipalities have signed
1. The Department of Cooperative Governance and Traditional Affairs, South African Local Government Association (SALGA), Eskom, Water Boards and provincial treasuries were invited to attend the engagement meetings with municipalities.
2. A detailed report has been prepared pertaining to the engagements with the different municipalities which has been shared with SALGA on 16 September 2015. This report covers the lessons learnt as well the policy issues that must be taken forward.
3. Unfortunately, 27 municipalities that have signed payment agreements with Eskom have been identified as defaulting on these agreements. This was reported through the section 41 reports of Municipal Finance Management Act (MFMA, Act No. 56 of 2003) from the entities for August 2015 (Appendix D).
4. To date, the following progress with government departments can be reported on:
* As at the end of June 2015 National organs of state owed municipalities R1.8 billion, and
* NT wrote to the Director-Generals of each National Department on the 21st of July 2015 advising them of the arrear debt that the Department may be liable for and a separate letter was sent to the Provincial Treasuries requesting provincial departments to honour their debt obligations to municipalities. A second letter addressed to the respective National Ministers was signed and issued to them on the 13th of August 2015. This letter contained the indicative amount owed by the respective Department to municipalities.
1. Progress to date on the matter of resolving the policy issues:
* Two engagements were held with SALGA regarding this process (1 April 2015 and 9 September 2015). In addition, a meeting has been arranged between the Political leadership of SALGA and the Deputy Minister of Finance on the 23 September 2015.
* The first workshop hosted by SALGA was held on the 16 September 2015 with a number of stakeholders. During this meeting it was agreed that the NT will convene an urgent meeting with all relevant government departments prior to the Budget Forum meeting and COGTA will convene a legislative task team with the same stakeholders before the 14th October 2015.
* A series of meeting will be scheduled between SALGA, CoGTA, and NT to take the policy issues forward. This will ultimate translate into a meeting between the DG’s of NT, DCoG and the CEO of Eskom.

**SUMMARY OF FINDINGS:**

1. The following is a summary of key issues which have been highlighted in these meetings with the affected municipalities:
2. **Revenue management –** One of the key observations from the engagements with municipalities thus far indicates that poor revenue management has meant that payment due to creditors far exceeds the revenue collected (including transfers). Credit controls policies are not effectively implemented as required by the MFMA. It is essential that municipalities start implementing these policies on defaulting households and institutions, including national and provincial departments in order to improve their revenue collection. Municipalities should develop revenue management strategies to enhance revenue and improve collections.
3. **Reporting –** Municipalities are found to be overstating the debtor’s figures and understating their creditors figures. Data reported through Section 71 reports is misleading and gives an inaccurate reflection of the financial state of municipalities. It has been observed that information reported through MFMA section 71 (monthly reports from municipalities) and MFMA section 41 reports (monthly reports from entities) do not match, with municipalities understating their creditors in their own reporting.
4. **Unfunded budgets –** It is observed that past repayments agreements entered into by municipalities were not affordable and realistic and in many cases were signed for compliance. Municipal budgets are not funded, unreliable and not sustainable over the medium term and in several cases creditor obligations are not factored into the budget. The payment of both current and arrear accounts for both Eskom and Water Boards revolve around the equitable share payment schedule and this has led to increasing interest payments.
5. **High operating costs –** It is also observed that municipalities have extremely high operating costs and in particular, above normal staff costs which implies that a large part of the equitable share is being utilised to pay salaries and not directly towards service delivery.
6. **Poor administrative leadership as well as weak council oversight –** Theaffected municipalities continued to accumulate debt and remain indebted to creditors, especially service delivery creditors while it appears that the Councils are unaware of this. In turn the majority of these municipalities also have high levels of debtors made up of households, businesses and governments bodies.
7. Most of these municipalities have **financial recovery plans** but these have **not been successfully implemented**. In some instances officials accused their political leadership of not providing buy-in when they attempt to enforce the credit control policies and measures identified in the financial recovery plans.
8. **Poor credit control** – Several municipalities cited their poor socio-economic profiles as a reason for their non-payment notwithstanding that the LGES aims to cater for the needs of municipalities’ poor households. Most worryingly, municipalities are not collecting from their own debtors who include businesses and government departments.
9. **Tariff setting –** Poor tariff setting processes in municipalities is resulting in tariffs that are not cost reflective being set. The increases set by municipalities are not in line with their rising costs and bulk cost increases. Several municipalities are also not making use of sliding block tariffs (for both water and electricity) which would assist in revenue generation, demand management and with cross-subsidisation of poorer households.
10. **Technical and virtual losses –** there are high levels of water and electricity losses which have reduced municipalities’ revenue dramatically. Many of the municipalities that National Treasury has met with have water and electricity losses of up to 50 per cent each/ respectively. This has been driven by physical/technical losses as well as billing and metering inaccuracies and theft. It has been observed that municipalities are supplying water to thousands of households where the supply is simply not metered. Of particular concern is Ngwathe local municipality in the Free State whose prepaid electricity system appears to have been stolen by a sophisticated syndicate. This has reduced the municipality’s revenue severely.
11. **Assets Ownership –** The ownership of assets in some instances is unclear and often results in disputes between bulk service providers and municipalities. This is especially the case with water infrastructure whose transfer from the then Department of Water Affairs and Forestry (DWAF) appears to not have been completed or clarified. As a result, some Water Boards operate infrastructure whose ownership is unclear and which results in disputes over who is responsible for the management and financial upkeep of those assets. It is imperative that the MWS leads the process to clarify the ownership of these assets.
12. **Weak institutional arrangements between district and local municipalities –** The division of powers and functions between district and local municipalities are contained in Section 84 of the Municipal Structures Act, 1998 (Act. No. 117 of 1998).

Section 84 of the Municipal Structures Act assigns the powers and functions of district and local municipalities while the Minister COGTA and Members of the Executive Council (MECs) have the responsibility to authorise or adjust municipal powers and functions.

Section 19 of the Water Services Act, 1997 (Act. No. 108 of 1997) allows for water services authorities to perform water services on their own or enter into a contract with a water services provider. Some of the conflict between District Municipalities (DMs) and Local Municipalities (LMs) stems from DMs not transferring the water component of the LGES meant for indigent households to LMs appointed as their water services providers. An additional complexity relates to the fragmented contractual arrangements between DMs, LMs and Water Boards where in many instances Water Boards undertake functions on behalf of a DM or LM without the necessary contractual arrangements (service level agreement) being in place. Examples are in Dr. Ruth Segomotsi Mompati, Ngaka Modiri Molema and Mopane DMs. The **fragmented institutional arrangements have generally compromised the efficient and effective provision of water services** and have also led, in part, to municipal debt to Water Boards.

1. It appears that a review of the powers and functions between DMs and LMs is required from COGTA together with the Department of Water and Sanitation and the relevant MECs.
2. **Arrangements with Eskom** –National Treasury intends holding a series of engagements with Eskom as well as COGTA and SALGA in order for all parties to understand some of the challenges and in order to make the appropriate recommendations. Some of the specific issues which have been raised in meetings with the municipalities relate to:
	* + Eskom’s requirement for a **15 day payment period for the current account** – several municipalities have complained that this is not in line with the 30 days payment rule in the MFMA and that the mismatch with municipal billing periods contributes to additional interest payments for municipalities. At the same time, according to Eskom, this is the same principle which is applied across all its customers and extending the payment period would have negative consequences for the company’s liquidity.
		+ In addition, several municipalities as well as COGTA and SALGA have asked for the review of the fact that Eskom charges an **interest rate of prime plus five per cent** on arrear accounts. Municipalities have suggested that this has contributed to the escalation of debt owed to Eskom. National Treasuryis in the process of reviewing the MFMA Section 41 reports in order to understand whether interest is a significant component of municipal arrears. A point to note is that, many of the agreements signed by municipalities with both Eskom and Water Boards revolve around municipalities’ equitable share receipts. This applies to both the payment of the current account and the settlement of arrears. This means that municipalities invariably fall into arrears in the months between their equitable share receipts which suggests that greater effort needs to be put into managing municipalities’ liquidity.
		+ **Charges related to municipalities exceeding their nominated maximum demand (NMD).** This is as a result of municipalities not implementing adequate planning and demand management in their municipal areas, but also not making informed decisions when contracting their maximum demand with Eskom

It must also be noted that the purpose of municipalities having to notify and manage their demand is to prevent overloading of the national grid which would place the system under severe technical and operational risk.

* + - **Coordination with Eskom in implementing credit control** – several municipalities reported that it is difficult for them to implement credit control in areas where Eskom provides electricity directly to households (i.e. where Eskom has the electricity distribution license). Municipalities would like the assistance from Eskom as electricity disconnections are thought to be a far more effective way of enforcing revenue collection for all trading services (water, sanitation and refuse).
		- The payment of the **connection charges** for municipalities is an emerging and serious challenge. National Treasury has begun the engagement with Eskom as well as the Association of Municipal Electricity Utilities in order to gain a better understanding of the challenge. This matter will also require the input of various units within NT.

The costs of providing networks are recovered through charges for connection to the networks (connection charges) and charges for the use of the networks (tariff charges). The connection[[2]](#footnote-2) charge, which in most instances is significant, is the charge allocated to a customer for the capital costs of new or additional capacity not recovered in the tariff.

In the past, Eskom provided the option of financing the costs of connection and the customer would repay this over a period of up to 25 years but this was discontinued a few years ago due to Eskom’s funding constraints as well as with the enactment of the National Credit Act, 2005 (Act No. 35 of 2005). Connection charges are now required to be paid up front. The challenge, however, is that municipalities cannot borrow for assets owned by Eskom and must now include the full cost of connection into their operational budgets in order to pay for it. Furthermore, in order to pay the connection charges, funding must have been included in municipal budgeting processes, but this can only happen after municipalities have been given the quotation for a connection by Eskom. Thus municipalities do not always have immediate approval to proceed with accepting the quote and paying the required connection charges. As a result, many municipalities will not be able to afford new connections and will continue to incur additional charges for exceeding their contracted NMD.

DEBT OWED BY PROVINCIAL AND NATIONAL GOVERNMENT TO MUNICIPALITIES:

1. Aggregate debt owed by National organs of state to municipalities for the period ended 31 December 2014 amounted to R1.5 billion. At this stage the department of Public Works owes approximately R1.4 billion of the R1.5 billion. As at the end of June 2015 National organs of state owe municipalities R1.8 billion.
2. Provincial departments owe R2.07 billion to municipalities, of which 91 per cent or R1.8 billion is arrears. As at June 2015, provincial departments owe R2.5 billion to municipalities.
3. National and provincial departments must settle current payments due to municipalities timeously. In cases where an invoice is disputed, it is advised that the department show their commitment and contribute a part payment towards the disputed amount with the intent to settle the balance when the dispute is resolved.
4. The municipalities in Free State province are the most affected. An amount of R542 million is owed to municipalities in this province by provincial departments. The table below provides the detail age analysis of all provinces.



CONCLUSIONs:

1. The culture of non-payment for services is impacting on the financial sustainability of municipalities (government debt) as well as the economic distress for the bulk suppliers (Eskom and Water Boards) and SMME’s viability.
2. NT will closely monitor these municipalities to ensure that agreements are not breached as well as to ensure that municipalities comply with MFMA requirements and other treasury regulations. In addition, the National Treasury will continue providing necessary support to these municipalities to ensure that budgeting and cash flow risks are mitigated.
3. Those municipalities who are found to default on the signed arrangements will automatically have Section 216(2) of the Constitution invoked on them.
4. NT is scheduled to hold a bilateral engagement with Eskom at the end of September 2015 in order to understand and resolve some of the issues highlighted above. Subsequent to this, a broader workshop will be held including Eskom, SALGA, COGTA, Nersa, DPE and other relevant stakeholders in order to take the matters forward.

**RECOMMENDATIONS:**

1. It is recommended that the Portfolio Committee:
2. **Notes** the resolution of PCC that states “*Support a position that will decisively address the culture of non–payment by municipalities as well as in our boarder society****”;***
3. **Notes** the contents of this report;
4. **Notes** the status of municipal debts owed to Eskom and the Water Boards;
5. **Notes** the process followed and that will be undertaken to encourage government departments to honour their debt obligations to municipalities;
6. **Notes** the broader policy issues that must be discussed with Eskom and the water boards once the process has been concluded;
7. **Note the principle adopted at the September Budget Forum,** that Section 216(2) of the Constitution be invoked for those municipalities that have not adhered to and honoured the repayment arrangements with Eskom and water Boards
1. [↑](#footnote-ref-1)
2. The related infrastructure required to connect a customer remains under the ownership of Eskom [↑](#footnote-ref-2)