

Project to Revise the Pricing Strategy for Water Use Charges and Develop a Funding Model for Water Infrastructure Development and Use and a Model for the Establishment of an Economic Regulator

Institutional and financial models for the Economic Regulator

April 2013 WP10465





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ANNEXURE A…………………………………………………………………………………………………………………………………...66

**ACRONYMS**

|  |  |
| --- | --- |
| CEO | Chief Executive Officer |
| CMAs | Catchment Management Agencies |
| CME | Compliance Monitoring and Enforcement |
| CMS | Catchment Management Strategy |
| CUC | Capital Unit Charge |
| DG | Director General |
| DPSA | Department Public Service Administration |
| DWA | Department Water Affairs |
| ER | Economic Regulator |
| GC | Government Component |
| GRAP | Generally Recognised Accounting Practise |
| HR | Human Resources |
| IFRS | Integrated Regulatory Framework |
| IGFRA | Intergovernmental Relations Framework Act |
| IT | Information Technology |
| IRF | Integrated Regulatory Framework |
| KOBWA | Komati Basin Water Authority |
| KPI | Key Performance Indicator |
| LG | Local Government |
| MFMA | Municipal Finance Management Act |
| MSA | Municipal Systems Act |
| NERSA | National Electricity Regulator of South Africa |
| NPE | National Public Entity |
| NWA | National Water Act |
| NWRI | National Water Resource Infrastructure |
| NWSRS | National Water Services Regulatory Strategy |
| OD | Organisational Development |
| O&M | Operating and Maintenance |
| PFMA | Public Finance Management Act |
| PSA | Public Service Act |
| ROA | Return On Assets |
| RPMS | Regulatory Performance Measurement System |
| TCTA | Trans Caledon Tunnel Authority |
| UNESCO | United Nations Educational, Scientific & Cultural Organisation |
| WB | Water Board |
| WMA | Water Management Act |
| WRC | Water Research Commission |
| WSA | Water Services Act |
| WSAs | Water Service Authorities |
| WSDP | Water Service Development Plan |
| WSPs | Water Service Providers |
| WSS | Water and Sanitation Services |
| WTE | Water Training Entity |
| WUAs | Water Users Associations |
| WVC | Water Value Chain |

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# Introduction

The Department of Water Affairs has instituted a project to investigate the most appropriate institutional model for an economic regulator for the water sector. This report forms part of this process, and sets out a range of background information as well as proposed institutional options, to serve as the basis for a discussion to take place within DWA on the options available.

The document deals with a number of aspects pertaining to the proposed economic regulator, as follows:

* Section 2 looks at the definition of economic regulation for the water sector
* Section 3 looks at the principles underpinning economic regulation for the water sector
* Section 4 looks at the proposed scope and functions of the economic regulator.
* Section 5 looks at the current functions being performed by DWA that constitute economic regulation and which would fall under the economic regulator in future;
* Section 6 sets out the possible institutional options for an economic regulator, both internal to and external to DWA, deliberates on the pros and cons of the various institutional options and proposes a preferred option;
* Section 7 provides the criteria against which the proposed corporate forms was assessed in order to make the recommendation;
* Section 8 looks considers the legal issues related to the performance of the economic regulation function
* Section 9 looks at the organisational design of the economic regulator
* Section 10 and 11 considers the financial arrangements for the economic regulator as well as the sources of revenue.
* Section 12 concludes the document.

# Definition of economic regulation for the water sector

As outlined in the Economic Regulator Review[[1]](#footnote-1) governments use economic regulation to improve the efficiency with which society's resources are allocated to influence or control the distribution of income and costs and to achieve broad social or cultural goals. Government imposes economic regulation to prevent monopoly profits, to prevent unjust discrimination and to ensure that consumers are charged "fair and reasonable" rates for services provided. Economic regulation may also be used to reduce the speed of economic change and the redistribution of income through administrative processes, a justification based on the notion that the public is generally averse to risk and that the marketplace, with its sometimes abrupt changes, unfairly distributes income and costs. Finally, regulation may be used to confer benefits on certain customers at the expense of others. Economic regulation is typically focused on the regulation of “business” issues i.e. relating to costs and value of services or goods.

The objective of economic regulation in the water sector is to ensure that good or services are provided in a cost efficient, fair, and sustainable manner, while bearing in mind social and economic priorities (equity objectives), set out by the policy makers (at national, provincial and local government levels).

The main objectives of economic regulation can be broken down into three broad elements:

* To protect consumers from abuse of monopoly power by institutions in the water sector,
* To protect water institutions and consumers from inappropriate short-term decisions, and
* To enable the public sector to carry out long-term policy objectives.

In the context of the water sector, economic regulation is therefore typically directed at regulating financing options, tariffs and charges and service standards of the various institutions/authorities involved in the supply and delivery of water (raw and potable) and sanitation services to the end consumer along the entire value chain. Economic regulation therefore intervenes directly in market decisions such as pricing, competition/monopoly interests, consumer protection and market entry or exit.

Economic regulation results in the setting of overall service standards and charge/tariff levels – as well as charge/tariff structures for different consumer categories. Economic regulation is consequently a tool for ensuring that water sector institutions respond appropriately to the implementation of water sector policy and broader government developmental objectives/imperatives (environmental, social and economic). Social imperatives and equity objectives typically require a degree of cross-subsidisation or pro-poor support.

Ultimately, the broad objectives of economic regulation are to:

* Encourage efficient, affordable service provision (productive efficiency).
* Set charges/tariffs for cost recovery to ensure long-term financial viability.
* Ensure alignment between standards for service delivery (consumer protection) and charges/tariffs and funding requirements.
* Encourage appropriate investment (including extension of services).
* Ensure the affordability of services to low income groups (social/equity objectives).
* Provide dispute resolution mechanisms.

In the South African context, it is argued that to meet the objectives it is essential that economic regulation is applied throughout the water value chain (water resources and water services). From a regulatory perspective, there is currently a conflict of interest with the DWA determining the raw water pricing strategy and setting the raw water charges, while also being the infrastructure developer and operator and the management body that spends the revenue from those charges. Currently DWA is the player and referee where raw water charges are concerned. The biggest concern in this regard relates to the substantial infrastructure portion of the raw water charge that is passed through institutions in the water value chain to the end consumer. An economic regulator must be able to take on these very serious challenges in water resources revenue and charge setting.

These challenges in the water resources sector interface with the charges in the water services sector, as described above, with, for example, the cost of raw water being 50% of the input costs to Rand Water.

The water services sector also has significant challenges in relation to economic regulation that must be grappled with, including the lack of proper strategic asset management in many municipalities which means that they do not accurately know the extent, condition and status of water and sanitation infrastructure and are therefore not able to cost the operation, maintenance and refurbishment of the infrastructure.

Given the broad objectives for economic regulation outlined above it would not be possible to achieve effective economic regulation if this was applied only to selected water services institutions. It is important to note that concept of economic regulation of the entire value chain is a new development in the international water sector.

Section 4.2 of the Economic Regulator Review clearly outlines the existing regulatory realities and challenges for the water sector in South Africa in the context of regulation of the entire value chain (water resources and water services) and the associated institutions. These institutions are all “government owned entities” thus, the role of an economic regulator in South Africa would be to regulate the *public* sector provision of water and water services.

What is important to realise in this context is that to be effective a regulator must have “teeth” and therefore the ability to effectively apply sanctions/incentives. The sanctions/incentives that can be applied are very different in the context of private sector vs. public sector provision of services. In the context of the private sector, large fines act as significant deterrents to non‐compliance. In the context of the public sector, large fines do not have the same impact, and alternative sanctions must therefore be able to be imposed.

Consequently before defining specifically what is meant by ***economic regulation*** in the context of the South African water sector, it is important that the definition is informed by the following:

* The broad objectives of economic regulation outlined above.
* The understanding that economic regulation does not exist in isolation of other regulatory functions/domains and there are overlaps and interdependencies with technical, environmental, social and health and safety regulation amongst others.
* Drinking water quality, effluent discharge, customer service, coverage, and asset condition may be a reaction to a problem of monopoly and should also be covered by economic regulation (technical regulation of service standards etc).
* The economic regulatory priorities (market failures) of the sector must be addressed.
* The scope of economic regulation (entire water value chain)
* Ability to determine and apply appropriate sanctions in the context of the constitutional provisions regarding cooperative government and
* Water sector and national government policy and broad economic and social development objectives.

Effective economic regulation of the water sector value chain is necessary to ensure that water sector institutions respond appropriately to water sector policy, national governments’ developmental objectives and the specific regulatory objectives outlined above and given the current/future regulatory needs and objectives, it is proposed that it would be appropriate to define ***economic regulation*** as

***“setting the rules to control, monitor, enforce and/or change tariffs/charges, tariff/charge determination structures and service standards for the water sector whilst recognising and supporting government policy and broader social, environmental and economic imperatives”***

This definition provides the overarching context that guides the regulatory models and options and the associated regulatory scope and functions set out in this document.

# Principles and requirements for effective economic regulation

This section sets out the key principles and requirements for effective economic regulation that underpin the institutional assessment of the economic regulator examined in this document.

## Regulatory Legitimacy

An effective economic regulator should be seen by stakeholders and regulated bodies to have regulatory legitimacy. In a review of regulators the following broad requirement for regulatory legitimacy was found to provide a consistent and coherent framework for good regulation. Baldwin and Cave propose five key tests of ‘legitimacy’ or ‘worthiness of support’ of a regulatory regime, these are:

* Is the action or regime supported by legislative authority?
* Is there an appropriate scheme of accountability?
* Are procedures fair, accessible and open?
* Is the regulator acting with sufficient expertise?
* Is the action or regime efficient?”

## Water Sector Governance

The economic regulator must operate within a defined framework for water sector governance. Water sector governance refers to a range of various systems (administrative, economic, political, social, etc.) that are in place to develop and manage water resources, and provide water services at different levels. The South African Constitution outlines basic values and principles that ensure effective public participation (proactive sharing of key information and soliciting inputs from the broader stakeholders) as part of the administrative governance. Good governance in the water sector is still evolving internationally. However, it can be tested against established systems, definitions, pillars and criteria, including: -

* Levels of Governance System (principles, policy, legislation, regulations and practices)
* Defining the traditions and institutions by which authority is exercised, i.e. decision-making (The three recognized pillars - open policy-making; a professional bureaucracy and a strong engaged civil society)
* UNESCO’s criteria for effective water governance (participation, transparency, equity, accountability, coherency, responsiveness, integrative and ethical considerations), and
* The King III Report key characteristics (transparency, discipline, accountability, independence, responsibility, fairness and social responsibility).

## Universal Regulatory Principles

Regulators and regulatory principles are nothing new, but regulatory success is not an easily measurable concept. Hence, the question of what may constitute ‘successful’ regulation is, in itself, the subject of much debate. A structured analysis or grouping of certain characteristics of what seems to be ‘working’, and what is not, is a more recent development that has been gaining momentum, particularly in the context of recent regulatory failures. It is possible, though, to identify common principles that appear to be universally workable and which form the basis of a common approach to regulation – i.e. an emerging framework for “good regulation”. The following universal regulatory principles were identified in a regulatory benchmarking study conducted for DWA as part of the development of options for an Integrated Regulatory Framework (IRF) for the water sector in 2009.

* **Clear Roles** – Is there clear separation of the roles of policy, oversight, operations and regulation and are regulatory responsibilities clearly defined and allocated. Regulators should have clear and quantified objectives accompanied by clear measures of success/failure.
* **Transparency** – How is access to information managed and is it free flowing? Are the various processes and decisions of the regulator and their justifications documented, transparent and open for scrutiny?
* **Accountability** – This is the counter principle to independence and ensures that the regulator is accountable to government, consumers and regulated bodies for its decisions and actions. Consumers and the regulated body should have a right of appeal against the regulator’s decisions.
* **Non-discriminatory** – The principles relates to avoiding unfair discrimination against and between regulated entities as well as unfair discrimination against consumers. Regulatory processes should not discriminate between regulated entities and regulatory decisions should be technologically neutral.
* **Independence** – This principle has three legs; independence from inappropriate political intervention, independence from inappropriate intervention by role-players, stakeholders, consumers and other interests (non-conflict of interest) and financial independence (source of revenue /funding).
* **Participation** – Do sector role-players/stakeholders participate in the regulatory process and periodic reviews? Is the voice of the citizen heard?
* **Effective Monitoring and Enforcement** – Does the regulatory regime allow for effective monitoring and enforcement of decisions by the regulator?
* **Minimal Regulation** – Is the regulatory framework only focused on areas where regulation is necessary to achieve specific objectives/outcomes?
* **Predictability** – This principle refers to constraints on arbitrary changes of regulatory or regulated companies’ powers and obligations, the publication and application of regulatory principles and importantly, consistency of decision making.

These are not the only possible regulatory principles. Due to the diversity of regulatory needs (internationally and locally) there are other principles that might be important in a given situation that may not appear on this list. Likewise there may be less or more emphasis placed on some of these principles where different approaches are taken to regulation and different models of regulation are used.

## Compliance Monitoring and Enforcement

A key requirement for effective regulation is that it is underpinned by strong compliance monitoring and enforcement capability. Those that break the law are to be held accountable and sanctioned for such practice. A critical element of this is ensuring effective monitoring, data collection and assessment, and the taking of appropriate action based on the results.

Compliance is strongly influenced by a number of features, including whether the regulation is seen as legitimate by those being regulated. Regulations perceived to be legitimate are more likely to be complied with than those lacking legitimacy. This includes legitimacy of the content of the regulation, the distributional effects, the process of making the regulations, and the process of implementation of the regulations. Perception of fairness of implementation, and people’s experience of how they have been treated by the regulatory authority, is a critical part of the recognition of legitimacy and the response to regulations.

Achieving compliance is also strongly dependent on the relationship between the benefits of breaking the regulations and the consequences of any sanctions that might be applied if non-compliance is detected. The likelihood of non-compliance being detected and acted on is an important part of improving compliance with regulation.

## Regulatory Independence

There has been significant and heated debate around the principle of regulatory independence and why this is preferable, desirable or necessary or not and what form it should take. As outlined in 3.3 above, this principle has three legs; independence from inappropriate political intervention, independence from inappropriate intervention by role-players, stakeholders, consumers and other interests (non-conflict of interest/regulatory capture) and financial independence (source of revenue /funding).

On one hand it is argued that regulatory independence is a necessary element in providing sector stakeholders with confidence in the regulatory regime. On the other hand it is stated that independence on its own is not the critical issue but rather the degree of emphasis placed on other principles such as authority, transparency, accountability, conflict of interest and participation. This is summarised by the following quote:

*“the term independence does not tell the whole story…What is needed is a credible and durable balance between authority and accountability* (Olson 2012)”

For effective and credible regulation this is also translated into the need for a clear separation of the roles of custodian, policy maker, shareholder, supporter and regulator.

It is therefore argued that in the context of economic regulation of the water sector and the public ownership of the regulated institutions, the concept of independence can be achieved by ensuring that through the structural and administrative design (functions and rules), other appropriate principles are embedded and established to reinforce and underpin regulatory legitimacy and credibility, regardless of the institutional option selected. Independence should be progressively built and established as a way of operating through demonstrated credibility, not necessarily imposed as an institutional form.

# Regulatory Scope and Functions

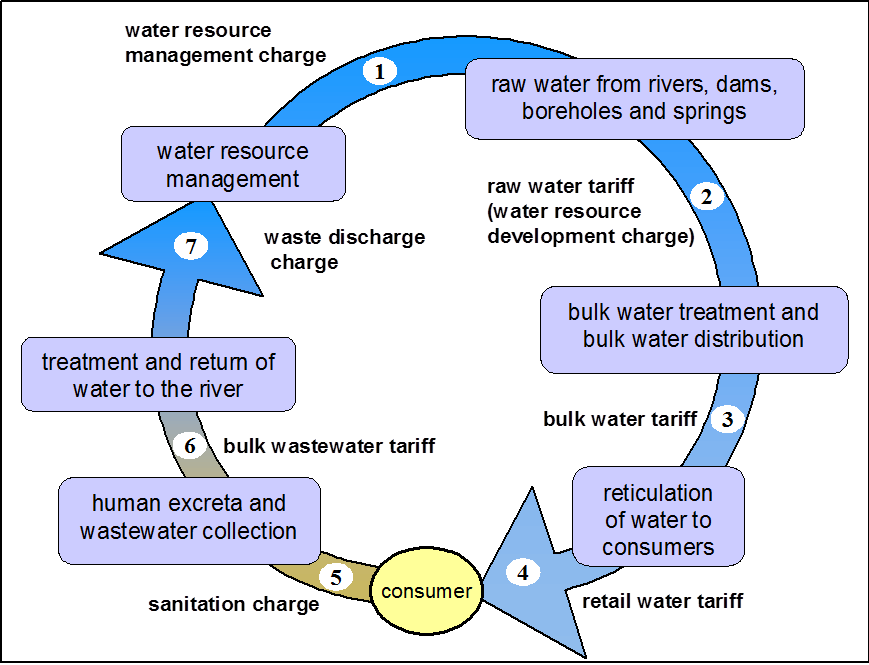
## Scope

The Economic Regulator Review conducted in June 1012 as part of the PERR project highlighted that currently there is no coherent economic regulation of the entire water value chain (water resources and water services) in South Africa, although some elements of economic regulation are currently targeted at specific institutions operating in the value chain such as water boards and municipalities. While there is a mechanism to regulate water resource pricing through the raw water pricing strategy, and guidelines for determination and implementation of water use charges, in reality the raw water charges are set by DWA without regulatory oversight.

Given the proposed definition for economic regulation as stated earlier in this document and the need to apply economic regulation throughout the water value chain it is essential that this be translated into a clear understanding of the proposed regulatory scope and the related functions. The regulatory scope needs therefore to be strongly aligned to the “business interfaces” in the value chain. The business interfaces in the water value chain are in effect the various water charges/tariffs and the related institutions that determine the charges/tariffs.

Figure 1 below indicates the various charges/tariffs imposed in the water value chain and therefore the logical focus areas for economic regulation.

The charges/tariffs and responsible institutions as illustrated in Figure 1 that need to fall within the ambit and scope of economic regulation are as follows:



**Figure 1: Water value chain charges/tariffs**

1. Water resource management charges as imposed currently by DWA but by CMAs in future
2. Water resource development charges relating to infrastructure related costs for DWA and the TCTA. The Capital Unit Charge is calculated by the TCTA for schemes that they are financing, and is factored into the raw water charge by DWA. DWA calculates the infrastructure charges for infrastructure that it manages. The raw water charge includes capital, O&M, depreciation and RoA elements. Charges for some international agreements are also factored into the raw water charges via DWA and/or TCTA.
3. The water research levy is calculated annually by the Water Research Commission on the basis of the raw water pricing strategy and is submitted to DWA for approval and inclusion in the water charges billed by DWA.
4. Bulk water tariffs and services relating to bulk water service providers (water boards/some municipalities/other intermediaries)
5. Retail water tariffs/services relating to Water Services Authorities as per the delegated powers and functions for water services
6. Sanitation charges/services relating to Water Services Authorities as per the delegated powers and functions for water services
7. Bulk waste water treatment charges/services relating to Water Services Authorities and some water boards (domestic and industrial waste)
8. Waste discharge charge which relates to water users discharging waste into a water resource and which is likely to be introduced in three catchments by 2014/15

## International Interests

One area of charges on water that is not specifically covered in figure 1 relates to the regulation of international interests where there are shared interests in water resources and specific off take agreements and linked charges. The NWA provides specifically for water management institutions responsible for international water management and associated agreements as is the case with inter-catchment basin transfers of raw water between countries. These transfers are undertaken through international water management institutions such as the Trans Caledon Tunnel Authority[[2]](#footnote-2) (TCTA) and the Komati Basin Water Authority (KOBWA)[[3]](#footnote-3). Compliance with international and regional agreements and the functions of the international water management institutions also need to be subject to economic regulation specifically in the case where charges for transfers between other countries and South Africa are passed down the value chain to users/consumers.

Economic regulation of international interests/agreements and related charges will have two distinct areas, the regulation of existing agreements and charges (this will be linked to the historic/existing agreements), and the processes for economic regulation of any new agreements in the future.

## Economic Regulatory Functions

Economic regulation does not exist in isolation of other regulatory functions/domains in the water sector, and there are overlaps and interdependencies with other key regulatory domains such as technical, environmental, and social regulation (see 2). Effective water sector regulation as a whole needs to incorporate all the necessary domains in an appropriately integrated and synergised manner.



Figure 2: Water sector regulatory domains

This section outlines the scope and functions of the economic regulation slice of this bigger picture. Thus the regulatory scope and functions outlined in Table 1 below is limited to the economic regulatory domain only and ***does not*** incorporate the other important regulatory domains, scope and functions except to highlight where there are key areas of overlap or interdependencies.

The table summarises the regulatory scope, functions, objectives and regulatory interdependencies with other regulatory domains. It needs to be recognised that this level of economic regulation is **not currently implementable** given existing legislative constraints in this regard. The implementation of the full-proposed economic regulatory functions and scope would require significant amendments to both the National Water Act and the Water Services Act prior to implementation.

While all water users and institutions involved in the various business interfaces would ultimately be included in the scope of economic regulation, it is advisable to start with the critical areas of regulation and increase the scope over time as capacity and experience increase and as the capacity of regulated entities to provide the necessary information for regulation increases.

Table 1: Regulatory scope, functions, objectives and inter-dependencies

| **Regulatory scope** | **Regulatory function/s** | **Regulatory objective** | **Regulatory inter-dependencies** |
| --- | --- | --- | --- |
| **Water resource management charges - DWA/CMAs** | Set rules for raw water management charges determination.  Approve raw water management charges. | Ensure reasonable charges to achieve catchment objectives. | Environmental / social (CMS) |
| Ensure financial sustainability of WM institutions. |  |
| Set special drought and seasonal tariffs | Water conservation and demand management | Environmental/social |
| Dispute resolution/ Regulatory review regarding charges | Deal with disputes/appeals. | Contractual/legal |
| **Water resource development charge – DWA** **/TCTA** | Set rules for raw water development charge determination.  Approve water development charges. | Ensure reasonable charges. |  |
| Sustainability of institutions. |  |
| Consumer/user protection. | Environmental |
| Strategic asset management. | Technical/standards/safety |
| Determine charges for raw water quality treatment infrastructure/processes. | Financial sustainability.  Raw water quality.  Consumer/user protection. | Environmental/ Technical |
| Dispute resolution/ Regulatory review re charges | Deal with disputes/appeals | Contractual/legal |
| **Other water charges (e.g. future AMD entities/tertiary treatment)** | Set rules for sale of water between entities.  Approve such water charges/tariff. | Ensure reasonable charges. |  |
| Sustainability of institutions. |  |
| Consumer/user protection. | Environmental |
| Strategic asset management. | Technical/standards/safety |
| Determine charges/tariffs for sale of treated water. | Raw water quality.  Consumer/user protection. | Environmental/ Technical |
| Dispute resolution/ Regulatory review re charges/tariffs | Deal with disputes/appeals. | Contractual/legal |
| **Bulk water tariffs and service standards** | Set rules for determination of bulk potable water tariffs.  Approve bulk potable water tariffs. Recommended bulk potable water tariffs where a municipality supplies other entities. | Ensure reasonable charges for bulk potable water customers.  Sustainable institutions. |  |
| Monitor cost implications of compliance with drinking water quality standards. | Cost of compliance with service standards (SANS 241).  Sustainable institutions.  Customer protection. | Health |
| Set rules for determination of bulk raw water tariffs.  Approve bulk raw water tariffs .  Recommend bulk raw water tariffs where a municipality has own supply/supplies other entities. | Ensure reasonable charge for bulk raw water customers. |  |
| Sustainability of institutions. |  |
| Monitor cost implications of compliance with bulk raw water quality standards. | Costs of compliance with aw water quality service standards.  Sustainable institutions.  Customer /user protection. | Environmental/ Technical |
| Assess reliability of supply (strategic asset management). | Specifying asset  Conditions.  Norms and standards complied with. | Technical/ social |
| Customer/consumer protection. | Norms and standards complied with. |  |
| Monitor efficiency and serviceability of supply | Specifying efficiency and performance targets.  Benchmarking. | Technical / social |
| Dispute resolution/ regulatory review. | Deal with disputes/appeals. | Contractual/legal |
| **Retail water tariffs and service standards** | Set rules for determination of retail water tariffs.  Assess compliance with retail tariff determination rules and make recommendations. | Ensure reasonable charges for retail water to customers. |  |
| Sustainability of institutions.  Norms and standards complied with. |  |
| Monitor costs for compliance with drinking water quality standards. | Costs of compliance with water quality service standards  (SANS 241).  Consumer protection. | Health |
| Monitor reliability of supply (strategic asset management). | Specifying asset  Conditions.  Norms and standards complied with. | Technical/social |
| Customer protection. | Norms and standards complied with. |  |
| Monitor efficiency and serviceability of supply | Specifying efficiency and or performance targets.  Benchmarking. | Technical/social |
| Service coverage. | Service coverage targets met. | Social |
| Dispute resolution/regulatory review. | Deal with disputes/appeals. | Contractual/legal |
| **Sanitation Charges and service standards.** | Set rules for determination of sanitation charges (tariffs).  Assess compliance with sanitation charges (tariffs) determination rules and make recommendations. | Ensure reasonable charge for sanitation services to customers. |  |
| Sustainability of institutions. |  |
| Monitor reliability of service (strategic asset management). | Specifying asset  Conditions.  Norms and standards complied with. | Technical/social |
| Customer protection. | Norms and standards complied with. |  |
| Monitor efficiency and serviceability of supply. | Specifying efficiency and or performance targets.  Benchmarking. | Technical/social |
| Monitor service coverage. | Service coverage targets met. | Social |
| Dispute resolution and regulatory review. | Deal with disputes/ appeals. | Contractual/legal |
| **Bulk waste water charges and service standards** | Set rules for determination of bulk sanitation/waste water charges (tariffs).  Assess compliance with bulk sanitation/waste water tariff determination rules and make recommendations | Ensure reasonable charge for sanitation customers. |  |
| Financial sustainability of institutions. |  |
| Monitor reliability of service. | Specifying asset  conditions.  Norms and standards met. | Technical/social |
| Customer protection. | Norms and standards met. |  |
| Monitor efficiency and serviceability of supply. | Specifying efficiency and or performance targets. | Technical/social |
| Dispute resolution/ regulatory review | Deal with disputes/ appeals. | Contractual/legal |
| **Waste discharge charge.** | Set rules for waste discharge charge determination.  Approve waste discharge charge. | Ensure reasonable charges. | Environmental |
| Financial sustainability of institutions.  Protect water quality and consumers | Environmental/ Health |
| Dispute resolution/regulatory review. | Deal with disputes/ appeals. | Contractual/legal |
| **International agreements/ charges** | Set rules for review of existing raw water charges. | Ensure reasonable charges. | Environmental |
| Sustainability of institutions. |  |
| Set rules for determination of raw water charges for new schemes/ agreements.    Approve new raw water charges. | Ensure reasonable charges. | Environmental |
| Sustainability of institutions. |  |
| Dispute resolution/ regulatory review | Deal with disputes/ appeals. | Contractual/legal |

It should be noted that these functions extend across the whole value chain, but that the powers of the economic regulator will need to be different at different points of the value chain due to the constitutional division of functions and the constrained powers of regulation and intervention of the national sphere over the provincial and local spheres. Due to the range of different institutions involved in the water value chain, economic regulatory approaches and mechanisms will be different and/or applied differently for different types or categories of institutions.

## Incremental approach

The suite of functions listed above is extensive, and will require extensive capacity to implement effectively. It should be noted that it is not only the capacity of the economic regulator that is necessary to make economic regulation work effectively - without appropriate capacity in the entities to be regulated, the effectiveness of the economic regulator will be severely curtailed. For example, provision of accurate information by a water services authority on the value and state of water services infrastructure assets is necessary for the economic regulator to be able to determine the appropriateness of tariffs to be charged, but many water services authorities are not currently in a position to provide this information, making the role of the economic regulator extremely difficult. Establishing processes and systems for accessing, collecting and validating such information will, therefore, become one of the first tasks of the economic regulator.

Because of the extensive nature of the activities to be implemented to achieve effective economic regulation and the challenges of capacity both in terms of the economic regulator and the regulated entities, it is proposed that an incremental approach be adopted where the economic regulator begins by regulating the most critical elements of the value chain and progressively builds its regulatory functions and capacity to include other elements over time.

In this regard, 3 below sets out the priority areas for economic regulation, focusing initially on national water resources infrastructure bodies, including WUAs that manage state infrastructure, bulk water services providers and water services authorities. Within these areas, the initial focus should be on getting the appropriate service and asset related information from the regulated bodies and aligning this to the proposed tariffs/charges and the required service levels. This programme will take several years to achieve.

The water resources management charges and WRC levies are relatively easy to regulate, and information on these will be relatively easy to obtain. The economic regulator may, therefore, choose to regulate these elements relatively early on not only because of their significance in impact on water users, but also because of their relative ease of regulation.



Figure 3: Proposed priority areas for economic regulation

# Current Economic Regulation Functions performed by DWA

The obvious place to start with economic regulation is to identify the functions already being performed and to consolidate these while adding in other regulatory functions as required. However, in analysing the current situation it becomes clear that while there are a number of oversight functions being performed by the Department as shareholder of water sector institutions (TCTA, WRC, CMA, WB, WSA, and WSP) that do consider the institutional and financial performance of the institutions, this does not, however, constitute the performance of economic regulation. Although the Department may be fulfilling a number of technical, social, and environmental regulatory functions, it is currently performing very few economic regulatory functions and existing legislative mandates for economic regulation are totally inadequate.

From our information, approximately six employees of the Department are involved with some form of economic regulation, but these employees also perform regulatory functions related to other regulatory domains.

## Regulation of Local Government (all domains)

### Regulatory Performance Management System (all domains of regulation)[[4]](#footnote-4)

In order to regulate local government more effectively in areas of water services, the Department has developed a tool called the Regulatory Performance Measurement System (RPMS). This is a web based system that measures WSAs against 11 key performance indicators derived from the Strategic Framework for Water Services (DWA 2003) and from the National Water Services Regulatory Strategy. It has been described as a simple tool used by the Regulator (DWA) to measure performance against key areas of business and to determine performance against key performance trends with the intention of promoting best practice in the sector. The results of this assessment have been published in a report dated April 2012.

The objectives of the RPMS are as follows:

* To improve business practice with regard to water services delivery in local government
* To improve local government compliance with national norms and standards
* To improve the impact of DWA regulatory processes by ensuring that responses to non-compliance are uniform and standardised across south Africa
* To ensure that data submitted by local government is verifiable, accurate and useful to other processes, and will improve local government’s capacity to deliver services through strategic feedback on problem areas

The KPIs are set out in table 2 below.

Table 2: RPMS Key Performance indicators

|  |  |
| --- | --- |
| **KPI** | **Aim** |
| 1. Access to water supply | As per existing DWA KPIs. |
| 1. Access to sanitation |
| 1. Access to free basic water |
| 1. Access to free basic sanitation |
| 1. Drinking water quality management | See paragraph 5.1.2 below. |
| 1. Waste water quality management | See paragraph 5.1.3 below. |
| 1. Customer service quality | Local government should strive towards excellence in the provision of services. The quality of customers services rendered is a reflection of the standard of water services being provided to customers. |
| 1. Institutional effectiveness | What tools do they have in place to enable effective running of their business i.e. WSDP, by-laws and policies. Effectiveness of resource allocation and staff costs are also assessed under this indicator. Planning must be followed through with effective implementation, monitoring and reporting within the business |
| 1. Financial performance | Financial planning ensures that there is funding available to undertake the required services  Financial controls ensure that business resources are used efficiently and financial systems enable reporting and decision-making  WSAct and MFMA regulates how WSA manage their finances  Aim is to establish insight into the financial sustainability of the WSA and probes areas of revenue collection efficiency and debt collection periods which are inextricably linked (reducing the debt collection period increases cash flow for water service provision). |
| 1. Strategic asset management | Asset management is a critical functional area within the water service business, as it impacts the quality of the services a municipality is able to provide to consumers  Properly designed and well managed water services infrastructure supports social and economic stability.  Poor asset management is an indicator of impending asset failure.  RPMS seeks to established whether the WSA has efficient asset planning tools and adequate asset information. Having an asset management plan is an indication that the four cores of asset management have been taken into account. The implementation of such planning is however critical and this is generally evidenced through regulatory site audits. |
| 1. Water use efficiency | This indicator assesses the % of non-revenue water generated at muni level. This strategic insight provides valuable information to water managers to assess the current state of water conservation and demand management initiatives. The loss of water impacts negatively on the revenue generation of the municipality, and if high non-revenue water is not prioritises and managed effectively, it will have a knock-on effect on the financial performance of the WSA. |

#### Municipal water services regulatory comparative analysis[[5]](#footnote-5)

This analysis forms part of the RPMS and provides detailed feedback at a much lower level to WSAs. The analysis reports on the performance of water services authorities for the last three municipal years ending in 2012. The purpose of the report is to publish WSA performance for selected key indicators across critical functional areas of the business. The objective of this report is to provide a mechanism through which WSAs can benchmark their individual performance against that of their peers in similar categories across the country.

In terms of this analysis, WSAs are categorised as follows:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Category | Type | Description | No. of WSAs | Total Population | % rural pop | % poor pop |
| A | Metros | Metropolitan municipalities | 8 | 19 941 886 | 9% | 30% |
| B1 | Secondary Cities | Major Cities, local municipalities with the large budgets | 19 | 6 895 870 | 27% | 40% |
| B2 | Large Towns | Municipalities with a large town as core | 18 | 2 307 874 | 22% | 35% |
| B3/B4\* | Small Towns and rural areas | Small Towns: municipalities with relatively small population and significant proportion of urban population but with no large town as core (78)  Rural areas: Munis which are mainly rural, at most, one or two small towns in their area (8) | 86 | 6 490 409 | 36% | 53% |
| C | District municipalities | District municipalities | 21 | 14 655 638 | 86% | 68% |
| Total | | | 152 | 50 291 677 |  |  |

### Blue Drop certification programme

This programme was initiated by DWA on 11 September 2008 with the view to:

* Introducing incentive-based regulation of the drinking water quality management function
* Introducing key requirements for effective and efficient management of drinking water quality by water services institutions
* Initiating transparency on the actual drinking water quality management performance of water services institutions
* Providing information to the public on DWQ performance per water supply system (to prevent generalisation) and
* Facilitating closer working relationships between water services authorities and water services providers (where relevant)

This assessment is conducted annually and the results are published in a report.

### Green drop certification programme

The DWA initiated this programme based on a similar motivation to and modelled on, the Blue drop initiative. The purpose of this initiative was to:

* Introduce incentive-based regulation of municipal waste water and effluent discharge function;
* Introduce key requirements for effective and efficient management of waste water and effluent discharge
* Promote transparency
* Provide consistent and reliable information to the public on municipal waste water and effluent discharge; and
* Facilitate closer working relationships between water services authorities and water services providers (where relevant)

## Regulation of other entities along the value chain

A description of current extent of economic regulation of relevant water sector institutions at different points along the water value chain is set out briefly in table 3below.

Table 3: current economic regulatory functions being performed by DWA

| REGULATED ENTITY | REGULATED ACTIVITY | ECONOMIC REGULATION FUNCTION PERFORMED BY DWA |
| --- | --- | --- |
| DWA | * Setting of Water Resource Management charges, waste discharge charges (to come) and water resources consumptive charges; * Use of income from users to build, operate, maintain, and refurbish water resources infrastructure; * Use of income from users to fund water resources management in Water Management Areas; * Value for money of costs incurred vs planned costs | No regulation/self regulation |
| TCTA | * Raising of off budget finance to develop water resources infrastructure * Structuring and raising of project finance * Determination of CUC for off-budget infrastructure * Value for money of costs incurred vs planned costs | No regulation/self regulation. As shareholder/ executive authority the Minister, through DWA, is mainly performing an oversight role in respect of the setting of the CUC for each project. |
| CMA | * Setting of Water Resource Management Charge for its WMA (when delegated). * Use of income from users to manage water resources in the WMA | No formal regulation of charge.  Oversight role by DWA on behalf of Minister as shareholder/ executive authority. The business plan and financial reports submitted to DWA as Executive Authority not regulator |
| WRC | * Setting of research charge * Use of income from research charge to achieve objectives in business plan | WRC submits annual proposal on research charge increase to Minister for approval. Minister determines allowable increase. |
| WSA/ WSP | * Bulk and retail tariff setting * Compliance with section 9 and 10 regulations * Service delivery – provision, operation and maintenance of services * Investment plan | S9 (technical regulation but has implication on economic regulation)  s10 regulation (economic regulation). It is unclear to what extent economic regulation is taking place in terms of this section. An added complexity is that non-compliance with this section/ norms and standards does not attract an appropriate penalty  s63 – Intervention  Consumer satisfaction surveys  Service quality issues  Regulation of information for consumer protection   * Intervention in finance related disputes |
| WBs | * Setting of bulk water tariff * Setting of bulk waste-water tariff Contracts entered into with WSA/ WSP – section 32(b) of the WSA – basis of funding for the WB * Setting of conditions for the provision of services in relation to the determination and structure of tariffs; and the payment and collection of money due to the water board ss33(1)(c);(d)). | No formal regulation  Section 10 of WSA – norms and standards for tariff setting, in draft form  Minister tables annual increases of water board water tariffs in Parliament |
| WUAs government water schemes | Levying of water charges on members on behalf of DWA  Use of revenue to ensure operation and maintenance of government water schemes | No regulation other than determination of the % of revenue that can be kept by the WUA to cover costs of collecting water charges on behalf of DWA |
| Dispute resolution | Resolution of disputes between entities within the water value chain | There has been some intervention between municipalities and water boards over non-payment issues |
| Other Entities (public/private)  Such as Mid-Vaal Water, tertiary treatment and future AMD entities etc. | * Bulk and retail tariff setting * Compliance with section 9 and 10 regulations * Service delivery – provision, operation and maintenance of services etc.   Investment plan | No regulation |
| International Agreements | Raw water tariff setting  Off-take agreements  Contractual compliance | No regulation |

# Institutional Options for the Economic Regulator

As can be seen from the preceding chapter, current economic regulation of the water sector is largely informal, relatively weak and not supported by appropriate legislative mandate for effective economic regulation. There is no specific economic regulatory methodology being applied, and the transparency of tariff and charge setting across the value chain is weak. Clearly, this situation needs to change, with stronger, more transparent and effective economic regulation being instituted. There are a number of aspects to this – improving the capacity to regulate, improving and formalising the regulatory tools to be used, improving the institutional arrangements for economic regulation and establishing an appropriate legislative framework and mandate for effective economic regulation

This chapter will focus on the issue of the optimal corporate form for the performance of economic regulation. Various corporate forms are available for the performance of economic regulation as governed by the Public Finance Management Act (PFMA) and the Public Service Act (PSA). This document however only discusses the three most relevant corporate forms considered for the purposes of economic regulation, namely:

1. Departmental restructuring to establish a dedicated departmental unit;
2. National Government Component; and
3. National Public Entity.

Each of these corporate forms has advantages and disadvantages, and each needs to be considered in the context of the functions that the economic regulator must perform, and particularly the core purpose of regulating charge setting, tariffs and service standards along the water value chain.

It is noted that key requirements for the water sector relate to the ability of the Economic Regulator to take regulatory decisions, monitor compliance and institute legal action against defaulting entities, and the clear separation of roles. These requirements are not necessarily addressed by the selection of a particular corporate form but must rather be catered for in the complete design of the Economic Regulator. For example, the selection of a National Public Entity as the most appropriate corporate form will not necessarily mean that the ER will be better able to institute legal action against another organ of state as an NPE is still subject to the IGRFA. It is important to note that amendments to existing and or the establishment of new legislative frameworks/mandates to facilitate effective economic regulation (table 2. Scope and functions refers), will be necessary regardless of the corporate form selected for the Economic Regulator.

## Option 1: Internal to the Department

The first option is to create a dedicated unit within DWA. This option would mean that the economic regulation function would be performed by DWA itself through a dedicated branch or unit. Such a unit would need to be appropriately designed with appropriate posts, clarification or redefining of job descriptions and responsibilities, appropriate budget, proper business processes for implementing the economic regulation functions, sufficient administrative support, etc.

The Department may choose to consolidate the new regulatory function into a branch or a unit within a branch.

The critical difference between these two options is the level at which the posts sit, with a branch being headed by a Deputy Director General, and a unit being headed by a Chief Director or lower. This is of importance in terms of the legitimacy and authority of the regulator and the ability to recruit the necessary scarce and technical skills to perform the economic regulation functions.

### The Key Elements of Option 1

The key elements of this Option are the following:

* The economic regulatory functions of the Department are consolidated and ring-fenced into a dedicated Economic Regulation Branch or unit within a branch. This would require that all the existing economic regulatory functions that are currently located within different Branches, Chief Directorates and Directorates are identified and relocated within the Economic Regulation unit. This would include shifts in the roles and responsibilities of the national and regional offices. It would also require strengthening of the enforcement capability of the Department to ensure that economic regulation could be enforced where necessary.
* New economic regulatory functions, currently not performed by DWA, that are incorporated into the regulatory scope and functions would need to be established and located in this unit.
* The economic regulatory functions would need to be re-organised and better integrated to ensure that there is appropriate, holistic and coherent economic regulation of the entire Water Value Chain (WVC).
* In light of the minimal economic regulation currently taking place, to perform the economic regulation function effectively, a large number of new posts would need to be created and filled and an appropriate budget allocated to the function. The Department would need to substantially strengthen the current levels of economic regulatory capacity and acquire additional specialist skills that are necessary to ensure that the capability to regulate is established, particularly financial, legal, engineering, and economic skills.
* While this option would not require legislative action to establish the branch, existing legislation, such as the NWA and WSA, as well as the PFMA, MFMA and Municipal Structures/Systems Acts may require significant amendments to enable the effective performance of the economic regulation functions in relation to all entities and municipalities in particular.
* Specific interventions would be required to ensure that the capacity and capability of all regulated institutions are progressively built to improve their capacity to be regulated. This will include policies, strategies, and s, systems and processes to ensure that access to and the provision of valid and accurate regulatory information is substantially improved. Without this, effective economic regulation will be extremely difficult.

### Advantages of Option 1

This option:

* Will, to a limited extent, enable a degree of separation of the economic regulation function from the policy, support and implementation roles of DWA, and provide a basis for more focused economic regulatory activities.
* Can be implemented swiftly, with no requirements for legislative amendments or promulgation of legislation to establish the regulator although significant legislative amendments will be required to give the necessary regulatory powers to the ER.
* Allows for an incremental approach, building on current functions and developing them further.
* Allows for close alignment between the policy imperatives of DWA and the implementation of these policy imperatives through economic regulation.
* No assignment or delegation of functions is necessary
* Can make use of DWA’s existing corporate and financial services and systems

### Disadvantages of Option 1

It needs to be noted that while this option will enable certain improvements in the regulation of key components of the water value chain to be made, it will ***not address*** the following:

* All the current identified regulatory gaps and constraints, without amendments to existing legislation.
* It will not enable alignment with some of the identified “best practice” in relation to independence, conflict of interest, and role separation and clarification.
* It will not resolve the challenge of “conflicting interests” in areas in which DWA will continue to be both the regulator and the regulated body.
* The challenges of recruiting and retaining highly skilled financial, legal, economic and engineering staff.

## Option 2: Government Component

A government component is a separate institution within the public service that is listed in Schedule 3 of the Public Service Act and subject to the provisions of the PFMA. The government component is a separate entity within the public service administration, with its own accounting officer, still accountable to the Minister. This organisational form allows for the delegation or assignment of functions to a government component within the public service without having to create a separate juristic person outside the public service e.g. a national public entity or business enterprise.

Such a component would be under the direct control of a Head of Component, with accountability and responsibility vested in the functionaries directly involved with the performance of the functions in question. The Head of Component is the accounting officer in terms of the PFMA. A government component can have its own administrative resources e.g. HR, Finance, IT, etc., or it can share these resources with its parent department.

A Government Component may have original statutory powers or assigned or delegated statutory powers and duties. Because an economic regulator for water would impact on the human right to water, the establishment of a government component would require an Act of Parliament.

A government component is linked to a principal department responsible for the relevant policy/functional area in order to assist the executive authority to exercise oversight over the component on policy implementation, performance, integrated planning, budgeting and service delivery. A government component falls within the Budget Vote of the principle department and may receive a transfer payment from the principal department.

This organisational form provides more than one accounting officer under the same Vote.

### Executive and the accounting officer

The Executive Authority is the Minister of DWA who is accountable to Parliament on the performance, compliance and functioning of the Government Component. As such, the Executive Authority has the ultimate (political) accountability for the component.

In assuming accountability, the Executive Authority must ensure that the component complies with the PFMA and the financial policies of the Department. The Executive Authority must maintain an oversight role, and must have access to all documentation and information pertaining to the affairs of the component.

The head of the component will be the Head of Component, appointed by the President in terms of section 12 of the PSA.

### Advantages of Options 2

The advantages of using this organisational form in the public service include:

* It allows a good balance between having an economic regulator that is separate from the Department but linked to it for purposes of oversight and achieving alignment with the governmental mandate;
* The Head of Component will be the accounting officer for the economic regulation function alone and will be able to focus solely on this important and complex function.
* The Head of Component has a similar standing to that of a DG of a Department
* There will be direct control and influence by the Executive Authority over service delivery outcomes and outputs without the need to create an entity outside the public service;
* Although the GC staff will still fall under the public service regulations, the GC will be able to focus is HR component on the recruitment, training and retention of staff with the specific skills required for economic regulation.
* The GC can make use of DWA’s existing corporate and financial services and systems or establish its own.
* Can be funded from the fiscus and/or water charges/regulatory levy.

### Disadvantages of Option 2

The disadvantages of this option include:

* The GC is bound by public service regulations which limit salaries and conditions of service which may pose challenges in recruiting the quality of skilled staff required for this function;
* Establishment of the GC could take between 12 to 24 months to establish depending on the length of time to get the necessary Act through Parliament;
* In terms of legal status, it remains part of the government, with a similar legal status to that of the principal department. This limits its ability to take legal action against the principal department and municipalities.
* It will not address the current identified regulatory gaps and constraints, without amendments to existing legislation.
* It will not enable full alignment with some of the identified “best practice” regulatory principles.

## Option 3: External Economic Regulator

Option 3 refers to the possibility of setting up the economic regulator outside DWA, as a National Public Entity (NPE). This corporate form allows for even more operational autonomy compared to the government component, as it is separate from DWA (and the public service) and accountable directly to Parliament. The PFMA defines a National Public Entity as follows:

***(a) a national government business enterprise; or***

***(b) a board, commission, company, corporation, fund or other entity (other than a national government business enterprise) which is—***

***(i) established in terms of national legislation;***

***(ii) fully or substantially funded either from the National Revenue Fund, or by way of a tax, levy or other money imposed in terms of national legislation; and***

***(iii) accountable to Parliament;***

For purposes of this Report, we will only discuss category (b) National Public Entities, as an economic regulator does not fit the definition of a government business enterprise. It is noted that there are also different categories of public entities:

|  |  |  |
| --- | --- | --- |
| Schedule | Category | Description |
| 2 | Major Public Entity | Intended to generate profits and declare dividends. May borrow money through its accounting authority in terms of s66 (3) (a) of the PFMA and according has extensive borrowing powers |
| 3A & C | National Public Entities | Extension of a Department with a mandate to fulfil a specific economic/ social responsibility of government.  Relies on government funding and public money (transfer from Revenue Fund or statutory levies/fees imposed)  Accordingly it has less autonomy than a schedule 2 PE |
| 3B & D |  | Provincial Public Entities |

For purposes of this discussion the National Public entity described in Schedule 3A is relevant, as the business of the ER will not be to make profits.

An NPE is established through national legislation in order to perform functions that are typically prescribed in law and serve identified ‘public purpose’ objectives. Public entities form part of the “general government”, and not the “business sector”, but they are juristic persons, have governing boards and have limited recourse to the resources and the authority of the State. A NPE’s governing board is accountable to Parliament through the Minister and the NPE forms part of a Minister’s “portfolio” of executive responsibilities. The governance arrangements for an NPE are specified in the enabling legislation and various codes and protocols such as the King Code and Protocol on Corporate Governance and are not determined by the Minister.

An NPE enjoys separate legal status and is a juristic person, and the functions and powers of the Economic Regulator would be directly assigned through its establishing legislation. Once established it must be listed as a NPE in Schedule 3 of the PFMA.

In terms of accountability, the Board of an NPE has to submit the following information to the DG of the parent Department and National Treasury:

* A projection of revenue, expenditure and borrowings for that financial year in the prescribed format; and
* A corporate plan in the prescribed format covering the affairs of that public entity or business enterprise for the following three financial years, and, if it has subsidiaries, also the affairs of the subsidiaries.
* An Annual report in the prescribed format covering the financial and functional performance of that public entity in the prior financial year, and, if it has subsidiaries, the performance of the subsidiaries.

### Advantages of Options 3

* A Public Entity falls outside the public service regulations and can therefore pay higher salaries, provide better working conditions, and recruit and retain highly skilled individuals.
* As a separate juristic person it is better placed to take legal action against water sector entities and municipalities if required.
* It provides a clear separation of roles and responsibilities (avoids conflict of interest and player/referee conflicts).
* Can be funded from the fiscus and/or water charges/regulatory levy.

### Disadvantages of Option 3

* It requires an Act of Parliament for establishment, and the approval of National Treasury and the DPSA, which may result in establishment taking up to 2 years.
* Unlike with options 1 and 2, the staff will not be considered public servants which may result in some challenges of staff transfers from DWA.
* This option is generally more expensive than the options internal to the public service.
* It will not address the current identified regulatory gaps and constraints, without amendments to existing legislation.

## Comparison of Corporate Forms

Table 4 below provides a summary comparison of relevant aspects of the three corporate forms.

Table 4 : Corporate Forms Comparison

|  |  |  |
| --- | --- | --- |
| Internal to DWA | Government Component | External to DWA |
| Strategic Direction | | |
| Minister | Minister | Minister as shareholder and Board |
| Governance and administration | | |
| Public service rules and regulations | Public service **rules and regulations** | Adhere to governance arrangements specified in enabling legislation and various codes and protocols e.g., King Code and Protocol on Corporate Governance |
| Accounts to executive authority | Accounts to the executive authority | Accounts to Parliament via the executive authority in terms of its enabling legislation |
|  | Head of a GC shall have the same duties and responsibilities as:   * A head of a national or provincial department - PSA * The accounting officer - PFMA | Board is the accounting authority |
| Legal status/ Framework | | |
| Government department | Remains part of the State similar to that of a department | Separate juristic person in terms of enabling legislation |
| Requires re-organisation of DWA and approval by DPSA if new branch is created | Original, assigned and/or delegated statutory powers and duties | Original, assigned and/or delegated statutory powers and duties |
| Requires reorganisation of budget structure | Requires act of Parliament for establishment, Can take 12 – 24 months | Requires act of Parliament for establishment, Can take up to 24 months |
| Financial Arrangements | | |
| Funded from fiscus and/ or water charges/regulatory levy | Transfer payment from DWA supplemented by revenue from water use charges/levies in terms of legislation | Transfer payment from principal department supplemented by revenue from water use charges /levies in terms of legislation |
| No separate bank account | Separate bank account, must maintain separate financial accounts and prepare own financial statements and annual report | Will have a separate bank account, must maintain separate financial accounts and prepare its own financial statements and an annual report |
| Reports annually to Parliament | For the purpose of reporting to Parliament accounts could be consolidated into the financial statements of the parent department | For the purpose of accounting to Parliament accounts are tabled in Parliament |
| Cash or accrual accounting depending on source of funding | Cash or accrual accounting framework similar to department; | Accrual Accounting framework. Chapter 6 of the PFMA applicable. |
|  | Retention of income on conditions set by National Treasury | Retention of income |
| HUMAN RESOURCES | | |
| Staff remains public servants | Staff remains public servants | Staff are employees of the entity |
| Dependent on corporate and support services of department | May share services with its parent department e.g., corporate services, in instances where separate corporate services may not be justified,  or may establish separate corporate and financial services | Separate administration and own systems do not allow for sharing of services |

# Criteria for Assessment

## Required Regulatory Outcomes

The assessment and decision on a preferred regulatory option or model is in effect a decision on which organisational structure is best suited to perform the specified and required regulatory functions (form follows function) into the future. There is no blueprint for this, no prescribed “plug and play” model that can guarantee success if used. International experience has shown that the best regulatory models are those that are developed on a case by case basis to address specific and clearly understood regulatory functions and outcomes, but also incorporate essential elements of “best practice” in regulation.

In this regard it is essential that the different institutional options/models for an economic regulator are assessed against a set of criteria that will provide a reasonable, objective and defensible basis for comparison and selection.

The assessment criteria for the options/models for the most appropriate regulation institutional structure need to include the following:

* Criteria to assess regulatory legitimacy.
* Criteria to assess the degree that the regulatory option is aligned to “best practice” and;
* Criteria to assess the fit of the regulatory option to the “market structure” of the sector and its stakeholders

These specific criteria are set out below.

### Regulatory Legitimacy

* Is the action or regime supported by legislative authority [just legislation]?
* Is there an appropriate scheme of accountability?
* Are procedures fair, accessible and open?
* Is the regulator acting with sufficient expertise?
* Is the action or regime efficient?”

### Regulatory Best Practice

* Clear Roles.
* Transparency Accountability/Non discriminatory.
* Independence/Autonomy.
* Participation.
* Effective Monitoring and Enforcement.
* Minimal Regulation.
* Predictability.

### Market Structure Fit

* Building on the strengths of current water sector regulatory structures mechanisms and initiatives.
* Progressively building regulatory capacity within the sector institutions.
* Introducing more appropriate separation of roles and responsibilities, reducing conflicts of interest and providing a basis for improved alignment of policy and legislation.
* Accommodating the necessary regulatory scope and mix that is required to ensure that the entire WVC is regulated in an integrated and holistic manner.
* Addressing existing critical regulatory gaps and constraints.
* Ensuring that the regulatory options/models address the existing water sector “market failures” on a priority basis.
* The regulatory option enables “quick wins” to be made.
* Accommodating the regulatory preferences of key sector stakeholders.

## Institutional Options Assessment Tool

Table 5 below sets out the broad assessment of three regulatory options against the regulatory criteria discussed above.

Table 5: Regulatory Criteria Assessment Tool

|  |  |  |  |
| --- | --- | --- | --- |
| **CRITERIA** | **Option 1 (Inside Branch)** | **Option 2 (Government Component)** | **Option 3 (External Regulator)** |
| **Degree of Alignment ( 2= good; 1 = partial, 0 = weak)** | | |
| **Regulatory legitimacy** |  |  |  |
| Is the action or regime supported by legislative authority | 1 | 2 | 2 |
| Is there an appropriate scheme of accountability | 1 | 2 | 2 |
| Are procedures fair, accessible and open | 2 | 2 | 2 |
| Is the regulator acting with sufficient expertise | 1 | 1 | 2 |
| Is the action or regime efficient | 1 | 2 | 2 |
| **Regulatory Best Practice (Do the options address regulatory principles?)** |  |  |  |
| Clear Roles | 0 | 2 | 2 |
| Transparency Accountability/Non discriminatory | 1 | 1 | 2 |
| Independence/Autonomy | 0 | 1 | 2 |
| Participation | 2 | 1 | 2 |
| Effective Monitoring and Enforcement | 1 | 1 | 2 |
| Minimal Regulation | 2 | 2 | 2 |
| Predictability | 1 | 2 | 2 |
| Judicial review | 1 | 1 | 2 |
| **Water Sector Fit (Does the option facilitate?)** |  |  |  |
| Building on existing regulatory capacity and structures | 2 | 2 | 2 |
| Progressively building regulatory capacity within the sector institutions. | 2 | 2 | 1 |
| Introducing more appropriate separation of roles and responsibilities | 0 | 1 | 2 |
| Addressing existing critical regulatory gaps and constraints. | 0 | 1 | 2 |
| Ensuring that the existing water sector “market failures” are addressed on a priority basis. | 1 | 2 | 2 |
| Enables “quick wins” to be made. | 2 | 0 | 0 |
| Accommodates the regulatory preferences of key sector stakeholders | 0 | 1 | 2 |

## Preferred institutional option

Based on the assessment criteria and external stakeholder preferences established during consultation processes the preferred institutional option for the Economic Regulator is the establishment of an external regulator, as a public entity. This option allows for the greatest separation of roles between DWA as a regulated body, and the economic regulator. It also allows for the necessary freedom in terms of the recruitment and appointment of the highly skilled technical staff that will be required to perform this function effectively. It builds on the relatively successful NERSA model.

The drawback of this option is that it will take some time to establish due to the procedures required for the establishment of a public entity. In the interim, therefore, it is important that the ER functions currently performed are consolidated in the DWA, and that capacity is built around this important function. The building of capacity within the DWA will enable the transfer of a core unit to the public entity when it is established.

# Legal Considerations

There are a number of legal considerations that influence the establishment of an economic regulator. These considerations may be broadly categorised as follows:

* The current regulatory framework does not enable performance of the proposed regulatory functions. It is accordingly necessary that legislative amendments will at the very least be required in respect of the National Water Act and the Water Services Act to allow for effective economic regulation.
* In light of the constitutional powers and functions assigned to local government (discussed below) it may be more feasible to conclude an intergovernmental agreement with local government wherein it is agreed that local government subjects its tariffs to approval by the Economic Regulator. If it is practical to use licensing of water services authorities and/or providers as a regulatory mechanism, the agreement should cover this aspect.
* Irrespective of the corporate form selected, the ER will be subject to the IGRFA with regard to the institution of litigation proceedings against other organs of state.

## Intergovernmental Relations Framework Act

The IGRFA establishes a framework for national, provincial and local government to promote and facilitate intergovernmental relations and to provide mechanisms and procedures to facilitate the settlement of disputes. In terms of Section 2 (1), the IGRFA is applicable to national, provincial and local governments. Section 2(2) provides specifically that the IGRFA is not applicable to “***any public institution that does not fall within the national, provincial or local sphere of government***”. The IGFRA defines an organ of state with reference to section 239 of the Constitution i.e.:

***“ (a) any department of state or administration in the national, provincial or local sphere of government; or***

***(b) any other functionary or institution –***

1. ***Exercising a power or performing a function in terms of the Constitution or a provincial constitution; or***
2. ***Exercising a public power or performing a public function in terms of any legislation, but does not include a court or a judicial officer.”***

From this definition it is clear that a Government Component will be subject to the IGRFA. This would also be true if the NPE was chosen as a corporate form through which economic regulation could be performed as the ER would be performing a public function.

Section 40 of the IGRFA provides that all organs of state must make every reasonable effort –

* to avoid intergovernmental disputes when exercising their statutory powers or performing their statutory functions; and
* to settle intergovernmental disputes without resorting to judicial proceedings.

If this is not possible the IGRFA provides the process to declare a dispute and the consequences of such a declaration and the steps to attempt resolution of the dispute.

Section 45 of the IGRFA provides that no government institution/ organ of state my institute judicial proceedings in order to settle an intergovernmental dispute unless the dispute has been declared a formal intergovernmental dispute in terms of section 41 of the IGFRA and all efforts to settle the dispute were made.

Even with legislative amendments, the economic regulator’s ability to apply pressure by resorting to the judiciary will be subject to the IGRFA which will require what may be a time consuming process of dispute settlement outside of court. The ER will however be able to resort to court where the provisions of the IGRFA have been complied with.

Since the regulated entities are mostly other organs of state, the implications are that the ER approach to enforcement will have to be proactive rather than reactive. In other words, rather than wait for an issue to escalate into a dispute, start intervening in a manner that will ultimately avoid a dispute altogether for example concluding an agreement with the defaulting party to take the necessary corrective action or to develop a plan of action where the progress of the defaulting party

is actively monitored.

## What sanctions would the regulator be able to impose on the regulated entities?

### Sanctions in terms of current water sector legislation

In terms of current water sector legislation, an ER will not have significant enforcement powers other than approaching a court. Table 6 below sets out the current status.

**Table 6. Sanctions in terms of current water sector legislation**

|  |  |  |
| --- | --- | --- |
| Institution | Current Enforcement Mechanism available to ER | ER may advise the Minister to exercise powers of intervention to ensure compliance |
| TCTA | Institute legal proceedings, subject to IGRFA | Advise the Minister to disestablish in terms of section 30 of the Government Notice 277, Government Gazette 21017 dated 24 March 2000 |
| WB | Institute legal proceedings, subject to IGRFA | Ito S28 (1) (d) of the Water Services Act, the Minister has the power to disestablish a WB, following consultation with:  • The relevant province  • The water board  • Every water services authority in the service area of the water board  Ito s73 the Water Services Act, the Minister has the power to:  • Perform the functions of a WB  • Issue model conditions for the provision of services |
| CMA | Institute legal proceedings, subject to IGRFA | The Minister may intervene in the affairs of a CMA by issuing a directive or assuming the functions of the CMA until it is able to perform its functions. The power to intervene may be exercised in the following circumstances:  • is in financial difficulties or is being otherwise mismanaged;  • has acted unfairly or in a discriminatory or inequitable way towards any person within its water management area;  • has failed to comply with any directive given by the Minister under this Act;  • has obstructed the Minister or any other water management institution in exercising a power or performing a duty in terms of the National Water Act;  • is unable to exercise its powers or perform its duties effectively due to dissension among the members of the board (or water users within its water management area;  • has failed to comply with the National Water Act; or  • has become redundant or ineffective.  The Minister may withhold any financial assistance to a catchment management agency until it complies with a directive issued by the Minister in terms of section 87 of the National Water Act and an ER may advise the Minister to exercise this power in the event of a defaulting CMA.  The Minister may disestablish a catchment management agency if it does not operate effectively in its area (section 88(1)(b) of the National Water Act). The Minister to an official in the Department of Water Affairs may only delegate the powers discussed above and it will not be possible for the ER to perform these functions on behalf of the Minister. At best the ER will be able to alert the Minister to the poor performance of the CMA and trigger the intervention by the Minister. |
| WUA | Institute legal proceedings, subject to IGRFA | Disestablish a WUA |
| LG | Institute legal proceedings, subject to IGRFA | ER may advise the Minister to intervene in terms of section 63 of the Water Services Act read with section 139 of the Constitution. Local government is discussed more fully below. |

#### Local Government

***Limitations on ability to intervene in the executive affairs of a municipal council***

To avoid overburdening this document we have included a discussion on the legal considerations for regulating municipalities as annexure **A** hereto. The conclusions of the discussion are summarised below, for ease of reference:

* The Constitution recognises the municipal council as the highest legislative and executive authority within a municipality that can make decisions on the exercise of powers within the municipality.
* A municipality derives its original powers from section 156 (1) read with schedules 4B and 5B of the Constitution and is the primary source of power for local government. One of the original powers listed in Schedule 4B provides that the municipality has the executive authority and right to administer *“water and sanitation services limited to potable water supply systems and domestic waste-water and sewerage disposal systems”*.
* The obvious significance of this lies in the fact that the ‘core’ functions of local government cannot be removed or amended by ordinary statutes or provincial acts. These functions cannot be changed but for an amendment to the Constitution itself. Moreover, the powers of national and provincial governments to legislate on Schedule 4B and 5B matters are limited.[[6]](#footnote-6) These two components are probably the most critical and fundamental features of local government’s institutional integrity.
* local government has legislative authority over Schedule 4B matters, which includes WSS.
* The Court defines the national competence as overseeing and views national government’s role on Schedule 4B matters (WSS) as a regulatory, rather than a determinative role and that the source for this limitation is section 155(7).
* This means that national government’s legislative power on Schedule 4B (WSS) matters does not extend to the ‘core’ of Schedule 4B matters but is limited to the setting of a legal framework, including minimum standards and monitoring requirements.
* Provincial government similarly has regulatory powers over Schedule 4B matters - these cannot be prescriptive with regard to the ‘core’ of Schedule 4B matters but are limited to the setting of a legal framework, which includes minimum standards and monitoring.

***Sanctions that can be imposed by the Economic Regulator***

In light of the preceding paragraph, where a municipality fails to comply with national norms and standards, the Economic Regulator will have the following recourse:

* Instituting legal proceedings, subject to satisfying the requirements of the IGRFA
* Notifying the relevant provincial government to intervene in terms of section 139 of the Constitution read with section 63 of the Water Services Act.

The provisions of the IGRFA are discussed above and we discuss the provisions of section 139 of the Constitution and section 63 of the Water Services Act below.

***Intervention by the relevant Provincial Executive***

Section 63 of the Water services Act provides that the Minister of Water Affairs in consultation with the Minister of Provincial Affairs and Constitutional Development may request the relevant Province to intervene in terms of section 139 of the Constitution, where the municipality has not performed any function imposed in terms of the Water Services Act.

Section 139 of the Constitution allows provincial executives’ authority to intervene to fulfil municipal obligations by taking appropriate steps to fulfil that obligation by:

* Issuing a directive to the Municipal Council, describing the extent of the failure to fulfil its obligations and stating any steps required to meet its obligations
* Assuming responsibility for the relevant obligation in that municipality to the extent necessary to:
  + Maintain essential national standards or meet established minimum standards
  + To prevent that municipal council from taking unreasonable action that is prejudicial to another municipality or to a province as a whole
  + To maintain economic unity

Only the executive council of a province may exercise this power and an economic regulator will not be able to intervene in terms of section 139 of the Constitution. At best the ER may alert the provincial government and the DWA of a situation contemplated by section 139 of the Constitution and advise those spheres on the remedial action to be taken. The DWA together with the provincial government will then have to take the action of issuing a directive and later assuming the function if the directive has not been effective.

An intervention in terms of section 139 of the Constitution is reserved for exceptional circumstances and there is a rigorous procedural process to be complied with before the executive authority functions of a water services authority may be assumed.

However intrusive and procedurally taxing this approach may be, the first leg of the intervention ie the issuing of a directive may prove to be a useful tool to implement a turnaround strategy for a water services authority that is not achieving national norms and standards.

Issuing a directive imposes a legal binding obligation on the Municipality to fulfill the identified executive obligation and is key to any later intervention measures. It furthermore defines the scope of the intervention. Courts will more likely uphold progressive intervention, starting with the least intrusive and ending, if need be with the most intrusive measures, the directive is the usual starting intervention.

The scope of the directive could possibly include special regulatory supervision, which is an enforcement process put in place when a water services authority’s performance has deteriorated beyond acceptable limits. The water services authority would be required, as part of the intervention, to sign an agreement under which the Economic Regulator closely monitors the operations of the water services provider including assigning a representative to attend council meetings to monitor the internal decisions of the water services authority. This would allow the ER to closely monitor a range of activities that impact on the performance of the water services authority, such as collection efficiency, quality of service, expenditure patterns, and production operations. Under the agreement the water services authority must put together an improvement plan and it must report monthly against this plan to the ER and the DWA. This plan will also detail what support the DWA and ER to enable the water services authority to fulfil its obligations will provide.

### Future Sanctions

The enforcement mechanisms available to the ER will be subject to the development and negotiation of new legislation and/ or amending existing legislation. A discussion on enforcement mechanisms is premature without a full discussion of the regulatory methodology or mechanisms that is available to the regulator. An added complexity is the fact that the regulated entities are organs of state and accordingly fines may not achieve the desired outcomes. In addition, the autonomy of local government designing enforcement mechanisms will require an intergovernmental agreement.

## To what extent will the ER be able to perform the proposed functions in terms of the NWA and WSA

As the current NWA and WSA stands the ER once established will have minimal powers and functions to carry out economic regulation of the water value chain. Even though the ER should be able to approve charges in relation to DWA, TCTA, WBs, CMAs, WUAs once established – the current legislative framework does not allow this. Consequently the establishment of the ER will have to be closely aligned to promulgation of amendments to and or new legislation for the water sector to enable the ER to be effective. At a high level the following changes would have to be enacted to allow the ER to function:

### Legislative changes required to establish the ER

Depending on the corporate form chosen:

* Establishing the ER internal to the department would not require establishing legislation, it will merely require an amendment of the Schedule to the PSA
* For both the Government Component and the NPE, establishing legislation would need to be enacted

Establishing legislation would at the very least cover the following issues:

* Establishment of the ER
* Powers and functions of the ER, read with the NWA and the WSA and other applicable legislation
* Composition of the ER (members/ committee)
* Appointment, tenure, termination, disqualification and requirements for membership of the ER
* Meetings of the ER
* Duties of the members of the ER
* Decisions by the ER
* Staff of the ER
* Funds of the ER
* Accounting by ER
* Reporting by ER

### Legislative changes to allow performance of the proposed scope and functions of ER

There is a requirement either to amend the NWA and WSA or to develop a standalone act that provides for the following:

* Clear definitions
  + economic regulation
  + regulated entities or services to be regulated
* Refers to the regulator and act establishing regulator
* Regulatory scope and functions
* Powers and duties of the regulator
* Advisory committees of the regulator
* Requires registration of all regulated entities
* Discusses tariff and charge approval processes/ requirements
* Sets out specifically the powers and duties of the ER in relation to WSAs
* Selection and appointment of external WSPs
* Key performance indicators
* Investigations
* Inspection and information gathering by the ER
* Methodology for regulation
* Sanctions
* If we want to ring fence monies/ or portion thereof – MSA needs amendment and specifically allow for it in this legislation
* Dispute resolution

## Dispute resolution

### Disputes between regulated entities

Where a dispute arises between regulated entities, the legislation establishing the ER should enable the ER to attempt resolution of the dispute by mediation, and failing mediation arbitration. The ER may act as the mediator or arbitrator or secure the services of an external expert to act as mediator or arbitrator. The decision of an external mediator or arbitrator will be regarded as a decision of the ER. If mediation fails, either the parties can agree to arbitration or institute proceedings in the appropriate court of law, following a process of dispute resolution set out in the IGRFA.

Where the parties agree that the Economic Regulator act as arbitrator in the matter, an aggrieved party may institute review proceedings in a High Court.

### Disputes between Economic Regulator and Regulated Entity

Where the Economic Regulator makes a decision, the decision will be administrative action in terms of the Promotion of Access to Information Act. Administrative Action is defined as:

***“any decision taken, or any failure to take a decision, by—***

***(a) an organ of state, when—***

***(i) exercising a power in terms of the Constitution or a provincial***

***constitution; or***

***(ii) exercising a public power or performing a public function in terms***

***of any legislation; or***

***(b) a natural or juristic person, other than an organ of state, when exercising***

***a public power or performing a public function in terms of an empowering provision,***

***which adversely affects the rights of any person and which has a direct, external legal effect…”***

If a regulated entity is dissatisfied with a decision of the Economic Regulator, it may institute proceedings in a tribunal or court for a judicial review of the decision. Proceedings for the judicial review of a decision by the ER must be instituted no later than 180 days after the date of becoming aware of the decision. Proceedings for judicial review must be instituted in the relevant High Court.

# Organisational design

## Legal requirements for organisational design

In terms of the current legislative and regulatory frameworks the Economic Regulator will have limited functions and powers to implement economic regulation of the water value chain. An added complexity is the constitutional mandate (authority function) of local government (WSAs) to provide municipal services related to water services and sanitation.

The organisational design proposed in this chapter assumes that the necessary legislative amendments will be made to the NWA and WSA to enable effective economic regulation of the entire water and assumes that the full regulatory scope and functions as set out in table 2 of this report will be implemented over a 5 year timeline

## Principles underpinning organisational design

The organisational design of the Economic Regulator has been guided by the following core principles:

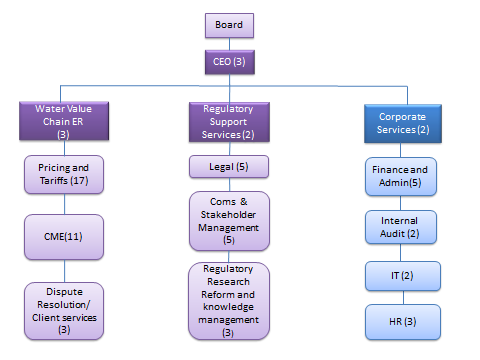
* **Centrality of Community and Customer**: The design of the organisational structure must prioritise the needs of the customer.
* **Incremental development**: The organisational design must be sufficiently flexible to accommodate changes to its external and internal environment.
* **Political alignment**: Organisational structures need to be aligned with the political structures to ensure elimination of duplication, dual reporting lines, overlaps or gaps in political alignment.
* **Service menu**: The ER’s service menu of functions and levels must be regularly reviewed based on its business plan and budget. The review should take place on an annual basis annual report.
* **Support services**: Specialised and professional support services should be centralised to achieve maximum economies of scale, high level of standardisation, quality and consistency, particularly for the smaller units/ departments in the ER.
* **Operations Integration model**: The operations and decision making of the ER must be integrated.
* **Application of information of information technology**: Business processes need to be supported by integrated IT systems for effective and efficient delivery of services and to provide a basis for analysis, measurement and strategic planning by means of business intelligence systems.
* **Business improvement**: Directorates must strive to improve customer satisfaction, staff satisfaction and operational efficiency. Operational efficiency is achieved by increasing productivity and enhancing value for money for any one area of activity.
* **Functional grouping**: Goals and functions for each directorate, department and branch must be developed in order to avoid the duplication of functions and jobs. This functional structure must inform the job descriptions of all the managerial positions.
* **Decentralisation of functions**: Departments and other functional or business units should perform their functions when necessary and as far as possible on a decentralised basis.
* **Span of control and levels of management**: The span of control should be structured to achieve flat management structures as far as possible. There should be no more than 6 vertical managerial levels to.
* **Integrated workforce planning**: Directorates need to formulate a strategy to build and retain an effective workforce for the future so as to support key business goals.
* **Designation of functional units**: Functional units must be designed in the following hierarchy: Directorate; Department; Branch; Section; Unit.
* **Focus on Core Competence:** The initial focus must be on building core economic regulatory competence “in house” within the unit. It would be more cost effective to “outsource” non-core functions or support on an as required basis rather than owning the resource.

## Staffing requirement for the Economic Regulator

Based on the external regulator option the organisational design of the ER would ideally in year 5, consist of around 64 permanent staff, including the CEO and his administration and 3 departments or units as follows:

1. Office of the CEO.
2. Economic Regulation Unit.
3. Regulatory Support Services.
4. Corporate Services.

The diagram (Figure 4) below depicts the high-level OD consisting of 64 employees:



**Figure 4: High level organisational structure of ER**

### Office of the CEO

The office of the CEO is responsible for implementation of the strategy and business plan of the ER which will be driven by an executive management team lead by the CEO. The executive management team will consist of the CEO, Company Secretary, and all Executive Managers. The Office of the CEO is the strategy hub – providing strategic guidance, and shaping the direction of the ER. Strategic branding and marketing for the ER will take place in this office with a staff compliment of 3 (three), including the CEO. The Company Secretary will play a dual role. The first role is that of providing strategic legal support to the Board. The second role is providing support to the executive management team of the ER and managing the legal affairs of the ER. Whilst the Company Secretary reports directly to the Board, he/she will operate at the same grade/ post level as executive managers that report directly to the CEO.

**Staff: 3**

### Water Value Chain Economic Regulation Department

Has an executive Manager and an assistant to ensure continuity of function and skills transfer served by an administrator.

**Staff: 3**

#### Pricing and tariffs

* Raw water pricing
  + Set rules for the determination of and approve raw water and waste discharge charges.
  + Assess CMA, TCTA, and WUA business plans and annual reports.
  + Conduct assessment of input costs and projections.
  + Review existing international raw water agreements.
  + Ensure that appropriate contractual arrangements are in place for raw water service delivery.
  + Develop, implement and review systems and processes for regulatory information collection and analysis.
* Bulk potable water pricing
  + Set rules for the determination of and approve bulk water (raw and potable) water charges /tariffs and bulk wastewater tariffs.
  + Set norms and standards for pricing and service standards of bulk water and sanitation service delivery.
  + Monitor compliance with norms and standards for the provision of bulk water services /tariffs.
  + Provide regulatory oversight over WBs and water services intermediaries through Business Plans and associated CAPEX planning and projections.
  + Conduct full analysis of input costs and all projections.
  + Set appropriate benchmarks for tariffs and standards.
  + Oversee the tariff consultation process.
  + Provide regulatory guidelines.
  + Develop, implement and review systems and processes for regulatory information collection and analysis.
* Retail municipal pricing
  + Set rules for tariff determination of retail water and sanitation tariffs.
  + Set norms and standards for pricing of retail water and sanitation service delivery.
  + Monitor compliance with norms and standards for the provision of retail water and sanitation services/tariffs.
  + Conduct analysis of input costs and all projections, including infrastructure planning and investment.
  + Set appropriate benchmarks for tariffs and standards.
  + Oversee the tariff consultation process.
  + Provide regulatory guidelines.
  + Develop, implement and review systems and processes for regulatory information collection and analysis.
* Contract regulation
  + Ensure that appropriate contractual arrangements are in place all primary business interfaces between institutions in the water value chain.
  + Provide model contracts for all primary business interfaces between institutions in the water value chain.
  + Determine what are services providers charging the end user and ensuring compliance with regulations.
  + Ensure compliance with tariff determination processes and norms and standards.

It will be critical to get this unit staffed with appropriately skilled people to conduct the research, develop the detailed methodologies and apply them as soon as reasonably possible following establishment.

It may not initially be possible to obtain the relevant skilled and experienced staff and it may be necessary to contract in the necessary skills while the necessary internal capacity is being built. Such contracts must be structured to ensure that consultants contribute to the building of institutional capacity and memory within the economic regulator.

Employees in this unit must have the necessary skills and competence to assess and analyse the basis for, calculations and validity of costs used to determine all charges and tariffs along the entire water value chain to ensure continuity and interdependence of charge/tariff analyses and approval processes.

**Staff: 17**

* 2 X Senior infrastructure investment analysts (looking at all entities investment decisions).
* 2 X Senior Economists.
* 1 economist per region for WSA = 6 (use three from CMA once cycle complete).
* 1 economist for every three CMAs = 3.
* 3 economists for the WBs (4 WBs per person).
* 1 X administrator.

#### Regulatory Research, Reform and Knowledge Management

* Monitor policy and legislative changes and impacts on regulated industry.
* Research sector/industry /policy changes.
* Research developments in other countries and regulatory decisions and regulation of water sector and trends.

**Staff: 3**

* Senior Researcher (economics).
* Researcher (legal or engineer).
* Knowledge Manager (librarian).

#### Compliance, Monitoring and Enforcement

* Monitors compliance with customers services charters.
* Monitor and report on compliance with legislation, norms & standards and other regulatory requirements.

**Staff: 11**

* 1 X senior manager.
* I X professional per region (check compliance of all institutions in region) = 9.
* 1 X administrator.

#### Dispute Resolution

* Handles complaints between regulated bodies.
* To resolve the complaint, all relevant information is gathered and the department facilitates. the complainant and the respondent’s efforts to reach an amicable solution.
* Where a solution cannot be reached, the complaint is escalated into a dispute, and referred to Legal Services and ultimately ending up in mediation or arbitration as provided for in the revised legislation.
* The Legal Services deals with the dispute in accordance with the Dispute Resolution guide to be developed by ER on establishment.
* The staff are not necessarily legal, more technical.

**Number of people: 3**

* Professional (water services technical expertise).
  + Consider nature of complaint and revert to complainant or escalate complaint to manager.
  + Attend court/ arbitration proceedings.
* Professional (raw water)
  + Consider nature of complaint and revert to complainant or escalate complaint to manager.
  + Attend court and arbitration proceedings.
* Administrative assistant
  + Collect and screen complaints received.
  + Confirm receipt of compliant.
  + Screen complaints and ensure that complaint first referred to SP.
  + Advise on process requirements eg completion of forms , not technical legal issues.
  + Legislation must empower the ER to resolve disputes between service providers.
* Complaints/ disputes to be dealt with:
  + Quality of supply.
  + Quality of service.
  + Billing.
  + Metering.
  + Tariffs/ charges
* If dispute fails refer to Legal Services Department.

### Regulatory Support Services

#### Institutional and Stakeholder coordination

This division is critical especially in the initial years after establishment for developing trust, building legitimacy and publicising the institution as a champion for economic regulation of the water value chain.

The function must therefore be led by a water sector institutional coordinator with extensive knowledge of the water sector and related institutional arrangements and their impact on economic regulation of the Water Value Chain. The institutional specialist will be supported by an operational team of 4 coordinators managing localised stakeholder engagement and mobilisation activities.

**Staff: 5**

* 1 professional - WR institutions.
* 1 professional - Bulk water services institutions.
* 2 professional – WSA.
* 1 X admin clerk.

### Corporate Services

#### Legal Services

This department will manage dispute settlement in accordance with the Dispute Resolution Framework provided for in the enabling legislation. This department also will be responsible for instituting/ defending legal action and may provide general legal advisory services to the board, CEO and other departments of the ER.

**Staff: 5**

* 1X Senior Legal Advisor with over 10 years’ experience in public sector and environmental law background with some conciliation, mediation and arbitration experience.
* 2 X Senior L Advisors – with more than 3 years’ experience (to attend to legal matters that have escalated to court).
* 1 X paralegal.
* 1 X administrator.

#### Finance and Administration

The senior management team of the unit will consist of a revenue manager and an accounts manager supported by debtors clerk and accounts clerk respectively. The revenue manager and accounts manager will report directly to the CEO with the revenue manager responsible for the function of administering the collection revenue. While the accounts manager’s focus will be on managing and administering the general finances of the ER.

**Staff: 4**

#### Human Resources

Organisational development, staffing and general human capital management will be the responsibility of the human resource department. These management posts will operate at a similar grade level, with possible variations depending on the number of positions directly reporting to each post. The human resources department will have a critical role to play in recruiting and retaining appropriately skilled and experienced staff. It’s accordingly critical that the HR practitioner hold and executive position to allow for remuneration policies and working conditions that will allow the relevant expertise to be retained within the ER. Skills development will be a critical requirement for the ER and will need to be strategically managed once established.

**Staff: 3**

* 1 X Senior HR practitioner, with 10 years’ experience.
* 1 X HR professional with 3 years’ experience.
* 1 X Administrator.

#### Internal audit

The internal auditor will be responsible for reviewing current practice, championing best practice and be a catalyst for improvement, with the objective of ensuring that the ER as a whole can achieve its strategic objectives. The duties of the auditor will be as follows:

* Evaluating controls and advising managers at all levels.
* Evaluating risks.
* Analysing operations and confirming information.
* Reviewing compliance.

**Staff: 2**

1 X Senior Auditor.

1 X Junior Auditor.

#### IT

This important department will need to develop IT systems to enable regulation and to manage these systems.

**Staff: 2**

2 X IT specialists (senior and junior).

## Phasing in of staff

Our experience with other public entity establishment processes may be summarised as follows:

* The Minister must appoint the governing board and this may take a take a considerable portion of the first year after establishment.
* Once the board is established, they first have to review the Business Case, oversee a Business Plan (or revisions to the BP), and then advertise for a CEO.  This process may take another few months.
* Once the CEO is appointed, he/she has his/her own vision and may not accept the BP as given.  Accordingly, the CEO may only appoint his/ her executive team in the second year. It is only once the executive team is appointed that additional staff and/ or consultants may be recruited and appointed.
* Once there is an appropriate number of staff (year three after establishment has been appointed they will probably spend the that year conducting research on the following issues:
  + conducting research on the entities to be regulated and how they determine their revenue requirements.
  + how they are reporting and to whom.
  + methodologies for regulation and categorisation of the different entities.
  + Determining capacity and information gaps in all institutions.
  + Identifying gaps in the regulatory framework.
  + Prioritising the approach to economic regulation and determining a phased implementation plan.
  + Conducting benchmarking of other ER regulators.
  + Assessing applicable sector legislation and other sector regulation that will impact on ER.
  + Developing and implementing regulatory guidelines systems and processes.
  + Assessing strategic infrastructure management decisions by regulated entities to ensure the financial feasibility of decisions made.
  + Approve tariffs (WUA, WBs, CMAs, DWA, WUAs, other intermediaries).
  + Check tariffs and service delivery standards against norms and standards (WSAs and WSPs.

As outlined in paragraph 9.3 above, the OD and staffing proposal projects the envisaged requirements for the economic regulator to function effectively in year 5 following establishment of the entity. Following any decision to establish an independent economic regulator it will clearly be necessary to develop and implement an interim phased staffing plan to progressively staff and capacitate the ER to execute its functions. This interim staffing plan should map out key staffing and capacity requirements and growth each year over the 5-year period until the full-proposed complement of approximately 64 staff is achieved. Use of short or fixed term contracts could be made to secure the necessary skills and expertise in order to facilitate and enable the economic regulator to “get out of the starting blocks” as quickly as possible and deal with prioritised establishment tasks, capacity building and the development and implementation of critical and priority driven regulatory functions as outlined above.

The progressive ER staffing plan should take into account the incumbent DWA regulatory skills capacity and seek to ensure that this is as seamlessly as possible incorporated into the ER entity in order to build some regulatory continuity and provide a critical foundation of regulatory skills and knowledge for the establishment and initial functioning of the ER.

# Financial arrangements

As discussed in Chapter 6, the three possible institutional options for Economic Regulation are:

1. Internal Unit (Departmental restructuring to establish a dedicated departmental unit).
2. National Government Component (GC); and
3. National Public Entity (NPE).

The financial arrangements for these three options differs slightly, as will the costs. Despite the recommendation on the preferred corporate form (paragraph 6.3) ie NPE this chapter provides comparison of the costs in paragraph section 9.2.4 to demonstrate the difference in cost between the three options.

## Financial flows

The expected financial flows in and out of the Economic Regulator are graphically illustrated as per Figure 5 below.

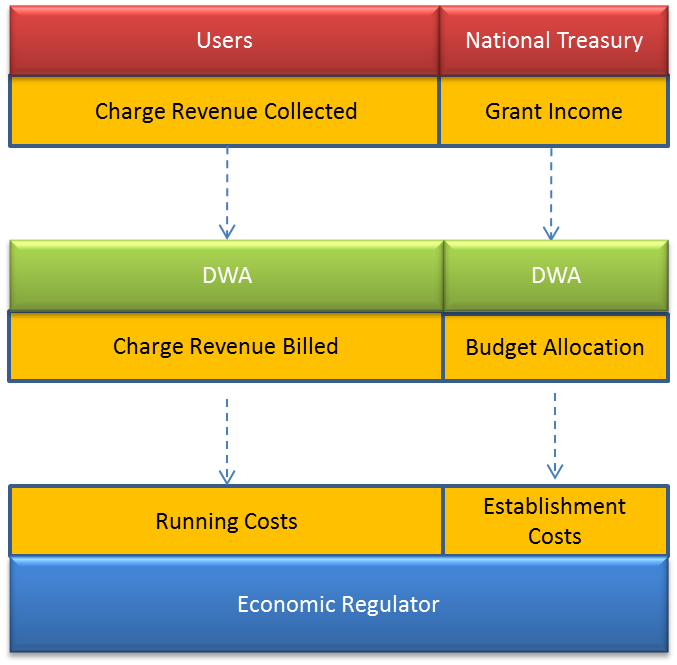


Figure 5. Financial cash flows for the Economic Regulator

The expected revenue, expenditure and other cash-flow implications are discussed in more detail below. Broadly, it can be seen that the only source of income that the Economic Regulator expects to receive is income from the Economic Regulation charge. The Economic Regulator will set the charge and the Economic Regulator will invoice DWA. DWA will collect the charge revenue from the users on behalf of the Economic Regulator and transfer the money to the Economic Regulator. This is the current practice for the WRC, CMAs and TCTA. The main outflows relate to establishment costs, which are once-off, staff costs, and overhead costs, which are recurring expenses.

## Cost analysis

The Economic Regulator, as an NPE, is assessed below in terms of phasing, establishment costs and operating costs. The relative cost of a Government Component and Departmental Unit are also shown in the cost comparator.

### Description of phasing

For effective development and functioning of the Economic Regulator unit, the staff complement

will need to be phased in. It is expected that approximately 14% of the staff vacancies will be filled in the first year as an NPE requires the appointment of a governing board and this will likely take up the most of the first year. In the second year the staff complement is expected to increase considerably with the remaining roles in regulation or related research being filled by consultants. Within 5 years, the staff complement is projected to increase with the consultants decreasing to zero. This is illustrated in the graph in Figure 6 below.

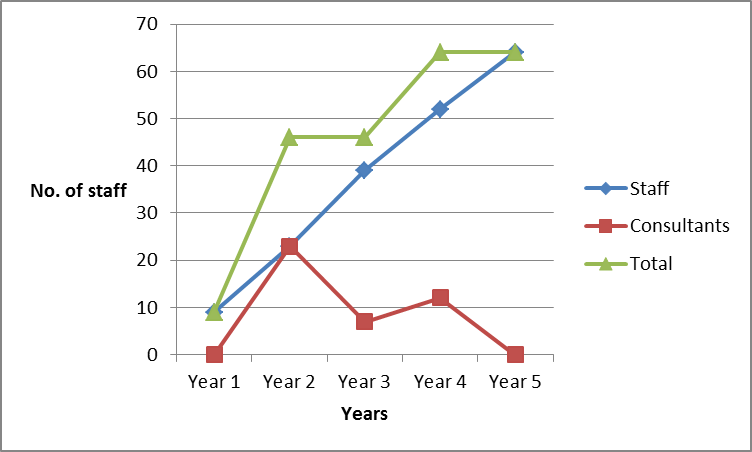


Figure 6 Staff and consultant phasing over five years

### Establishment costs

The Economic Regulator will be a new entity and is technically starting from scratch. The costs expected to establish the Economic Regulator consist of fixed assets e.g. computers, basic office software, printers, furniture and other office equipment, IT network connections, marketing and communication strategy costs, recruitment costs, induction, training and legal fees (e.g. contracts).

Most of the costs are expected to be incurred in the first year with on-going costs relating to replacement of fixed assets, further recruitment and training. The estimated cost breakdown for the establishment of the NPE option is set out in Table 7 below:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Estimated Establishment costs** | **Year 1** | **Year 2** | **Year 3** | **Year 4** | **Year 5** |
| **R'000** | | | | |
| Fixed Assets |  |  |  |  |  |
| *Computers and basic Office software* | *135* | *222* | *269* | *232* | *226* |
| *Printers and other office equipment* | *15* | *35* | *35* | *45* | *45* |
| *Furniture* | *185* | *-* | *505* | *-* | *-* |
| IT Network installation | 100 | - | 112 | - | - |
| Institutional establishment | 750 | - | - | - | - |
| Enabling Legislation | 500 | - | - | - | - |
| Marketing & Communication strategy | - | 1 050 | - | - | - |
| Recruitment costs | 1 036 | 1 157 | 1 478 | 1 589 | 1 762 |
| Induction training | - | 250 | 280 | 297 | 314 |
| Legal fees (contracts, etc.) | 100 | - | - | - | - |
| **Total** | **2 821** | **2 714** | **2 680** | **2 162** | **2 347** |

Table 7. Establishment costs for NPE

### Operating costs

The cost of running the Economic Regulator is expected to be dominated by staff costs and certain consulting services to assist with the establishment process. Other running costs are expected to be advisory board costs and overhead costs.

Table 8 below provides a breakdown of the operating costs that can be expected for the NPE. The costs are provided in nominal terms, assuming an inflation rate of 5.9%.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Operating costs for the NPE** | **Year 1** | **Year 2** | **Year 3** | **Year 4** | **Year 5** |
| **R'000** | | | | |
| Staff costs | 10 546 | 22 320 | 37 370 | 53 544 | 71 478 |
| Consultants | - | 32 828 | 35 126 | 19 534 | - |
| Advisory Board/Governing Board | 5 217 | 5 525 | 5 851 | 6 196 | 6 562 |
| Overheads | 8 294 | 10 997 | 11 895 | 13 100 | 14 700 |
| **Total** | **24 057** | **71 670** | **90 242** | **92 375** | **92 739** |

Table 8. Operating costs for the NPE

The main expenses that are expected to contribute to the overhead costs would consist of travelling costs, marketing costs and office costs. Office costs would consist of expenses relating to lease of premises (incl. utility charges), telephone and fax lines, IT costs (Network support, etc.), and provision for replacement of assets.

The staff costs are based on the organisational design described in Chapter 8 above.

This consists of 64 staff members in year five, including the CEO and his/her administration and the three departments, namely Regulatory Support services, Corporate Services and Water Value Chain (WVC) ER.

### Cost Comparator

The existing costs of running the Economic Regulator unit is minimal as there are no dedicated structures and only about six staff members currently dedicated to Economic Regulation. The cost of this function is approximately R3 million p.a and is expected to increase to roughly R100 million. The increased operating budget to run the Economic Regulator is substantial as the regulator is practically starting from scratch.

A comparison of the three potential corporate forms is provided as follows:

### Establishment Costs

The establishment costs for the GC and the NPE are similar at approximately R2.3 million on average per year (R12 million cumulative over five years); while the Internal unit model is slightly lower at R1.6 million per annum (R 8 million cumulative over 5 years). This is due to the cost savings relating to using DWAs shared services like Human Resources, Legal, Finance, and admin. These costs are summarised in Figure 7 below.

Figure 7. Establishment costs per Institution

### Operating costs

In year five, the running costs for the NPE and GC are expected to be approximately R 93 million and R 81 million respectively in comparison to the Internal unit being R 56 million. As mentioned above, for the Internal Unit, there are costs savings on staff due to using DWA’s shared services. There are further cost savings relating to board, annual report and external audit. However, the unit would have committees with part time and full time commissioners, and thus there would still be some advisory board costs. These costs are summarised in Figure 8 below.

Figure 8. Operating costs per Institution

## Summary of total estimated costs for the NPE

The total expenditure expected for the NPE institution over the first 5 years is summarised in the Table 9 below.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Total Costs: NPE** | **Year 1** | **Year 2** | **Year 3** | **Year 4** | **Year 5** |
| **R'000** | | | | |
| **Staff Costs** | 10 546 | 22 320 | 37 370 | 53 544 | 71 478 |
| **Consultants** | - | 32 828 | 35 126 | 19 534 | - |
| **Overheads** | 8 294 | 10 997 | 11 895 | 13 100 | 14 700 |
| **Board Costs** | 5 217 | 5 525 | 5 851 | 6 196 | 6 562 |
| **Establishment** | 2 821 | 2 714 | 2 680 | 2 162 | 2 347 |
| **Total** | **26 878** | **74 384** | **92 922** | **94 538** | **95 087** |

Table 9. Total estimated costs for the NPE

Establishment costs are expected to be about R3 million in the first year with staff costs being R10.5 million, board costs 5.2 million and overhead costs being R8.2 million being the primary contributors of a total of approximately R 26.9 million. The costs are expected to increase significantly in Year 2 as more staff and consultants are employed. The staff costs are expected to increase to R71 million in year 5 with total costs of R95 million. In comparison the Government Component’s and Internal unit’s total expenses are expected to be R82 million and R58 million respectively in year 5.

# Sources of revenue

## Principles

As a basic principle, water users should pay for the costs of economic regulation. The challenge is which users should pay? The users who are most likely to benefit from the regulator being put in place are the domestic and industrial users (users at the higher end of the value chain). But the pricing strategy does not have jurisdiction over the prices/charges they pay for their water. This essentially leaves the charging to the raw water users who would also benefit from having a regulator.

## **Practicalities** **of** **implementation**

An issue in implementing this charge is where this charge should be levied. Should this charge be a separate charge completely? Or be added to an existing charge such as the Water Resource Management (WRM) Charge or the National Water Resource Infrastructure charge (NWRI)-Depreciation, Return On Assets (ROA) or Operations and Maintenance (O&M)?

The National Water Act (NWA) does not make provision for a charge dedicated to the operation of an Economic Regulator so a separate Economic Regulation charge is not feasible. The charge would have to be included in one of the existing charges provided for in the NWA such as the WRM charge or the NWRI charge.

The user base for the WRM charge is quite small and the full cost would be a burden to the users. Including an additional Economic Regulation charge, would have the effect of doubling the current WRM charge. Including the economic regulation charge as part of the WRM charge has therefore been excluded as an option.

Economic Regulation is a critical part of ensuring effective asset management and therefore effective maintenance over time. It does not impact refurbishment or betterment of the infrastructure. The revised pricing strategy has thus included the charge to indirect operations and maintenance costs as part of the NWRI charge.

No provision has been made for the economic regulation charge in any legislation. There could be a Water Sector Economic Regulator Act enacted as a solution, or the NWA could be amended to remedy this.

There is also a challenge around the sole right of municipalities to set the water prices and all associated service to their users and the inability of DWA to dictate to them what tariffs they may set.

## Review of possible sources

The main source of revenue for the Economic Regulator will be the revenue received from the Economic Charge. The Charge revenue should cover the costs of operations with no profit element. The Economic Regulator is not expected to receive a grant. As the charge is expected to be added to the O&M charge, any stipulations relating to the social component of the O&M charge will impact the Economic Regulation charge, so it is covered there. There may also be a grant from National Treasury for the Establishment costs. Other possible sources of income could be penalties for late payments of the charge.

## Modelling of impact of revenue required on user charges

The charge proposed should cover the costs of Economic Regulation as per the cost analysis above and have no profit element.

Based on the NPE cost in Year 5 of R 95 million, and the registered volume across all the schemes in South Africa for the Department’s 2012 financial year of 10 billion m3, the potential Economic Regulation charge would be R1.03.

For water resource management, the charge of R1.03 would have a significant impact on the users in all industries. The addition of the Economic Regulation charge would about double the total WRM charge, thus adding the charge to the existing WRM charge is not feasible. The impact of this is summarised in Table 10 below.

|  |  |  |  |
| --- | --- | --- | --- |
| **Industry** | **Ave charge (c/m³) : 2012/2013** | **ER charge (c/m³)** | **% of existing charge** |
| D&I | 2.62 | 1.03 | 39% |
| IRR | 2.15 | 1.03 | 48% |
| Forestry | 1.29 | 1.03 | 79% |

Table 10. Impact of adding the ER charge to the WRM charge

On the other hand, adding the Economic Regulation charge to the NWRI charge has a minimal effect on the average user. See the Table 11. below.

|  |  |  |  |
| --- | --- | --- | --- |
| **Industry** | **Ave charge (c/m³) : 2012/2013** | **ER charge (c/m³)** | **% of existing charge** |
| D&I | 74.03 | 1.03 | 1% |
| IRR | 9.16 | 1.03 | 11% |

Table 11. Impact of adding the ER charge to the NWRI charge

See the below Table 12 for the analysis of one of the Western Cape schemes, the Bergriver (Voelvlei Dam). The impact of the addition of the Economic Regulator charge is not significant, an overall increase in Billing of approximately 4%.

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **SMP ID** | **Sector** | **Registered Volume ('000 m³)** | **2011/2012 Charges (c/m³)** | **Theoretical Billing (R'000 )** | **ER charge (c/m³)** | **New charge (c/m³)** | **Revised Billing (R'000 )** | **Additional Billing (R'000 )** | **% of existing Billing** |
| 4 | Irr | 11 518 | 2.10 | 242 | 1.03 | 3.13 | 360 | 119 | 49% |
| 45 | D&I | 4 274 | 18.02 | 770 | 1.03 | 19.05 | 814 | 44 | 6% |
| 121 | D&I | 70 400 | 38.96 | 27 428 | 1.03 | 39.99 | 28 153 | 725 | 3% |
| 127 | Irr | 14 552 | 9.64 | 1 403 | 1.03 | 10.67 | 1 553 | 150 | 11% |
| 411 | D&I | 704 | 18.02 | 127 | 1.03 | 19.05 | 134 | 7 | 6% |
| 412 | D&I | 17 476 | 20.54 | 3 590 | 1.03 | 21.57 | 3 770 | 180 | 5% |
| 413 | D&I | 1 500 | 20.54 | 308 | 1.03 | 21.57 | 324 | 15 | 5% |
|  |  | 120 423 |  | 33 868 |  |  | 35 108 | 1 240 | 4% |

Table 12. Impact of adding the ER charge to the WRI charge in the Berg River scheme

## Recommendation

From the above analysis, it is recommended that the Economic Regulation Charge may be added to the indirect O&M costs under the NWRI charge. Economic Regulation is a critical part of ensuring effective asset management and therefore effective maintenance over time and the addition of the charge to the O&M component would not have a significant impact on the user base.

## Financial systems considerations

Establishing the Economic Regulator will require financial systems to be established. The type of financial system required depends on the complexity and volume of information to be processed. The activities would be to bill and collect revenues and these need to be recorded in the accounting system. The expense item transactions would also need to be recorded. The institution would need to be audited, thus the financial system chosen would have to comply with the applicable accounting standards e.g. GRAP or IFRS etc.

The inflows and outflows are not too complex and the staff complement of 64 is not significant. These can all be managed on a basic bookkeeping system for medium to large sized enterprises such as Pastel or Softline ACCPAC. The software will be used for billing, debt management and financial accounting.

None of the financial management responsibilities above are new to DWA. These transactions could be managed on the current financial management framework of DWA, thus there may not be a need for a new financial system. Currently DWA bills and collects on the WRC and WRM charges. DWA pays the WRC/WMA what they should have collected based on 100% billing and revenue collection. The same applies to TCTA as well. The Economic Regulator charge would potentially have to be billed, collected and paid in the same way.

# Conclusion

The content of this report has been developed in consultation with the project work stream that has guided the ultimate recommendations made by the project team. This report has set out the definition, scope and functions of the proposed economic regulator for water, as well as a consideration of three possible corporate forms for the ER.

Based on the objectives to be achieved by economic regulation and the understanding that the ERs role is ensure the implementation of relevant water sector policy, the definition of economic regulation has been articulated as follows: ***“setting the rules to control, monitor, enforce and/or change tariffs/charges, tariff/charge determination structures and service standards for the water sector whilst recognising and supporting government policy and broader social, environmental and economic imperatives”.***

The universal principles for economic regulation have been captured and include clear roles, transparency, accountability, non- discriminatory, independent, transparent, participation, effective monitoring and enforcement, minimal regulation and predictability. There has been significant and heated debate around the principle of regulatory independence and why this is preferable, desirable or necessary or not, and what form it should take. This report therefore argues that in the context of economic regulation of the water sector and the public ownership of the regulated institutions, the concept of independence can be achieved by ensuring that through the structural, governance and administrative design (functions and rules), other appropriate principles can be embedded and established to reinforce and underpin regulatory legitimacy and credibility, regardless of the institutional option selected. It can further be argued that regulatory independence should be progressively built and established by the way the ER operates and builds/demonstrates credibility, not necessarily imposed as an institutional form.

The Economic Regulator Review conducted in June 1012 as part of the PERR project highlighted that currently there is no coherent economic regulation of the entire water value chain (water resources and water services) in South Africa (or anywhere else in the world), although some elements of economic regulation are currently targeted at specific institutions operating in the value chain such as water boards and municipalities.

Given the proposed definition for economic regulation as stated earlier in this document and the re3cognised need to apply economic regulation throughout the water value chain it is essential that this be translated into a clear understanding of the proposed regulatory scope and the related functions. The proposed regulatory scope and functions as set out in this document have been aligned to the key “business interfaces” in the value chain. The business interfaces in the water value chain are in effect the various water charges/tariffs and the related institutions that impact on/ determine the charges/tariffs. This provides for a holistic and integrated approach to economic regulation of the WVC.

The three corporate forms that have been assessed as part of this report are an internal unit/ branch in DWA, a government component and a national public entity. Based on the assessment criteria and external stakeholder preferences established during consultation processes the preferred institutional option for the Economic Regulator is the establishment of an external regulator, as a national public entity. This option allows for the greatest separation of roles between DWA as a regulated body, and the economic regulator. It also allows for the necessary freedom in terms of the recruitment and appointment of the highly skilled technical staff that will be required to perform this function effectively. It builds on the relatively successful NERSA model.

The drawback of this option is that it will take some time to establish due to the procedures required for the establishment of a public entity. In the interim, therefore, it is important that the ER functions currently performed are strengthened and consolidated in the DWA, and that capacity is built around this important function. The building of capacity within the DWA will facilitate the transfer of a core unit of competency to the public entity when it is established.

From the organisational design chapter, it is anticipated is the NPE option is selected, that over a 5-year timeframe at least 64 staff will be required to fully perform the proposed functions of the Economic Regulator, which will include the CEO and his administration, a water sector economic regulatory unit, a regulatory support unit and relevant corporate services.

Following any decision to establish an independent economic regulator as a NPE it will be necessary to develop and implement an interim phased staffing plan to progressively staff and capacitate the Economic Regulator to execute its functions. This interim staffing plan should map out key staffing and capacity requirements and growth each year over the 5-year period until the full-proposed complement of approximately 64 staff is achieved. In the initial years after establishment, it is anticipated that the use of fixed term contracts will be necessary.

If the Economic Regulator is established as a NPE, the summary of expected costs over a five year establishment cycle has been projected as follows:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Total Costs: NPE** | **Year 1** | **Year 2** | **Year 3** | **Year 4** | **Year 5** |
| **R'000** | | | | |
| **Staff Costs** | 10 546 | 22 320 | 37 370 | 53 544 | 71 478 |
| **Consultants** | - | 32 828 | 35 126 | 19 534 | - |
| **Overheads** | 8 294 | 10 997 | 11 895 | 13 100 | 14 700 |
| **Board Costs** | 5 217 | 5 525 | 5 851 | 6 196 | 6 562 |
| **Establishment** | 2 821 | 2 714 | 2 680 | 2 162 | 2 347 |
| **Total** | **26 878** | **74 384** | **92 922** | **94 538** | **95 087** |

In comparison, the Government Component’s and Internal unit’s total expenses are expected to be R82 million and R58 million respectively in year 5. There are a number of costs savings in the case of the internal unit, as the assumption is that an internal unit would make use of DWA’s corporate services.

Consideration has been given as to how the total costs of the ER should be funded and recommend the creation of an economic regulation charge that may be added to the indirect Operation and Maintenance costs under the NWRI charge as economic regulation is a critical part of ensuring effective asset management. Moreover, the addition of the charge to the O&M component would have the least significant impact on the user base. This economic regulation charge methodology could be applied regardless of the institutional form chosen for the ER.

Consideration has been given to the key aspect of legal issues affecting the proposed ER. At present the water sector legislation does not allow for effective economic regulation of the WVC and significant amendments (and/ or the promulgation of new legislation) are necessary in order for an ER to perform the proposed ER functions as set out in this report, regardless of the institutional form chosen. National and Provincial Governments powers in relation to the executive authority of local government is limited to the setting of a legal framework, including minimum standards and monitoring requirements and accordingly an Economic Regulator’s powers will be limited to setting and assessing compliance with national norms and standards. In light of the fact that the regulated entities are all public entities, an Economic Regulator will be subject to the requirements of the IGRFA and will have to attempt resolution of the dispute prior to instituting legal proceedings in a High Court.

The establishment of an economic regulator for the entire WVC is a critically important strategic initiative for DWF and the entire water sector. It is clear that sector stakeholders view this as a urgent and critical initiative as there are well defined challenges related to institutional sustainability, declining service delivery standards, affordability of services, water quality, equity and service coverage that need to be monitored and addressed urgently. The requirement for improved and effective economic regulation of the WVC is in-disputed and it should be recognised that regardless of the institutional form that is finally agreed and adopted, the implementation of the ER will require a progressive and incremental approach if it is to be successful. It requires that the political and administrative leadership of DWA fully support and align the selected regulatory model and promote and commit to the effective implementation of the ER. A critical success factor would be ensuring that adequate resources are made available to underpin the effective establishment of the selected ER model.

**Annexure A: Executive Authority functions of Municipalities and National and Provincial governments limited powers to intervene in the executive affairs of a muni**

**Status of Municipality**

As a point of Departure, it is important to note the status of Municipalities in terms of section 151 of the Constitution of the Republic of South Africa[[7]](#footnote-7) (the Constitution). Section 151 of the Constitution reads as follows:

***“151. (1) The local sphere of government consists of municipalities, which must be established for the whole of the territory of the Republic.***

***(2) The executive and legislative authority of a municipality is vested in its Municipal Council.***

***(3) A municipality has the right to govern, on its own initiative, the local government affairs of its community, subject to national and provincial legislation, as provided for in the Constitution.***

***(4) The national and provincial government may not compromise or impede a municipality’s ability or right to exercise its powers or perform its functions.***

From the above, it is clear that the Constitution recognises the municipal council as the highest legislative and executive authority within a municipality that can make decisions on the exercise of powers within the municipality. The judgement, delivered by the Constitutional Court in **Fedsure Life Assurance and Others v Greater Johannesburg Transitional Metropolitan Council and Others***[[8]](#footnote-8)* forms the bedrock of any analysis of local government’s powers. It was in this case that the Constitutional Court made an unequivocal statement as to the status of local government in the post-1994 constitutional framework. The Court made it clear that *“local government is no longer a public body exercising delegated powers. Its council is a deliberative legislative assembly with legislative and executive powers recognised in the Constitution itself.”*

This gives rise to the question: what powers does a municipality have? A municipality has original powers derived from the Constitution and assigned powers in terms of national or provincial legislation. For purposes of this report we will only discuss original powers.

***Original powers of the municipality***

A municipality derives its original powers from section 156 (1) read with schedules 4B and 5B of the Constitution and is the primary source of power for local government. One of the original powers listed in Schedule 4B provides that the municipality has the executive authority and right to administer *“water and sanitation services limited to potable water supply systems and domestic waste-water and sewerage disposal systems”*.

The obvious significance of this lies in the fact that the ‘core’ functions of local government cannot be removed or amended by ordinary statutes or provincial acts. These functions cannot be changed but for an amendment to the Constitution itself. Moreover, the powers of national and provincial governments to legislate on Schedule 4B and 5B matters are limited.[[9]](#footnote-9) These two components are probably the most critical and fundamental features of local government’s institutional integrity.

***National government’s powers on Schedule 4B matters***

National government’s law making powers on Schedule 4B matters was the subject of an important case, to be heard by the Pretoria High Court in 2002. The City of Cape Town challenged national legislation that made:

* municipal electricity distribution subject to a licence issued by the National Electricity Regulator of South Africa (NERSA); and
* municipal electricity tariffs subject to NERSA approval.

The City of Cape Town contended that it has the constitutional power to set its own electricity tariffs and to supply and distribute electricity in its area without needing a licence approved by NERSA. Its Schedule 4B function of “electricity reticulation” entitled it to make and carry out decisions regarding electricity reticulation in its area and to exercise any power reasonably necessary for, or incidental to, the effective performance of its functions. This would include the right to set its own tariffs. This case was not finalised as the new ANC government was elected.

We however agree with the view taken by the City of Cape Town for the following reasons.

1. National government’s legislative competence in respect of Schedule 4B matters: in terms of section 155(7) of the Constitution is limited to regulate

National government can legislate on Schedule 4B matters on the basis of section 155(7), which affords national government the power to ‘regulate’ the exercise by municipalities of their executive authority. This legislative power is limited, since it is circumscribed by the context of seeing to the “*effective performance by municipalities of their functions in terms of Schedule 4*” and the term “regulating”. The term ‘regulating’ in the context of section 155(7) was held by the Constitutional Court to connote “*a broad managing or controlling rather than direct authorisation function*”.[[10]](#footnote-10) Textually, the word ‘regulate’ is used in the context of the exercise of a legislative and executive power of both national and provincial governments in respect of municipal executive authority. The powers in terms of section 155(7) do not extend to the ‘core’ of Schedule 4B matters, but rather deal with the framework within which local government is to exercise these powers.[[11]](#footnote-11) ***In other words, the regulatory power enables national government (and also provincial government) to set essential national standards, minimum requirements, monitoring procedures etc.***

1. National governments legislative competence in respect of Schedule 4B: section 44(1)(a)(ii) of the Constitution is limited.

Section 155(7) provides that national government subject to section 44 of the Constitution, and the provincial governments have the legislative and executive authority to see to the effective performance by municipalities of the their functions in respect of matters listed in Schedules 4 and 5, by regulating the exercise by municipalities of their executive authority referred to in section 156(1). National government can also legislate on Schedule 4B matters on the basis of section 44(1)(a)(ii) of the Constitution[[12]](#footnote-12). There is no limitation contained in this provision. Our understanding of this section is that Parliament would be prohibited from legislating on the ‘core’ of 4B matters, such as air pollution, municipal health services, municipal planning and water services. Parliament would have to limit its legislative efforts on those and other 4B matters to framework legislation, national standards, minimum requirements, monitoring procedures etc.

In summary:

* Local government has legislative authority over Schedule 4B matters, which includes WSS.
* local government has legislative authority over Schedule 4B matters, which includes WSS.
* the Court defines the national competence as overseeing and views national government’s role on Schedule 4B matters (WSS) as a regulatory, rather than a determinative role and that the source for this limitation is section 155(7).
* This means that national government’s legislative power on Schedule 4B (WSS) matters does not extend to the ‘core’ of Schedule 4B matters but is limited to the setting of a legal framework, including minimum standards and monitoring requirements
* Provincial government similarly has regulatory powers over Schedule 4B matters - these cannot be prescriptive with regard to the ‘core’ of Schedule 4B matters but are limited to the setting of a legal framework, which includes minimum standards and monitoring.

***Intervention by Provincial government in the executive authority of a municipality***

Section 139 of the Constitution allows provincial executives’ authority to intervene to fulfil municipal obligations by taking appropriate steps to fulfil that obligation by:

* Issuing a directive to the Municipal Council, describing the extent of the failure to fulfil its obligations and stating any steps required to meet its obligations
* Assuming responsibility for the relevant obligation in that municipality to the extent necessary to:
  + Maintain essential national standards or meet established minimum standards
  + To prevent that municipal council from taking unreasonable action that is prejudicial to another municipality or to a province as a whole
  + To maintain economic unity

Only the executive council of a province may exercise this power and an economic regulator will not be able to intervene in terms of section 139 of the Constitution. At best the ER may alert the provincial government and the DWA of a situation contemplated by section 139 of the Constitution and advise those spheres on the remedial action to be taken. The DWA together with the provincial government will then have to take the action of either issuing a directive or assuming the function.

***What category of municipality has the executive authority re Schedule 4B matters?***

The Constitution categorises municipalities as follows:

|  |  |
| --- | --- |
| Category | Description |
| A | A municipality that has exclusive municipal executive and legislative authority in its area (metropolitan) |
| B | A municipality that shares executive and legislative authority in its area with a category C municipality (local) |
| C | A municipality that has municipal executive and legislative authority in an area that includes more than one municipality (district) |

In terms of the section 84 of the Municipal Systems Act, a district municipality has the following functions:

* Potable water supply systems- s84(1)(b)
* Domestic wastewater and sewerage disposal systems. – s84 (1)(d)

Section 84(3) however allows the Minister of local government, by notice in the Government Gazette, and after consultations with the Minister of DWA and the MEC for local government, to authorise a local municipality to perform a function or exercise a power mentioned in ss 84(1) (b) and (d) and the transfer of staff, assets, etc. will follow such and authorisation.

Unless specifically authorised by a government notice provided for in section 84(3), district municipalities has the executive powers and functions in relation to WSS.

***What category of municipality has the executive authority re Schedule 4B matters?***

The Constitution categorises municipalities as follows:

|  |  |
| --- | --- |
| Category | Description |
| A | A municipality that has exclusive municipal executive and legislative authority in its area (metropolitan) |
| B | A municipality that shares executive and legislative authority in its area with a category C municipality (local) |
| C | A municipality that has municipal executive and legislative authority in an area that includes more than one municipality (district) |

In terms of the section 84 of the Municipal Systems Act, a district municipality has the following functions:

* Potable water supply systems- s84(1)(b)
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Unless specifically authorised by a government notice provided for in section 84(3), district municipalities has the executive powers and functions in relation to WSS.

1. Pegasys Strategy and Development (Pty) Ltd (29 June 2012). [↑](#footnote-ref-1)
2. The South African interest in the Lesotho Highlands Water Project [↑](#footnote-ref-2)
3. The South African/Swaziland Komati River interests. [↑](#footnote-ref-3)
4. DWA (2012). Municipal Water Services Performance Assessment Report. The analysis is done in terms of several sources of data i.e.:

   • KPI 1 to6 is from existing internal DWA systems, including that of the blue and green drop programmes

   • KPI 7 to 11, manual data mechanisms was used to source data. [↑](#footnote-ref-4)
5. DWA (2012). [↑](#footnote-ref-5)
6. Independent Electoral Commission v Langeberg Municipality 2001 (9) BCLR 883 (CC) para 25. [↑](#footnote-ref-6)
7. Act 108 of 1996. [↑](#footnote-ref-7)
8. 1998(12) BCLR 1458 (CC). [↑](#footnote-ref-8)
9. Independent Electoral Commission v Langeberg Municipality 2001 (9) BCLR 883 (CC) para 25. [↑](#footnote-ref-9)
10. In Re: Certification of the Constitution of the Republic of South Africa, 1996 1996 (10) BCLR 1253 (CC) at para 377. “…the function of national legislation is restricted to regulation. It is adequate for present purposes to state that the term “regulate” connotes a broad managing or controlling rather than a direct authorisation function. Thus Parliament is entitled, in relation to provincial legislative power under NT 164, to establish the general framework within which such power is to be exercised. This leaves room for provinces to determine details of LG matters within that framework and to legislate for them.” [↑](#footnote-ref-10)
11. De Visser. J. Powers of Local Government. Local Government Working Paper Series No.2 Community Law Centre, UWC (2002). [↑](#footnote-ref-11)
12. “to pass legislation with regard to any matter, including a matter within a functional area listed in Schedule 4, but excluding, subject to subsection (2), …” [↑](#footnote-ref-12)