DEPARTMENT OF WATER AFFAIRS
PRICING AND, ECONOMIC REGULATION REFORMS (PERR) PROJECT

(Pricing Strategy Review, Development of Infrastructure Funding Model and the Establishment of Economic Regulation)

Minutes of a meeting of the Economic Regulation Work Stream

Date: 8 August 2012
Time: 9:00–12:00
Venue: Southern Sun Hotel, Steve Biko Street, Arcadia, Pretoria

Present:
<u>Department of Water Affairs</u>
Bofilatos, E
Machedi, NS
Mahasha, M
Mochotlhi, D (Chairperson)
Mofokeng, A
Morodi, C
Moshidi, S
Mqina, T
Muller, H
Ramonetha, N
Ramorula, R
Sekgothe, P
Sigwaza, DP

<u>Stakeholder representatives</u>

Opperman, N	Agri-SA
Flowerday, J	Amatola Water
Gabriel, MJ	Department of Agriculture, Forestry and Fisheries (DAFF)
Nyembe, M	Rand Water
Moraka, W	South African Local Government Association (SALGA)
Roets, D	African Forum for Utility Regulators (AFUR)
Fleet, S	Umgeni Water
Stadler, O	Bloemfontein Water

<u>Professional service providers (PSPs)</u>

Pegram, G	Pegasys
Madinginye, TDS	Pegasys
Schreiner, B	Pegasys
Cupido, A	Pegasys
Sussex, A	Write Connection (Scribe)

1. OPENING, WELCOME AND PURPOSE OF THE MEETING

Ms Deborah Mochotlhi opened the meeting, welcomed everyone to the first meeting of the economic regulation work stream, and allowed a round of introductions. Ms Mochotlhi was the chairperson of the economic regulation work stream, and Mr William Moraka from SALGA was the co-chairperson.

As per the Inception Report, the purpose of the PERR project was to "enable DWA to have good policies on the pricing of water, cost reflective tariffs for the entire water value chain in South Africa with potential for the poor and a good funding framework for infrastructure development, operations and maintenance".

The scope of the economic regulation task was to "identify, evaluate and recommend a coherent and innovative model for economic regulation across the entire water value chain, and to develop proposals for the establishment of an economic regulator".

The chairperson noted that the work stream had no decision-making powers, and any recommendations form the work stream would go to the Project Steering (PSC) for approval or refinement.

2. ADOPTION OF THE AGENDA

The purpose of the meeting was to consider the Inception Report, the extended project scope and deliverables, and the issues at the PSC meeting of 13 July 2012. The work stream meeting would not deal with contractual matters related to the professional service providers.

The agenda was adopted.

3. THE INCEPTION REPORT AND INTERNATIONAL REVIEW FINDINGS

Presentation: International reviews, conceptual model and Inception Report

Ms Schreiner made the presentation.

Purpose:
- Consider issues arising from the review
- Consider the proposed principles
- Consider the proposed scope changes and implications
- Give direction on the way forward.

Economic regulator review

The review investigated why a sector would require economic regulation, and studied some of the approaches and principles that apply to economic regulation. The South African experience of economic regulation was compared with international examples from the UK, Kenya, Zambia, Australia, Brazil, Mexico and the Philippines.

Economic regulation – definition
- The definition of economic regulation contains the following four elements:
  - **Price regulation:** regulating tariff/charge levels and tariff/charge structures to ensure delivery of services/water at an affordable cost while ensuring the long-term financial viability of water institutions, infrastructure and service delivery.
  - **Service quality regulation:** defining levels of service related to quality, technical requirements, reliability and customer responsiveness.
  - **Consumer protection:** resolving consumer complaints/queries that the responsible water institution has failed to or been unable to resolve.
  - **Competition regulation:** monitoring and regulating competition in the sector or benchmarking of efficiencies to control the possible abuse of monopoly power and to protect the interests of consumers and the public.
- "The rules and organisations that set, monitor, enforce and change allowed tariffs and service standards".
- Economic regulation intervenes directly in market decisions such as pricing, competition, market entry or exit.
- Economic regulation requires detailed data and information on assets, cost of capital and operating costs of utilities.
- Economic regulation has generally been applied to water services (water supply and sanitation), but little or no economic regulation has been applied to raw water.

Economic regulation enablers
The enablers of economic regulation include:
- **Mandate (political governance)** – the extent to which government has established policy, legislation and regulations (regulatory framework) to ensure effective governance.

- **Coherent policy and legislation** (including regulatory requirements) – are these appropriately established to fulfil the mandate and specifically address the degree of integration, alignment and/or co-operation?
- **Regulatory capacity** – are the dedicated capacity, skills, structures, systems, processes and resources necessary for the regulatory entity to execute the regulatory mandate available?
- **Institutional capacity** – do the institutions that are to be regulated have the necessary levels of capacity, skills, systems, processes and resources available to enable them to be regulated?
- **Access to information** – the ability to regulate effectively is directly related to the availability of accurate information pertinent to the regulatory domain.

Regulatory models
Possible regulators models include:
- **Regulation by agency** – typically involves regulation by government (national and or local) or regulation by an independent regulator where regulatory mandates are clearly defined by legislation.
- **Regulation by agency** – supported by an expert panel (where government is the regulator but the expert panel provides for a degree of independence/autonomy).
- **Regulation by contract** – where the regulation mechanisms are specifically defined in contractual provisions such as licences, concession contracts, service provider contracts and service level agreements.
- **Contracted out regulation** – where certain regulatory functions may be contracted out to third parties.

Principles
The principles for economic regulation include:
- **Clear roles** – separation of policy, oversight, operations and regulation; clearly defined regulatory responsibilities; clear and quantified objectives and measures of success/failure.
- **Transparency** – access to information; processes and decisions of regulator and justifications documented, transparent and open for scrutiny.
- **Accountability** – regulator is accountable for decisions/actions. Consumers and regulated bodies have right of appeal against decisions.
- **Non-discriminatory** – regulatory processes don't discriminate between regulated entities; regulatory decisions are technologically neutral.
- **Independence** – independence from undue political intervention, role-players, stakeholders, consumers and other interests, and financial independence (source of revenue /funding). Does not necessarily reflect institutional independence, but a way of operating.
- **Participation** – sector role-players/stakeholders participate in regulatory process and reviews.
- **Effective monitoring and enforcement** – regulatory regime allows for effective monitoring and enforcement of decisions.
- **Minimal regulation** – regulation is focused on areas necessary for specific outcomes.
- **Predictability** – constraints on arbitrary changes of regulatory powers and obligations; publication and application of regulatory principles and consistency of decision making.
- **Regulatory legitimacy** – five key tests of legitimacy of a regulatory regime:
    - 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?

Critical design features
Critical design features for an economic regulator include:
- Working within the existing organisational framework:
    - Build on existing regulatory base, capitalise on existing strengths and find solutions for weaknesses.
    - The credibility of the regulator is enhanced if it fits in with existing practices and organisational arrangements.
- Creating an appropriate role for politics:
    - Role for politics in regulation should be defined
    - Can provide source of collective decision making and accountability.

- Limiting the discretion given to regulatory decision makers:
  - Public and service providers are better protected where regulator has limited discretion in decision making
  - Makes outcome of decision more predictable and transparent
  - Decreases risk of lobbying or pressure to change outcome of decisions
  - Particularly true in context of a new regulator.
- Trading off sophistication in favour of simplicity:
  - Simple rules may be more effective, particularly where regulatory capacity is limited and information may be lacking or unreliable.
- There is no single international best practice for regulatory design.

Economic regulation approaches

- Price-cap regulation:
  - Maximum price is set
  - Provider must operate within that cap
  - Not clear whether it would act as an incentive to municipalities/government agencies
  - Effective for private sector providers.
- Cost of service or Rate of return regulation:
  - Looks at determining an efficient cost for delivery of services
  - Used to be calculated on cost of providing services in previous years, but this is flawed
  - Currently approach is to use a benchmark or yardstick for a similar organisation
    - Yardstick comparison
  - Four main approaches used:
    - Productivity indices,
    - Stochastic analysis of production and cost functions
    - Mathematical modelling
    - Engineering models
  - Possible for these different approaches to be combined into one more complex process.

Lessons and issues

- Transformational regulation is needed in the context of high inequity in South Africa. Equity calls for redistribution and redress, and for actions that will address the needs of the poor, close the gap between rich and poor and benefit the poor disproportionately.
- Access to reliable information is critical.
- Institutional arrangements may be secondary to ensuring sufficient capacity, clear roles and responsibilities and effective regulatory mechanisms
- Moving from current situation to improved regulatory option/model needs *a transformational regulatory reform process* in a well-programmed, progressive and transitional manner.
- An ‘independent’ regulator is not always the optimal solution.
- Design criteria that have proved robust internationally include:
  - Working within the existing organisational framework
  - Creating an appropriate role for politics
  - Limiting the discretion given to regulatory decision makers
  - Trading off sophistication in favour of simplicity.
- There are different models for who determines the standards and who applies them. In some cases the same body is responsible for setting and regulating minimum standards.
- It is critical for the economic regulator to have ‘teeth’. Applying sanctions to public sector bodies is much more difficult than in the private sector context. Intervention capacity and authority can be extremely useful, for example, Special Regulatory Supervision (SRS) intervention in Zambia.

Draft conceptual model

Ms Schreiner presented four slides depicting aspects of the draft conceptual model:

- Institutions, products and clients for water management
- Water flows and infrastructure
- Financial flows for infrastructure development and operation
- Elements of the conceptual financial model.

Inception Report

Tasks and activities had been revised on the basis of the input from the PSC meeting and work stream meetings for the pricing strategy and the funding model.

Ms Schreiner presented slides on the revised timeframes, pricing strategy review scope and proposed additional scope.

Conclusions

It was expected that the biggest impact of extending the scope would be in the following areas:
- Assessing the revenue generated by water services, and how this links into the full value chain
- Extending the financial model itself
- Exploring alternative sources of finance at a water services level
- Giving consideration to appropriate models for tariffs for water services and the implications for national norms and standards.

The next set of economic regulation deliverables would include:
- Review international regulator models
- Develop institutional and financial models
- Tariff-setting and financial process handbook.

Discussion

Mr Mqina referred to an item on the slide on lessons and issues: 'Limiting the discretion given to regulatory decision makers'. He asked what that meant in the South African context.

Mr Mqina also mentioned the migration process, saying that it would be addressed during the development of the institutional model. The process would have to start by optimising the current situation, and the step-by-step process required to arrive at the desired outcome. Mr Mqina suggested that a 'roadmap' would be useful which detailed steps, enablers and principles.

In terms of funding, the working group should consider the cost of services in relation to the rate of return from regulation, and debate whether the costs would be covered from taxes or tariffs. By September 2012, DWA would have to advise National Treasury with regard to the means of funding the regulatory institution from inception to realisation. The document should make it clear that regulatory capacity would have cost implications.

Ms Nyembe (Rand Water) noted that one of the funding component principles mentioned the independence of the economic regulator, and she asked how this could be achieved. She asked how the concept of regulatory independence was managed internationally, and how those regulators were funded.

Ms Nyembe also commented on the involvement of a political component as one of the critical design concepts. She asked how the interests of other stakeholders would be safeguarded if a political component was introduced into the model, particularly those of private investors and funders. She was concerned that the interests of stakeholders would risk being superseded by political interests.

Mr Muller invited work stream members to suggest practical issues related to economic regulation that the study should address and resolve.

Mr Muller believed that the inefficient use of grants should be flagged; there was little use in regulating at a municipal level, when grants were being awarded by national government and inefficiently applied at local level.

Ms Sigwaza commented that some countries were more fortunate than others in terms of the scope of regulation requirements. For example, Zambia already had utilities in place. It was easier to regulate utilities than to regulate local government. In South Africa, challenges existed around dealing with regulation at both local and national levels, in line with the constitutional mandates. She referred to institutional perceptions that the separation between water services authority and water services provision was not working at local government level. The project should identity practical solutions that could be applied early.

Ms Sigwaza commented that the roles of catchment management agencies (CMAs) were unclear. DWA had been engaging with the issue as part of the National Water Resource Strategy (NWRS). Many of the functions of CMAs were regulatory in nature. It appeared that there would then be a national regulator as well as regulation agencies acting on behalf of national government. She asked for clarity on how CMAs would be regulated whilst performing revenue collection and billing at a regional level.

Ms Schreiner (Pegasys) agreed that the issues raised by the work stream required further investigation. Any solutions should be practical, implementable, and within the capacity of the state.

Ms Schreiner emphasised the reality that a truly independent economic regulator was unattainable. Regulation was a site of contestation, and influence and self-interest would always play a role. The goal would be to keep regulation as impartial and fair as possible, but the process would never be truly independent.

Ms Schreiner agreed with Ms Sigwaza's point about the regulation of utilities in Zambia, and said that in South Africa there were constitutional challenges in terms of regulation. She believed that it was important to investigate sanctions and identify the most effective ways of implementing them.

Mr Muller raised two points:

- Economic regulation and technical regulation of the quality of service should be linked.
- The economic regulation model should take legislative requirements in relation to the tariff cycle into account. It was unfortunate that National Treasury was not present to guide the work stream on the matter.

Dr Pegram (Pegasys) explained that the conceptual model was a means of thinking about regulation. The focus of economic regulation in Zambia, for example, was to manage the relationship between bulk supply and reticulation, on the one hand, and the interface with municipal and domestic users on the other. The same was true in the United Kingdom. In both cases, the relationship between utility and customer was regulated in terms of tariffs, and sometimes also in terms of the quality of the water that was provided. Many of the international examples followed that pattern.

There were complexities in the South African context of regulating local government when the relationship between spheres of government was constitutionally prescribed.

In relation to bulk water, there was an opportunity to regulate water boards in South Africa in a similar fashion to the international examples. As Ms Sigwaza had mentioned, the question was how to regulate the CMAs that were imposing tariffs on the water services sector as well as imposing tariffs directly on other users. Taking the entire water value chain into account, technical regulation resided with local government, and the question was how to manage people's access to water from the water resource (direct water), the quality of that resource, and the regulatory functions in relation to water resources management.

Dr Pegram said that the discussion in the work stream suggested the need to clarify the extent of the PERR project on economic regulation, in order not to confuse the role of CMAs in regulating water use with that of the economic regulator. The two needed to be aligned, but their roles were different.

The economic regulation function would have to engage any parties that set tariffs, and the following questions would have to be asked:

- What were the tariffs?
- Were the water users (agricultural, industrial and domestic) getting value for money in terms of what they were receiving for the tariffs that they were paying? It would be useful for the work stream group to explore was how 'value for money' from the services provided by local government, water boards and CMAs could be defined.

Another useful role for the economic regulator would be to investigate whether the subsidies and grants made to institutions from public funding were being spent effectively.

Dr Pegram agreed with Mr Mqina that the conceptual model provided a useful means of unpacking the nature of the regulatory function, the differences between regulatory levels, and the challenges faced at each level in the value chain.

Ms Roets (AFUR) thanked DWA for the invitation to attend the meeting. She agreed that South Africa was in a unique situation, as most of the regulators throughout Africa either regulate water services or water resources. The PERR project aimed to combine those regulatory functions, which she believed would pose challenges.

Ms Roets commented on the issue of political influence, and said that there was no regulator in Africa that was truly independent; they had administrative autonomy, but not true independence. AFUR's investors and partners considered regulation to be sufficiently independent if it was accompanied by transparency and accountability. The regulator's role was always vulnerable to political influence.

Ms Roets mentioned referred to the method of regulating services in Morocco and Mauritania. Those countries regulated local government in a context that was similar to South Africa, unlike the East African countries which tended to regulate utilities. She complimented the group on the investigation and groundwork that had been done. She believed that the work was sound, but that challenges would arise. She encouraged the group to study the Mauritanian and Moroccan systems, as both could yield lessons that could be applied in the South African context.

Ms Nyembe suggested that it would be useful for the work stream to obtain input from some of the credit-rating agencies. She said that Rand Water had engaged with credit-rating agencies quite extensively, and in some of the ratings that Rand Water had received, a common concern had been raised related to economic regulation.

Mr Moraka (SALGA) raised the following points for consideration by the work stream:

- The Inception Report posed the question of whether to have one central regulator or a regulator per sector. An agreement needed to be reached whether the solution should be holistic or segmented, and he believed that this warranted further investigation.
- There was a need to determine exactly what was to be regulated, and the work stream should exercise caution in this regard. Infrastructure investment was a key issue, as were the cost of operations and maintenance (O&M) and the appropriateness of investment, amongst others. In the United Kingdom, an infrastructure commission drove services and infrastructure investment, as well as a system of penalties for levels of investment deemed to be insufficient. He had raised the issue in the context of government having 17 critical infrastructure programmes (CIPs); if regulation was introduced in 2014 that hindered those CIPs, that regulation would be untenable.
- The plans of the National Planning Commission (NPC) should be taken into account, regardless of the economic regulation model that was adopted. Mr Moraka did not support the debate over whether regulation applied to utilities or municipalities, and believed that regulation applied to a service. Municipalities were simply the delivery mechanism. Whether the infrastructure that was regulated fell under a water board or municipality was of no consequence in his opinion.
- An additional question was how cross-subsidisation could be realised in the fiscal system. If insufficient funding was available from the fiscus to meet sector obligations, which were regulated, cross-subsidisation would be required.
- There were alternatives to pure regulation, and it would be useful to investigate those mechanisms in the international arena. For example, Kenya had a water services trust that served as a regulatory mechanism for investment in infrastructure.

Ms Schreiner understood Mr Moraka's point that a service should be regulated rather than the provider, but she asked how action could be taken against a municipality if the need arose. She referred to the Blue Drop/Green Drop report an example of a regulatory approach that had worked well. Regulation occurred though public knowledge and competition with others.

Ms Schreiner raised the following points:

- Discussions had taken place around the role of the Water Tribunal, how to ensure that it was effective, and whether to expand the role of the Tribunal to enable it to impose civil penalties for non-compliance with water legislation; currently this could only be achieved in court. The project team would investigate the role of the Environmental Protection Agency (EPA) in the USA, which could impose civil penalties. She posed the question of the possible role of a tribunal in relation to economic regulation.

- The second point related to the regulation of price as opposed to the regulation of standards. There were several international examples of an economic regulator that looked at both price and standards in relation to the water services sector. She posed the question of whether a regulator was required at a water resource level to regulate both price and standards, and if so, what was meant by standards in that context – raw water quality or the standard of the infrastructure.

Dr Pegram felt that Mr Moraka's and Ms Schreiner's comments highlighted an important part of the discussion. Municipal supply, which was the constitutional mandate of local government, needed to be regulated in terms of norms and standards and in terms of the prices that were charged, but local government had a degree of flexibility in terms of the Municipal Finance Management Act (MFMA) and in terms of its mandate to set tariffs that were not only water related.

Dr Pegram said that if value for money was the measure used for economic regulation, it would be difficult to apply in terms of resource quality objectives and water quality. Evaluating value for money related more to institutional regulation than to technical regulation. It would involve assessing whether the business plan was sound, whether the organisation was fulfilling its mandate, and whether there was value for money in terms of what was being charged. At the level of a water board or CMA, institutional regulation was the means of assessing value for money relative to the tariffs. At the customer level, the item being regulated in terms of water services was the quality of that service.

Dr Pegram said that Mr Moraka had raised an important issue, namely that regulation did not relate only to whether certain standards were being achieved and whether tariffs were acceptable, but to the question of whether other mechanisms could be used, including mechanisms that were not traditionally regulatory. For example, trusts, grants and subsidies had a regulatory influence that tariffs did not. It was important to assess whether economic regulation would enable financial allocations.

Mr Muller agreed with a point made earlier about hearing from the stakeholders what they wanted economic regulation to achieve. With regard to the Inception Report, if the project team was satisfied with the comments made in the discussion, he requested that they ensure that all of the comments were covered in the Inception Report.

Action: Technical team

Mr Opperman (Agri-SA) said that Agri-SA was optimistic about the establishment of an economic regulator. Apart from the risks that had already been identified in the Inception Report, Agri-SA believed that it was important to ensure that at local and national government levels, the solution was soundly aligned with legislation, policies and institutional capacity, so that issues could be rectified through regulation. Roles and responsibilities needed to be clearly defined.

Mr Opperman said that a sectoral constraint of regulation was the three-tiered level of engagement with the department at the levels of national office, regional offices and catchment management agencies (CMAs). It was important to understand the structure of DWA as a national department with regional offices; in this regard, DWA differed structurally from other government departments. There were legislators at national and provincial levels. When Agri-SA participated in the annual tariff-determination dispensation, it was difficult for water users to be represented in the structures of the department. In areas where a CMA had not been established, the regional office acted as the CMA. Mr Opperman believed that the decision to establish nine rather than the originally proposed 19 CMAs would be more workable. Once the nine CMAs were in place, it would be easier to address many of the issues. In the meantime, it had to be borne in mind that there were structural constraints within the sector that made it difficult for users to be represented at all levels.

Mr Flowerday (Amatola Water) made the following points:

- In terms of the quality of water, the Blue Drop/Green Drop reports had been a good start, and that success should be built upon. A similar system should be implemented for raw water. He added that Amatola Water's experience of catchment management had been positive.
- The second issue concerned pricing; he felt strongly that 'money from water should stay in water'. That money was not always ring-fenced at municipal level, and it was important to ensure that that did occur and that it was closely regulated. Any approach should focus on the poor in rural areas and not only the metropolitan areas.

- The reliability of supply would be difficult to regulate, but infrastructural backlogs should be addressed. Differences between the various regions and provinces should be taken into account in considering a solution. Ideally the regulator should create the smallest possible additional cost burden to the structure.
- He advocated that incentives should be considered. Regulators typically imposed penalties and fines, which were not always productive. The Blue Drop/Green Drop reports had already shown that social incentives could be very effective.

Ms Nyembe wished to add to the points she had made earlier about the key requirements from a credit-rating perspective with regard to fund raising and safeguarding the interests of Rand Water's debt providers. It was important to separate regulatory roles from those of the providers. For example, DWA was both the provider of raw water and the regulator. There needed to be a clear separation of those roles. Economic regulation should be external to the provider in order to ensure transparency.

Ms Nyembe said that a discussion had taken place on the regulation of standards, which also impacts on the costs passed on to end consumers. The tariff charges and measures that were imposed did not necessarily have to be passed on to the consumer, especially in cases where there was poor performance. In cases of non-performance, penalties should apply.

Ms Nyembe also mentioned the principle of looking at the infrastructural cycle. From the perspective of Rand Water, the regulator should set performance standards that would drive the tariff process in terms of the expected returns from institutions. Benchmarks could be set for comparison purposes, in terms of what each entity was expected to deliver. The benchmarks could be used to drive performance and to assess tariff proposals. Rand Water had received numerous requests from the parliamentary portfolio committee for customers to sign off any capital requirements. If there were assets that had been deployed that needed replacement, an economic regulator could confirm the existence of those assets and the need for their replacement.

Mr Stadler (Bloemfontein Water) said that from a regulatory point of view, for pricing, Bloem Water currently followed processes of various departments at different levels, such as municipalities and water boards. The process was complicated. If a single regulator was in place, it was not clear which of the parties at different levels (including waste water) would be in a position to judge what the tariffs should be. He believed that having one regulator would be impractical.

Mr Stadler said that unless current legislation was amended by the time the proposal for economic regulation was ready to be implemented, the solution would have to align with current legislation. He believed that the regulatory role should be separated to match the different levels in the model.

Ms Schreiner asked Mr Stadler to explain what he meant by one regulator and separate levels. Mr Stadler explained that if there was a single regulator, it was not clear whether the institutions along the value chain (consisting of raw water, water research, water boards, municipalities etc.) would present a single tariff proposal to that regulator, or whether the entities would approach the regulator separately. A single submission would pose problems, given that the tariffs could be different at the various levels.

Mr Moraka asked whether the option of self-regulation had been considered, and said that a regulator should be an enabler. An environment should be created that encouraged investment. He asked whether the term 'economic regulator' was correct, and whether it should not rather be 'water sector regulator'.

Ms Schreiner responded that the issues might be different for water services and water resources. From a water resources management perspective, compliance and enforcement of licences were regulatory activities. She felt that the economic regulator should not necessarily encompass all of those elements in a single entity. The boundaries would have to be established. CMAs would probably take responsibility for licences. She believed that the issues were related both to institutional and economic regulation. A term other than 'economic regulator' might be considered more appropriate once the parameters of the regulatory entity had been identified.

Mr Fleet (Umgeni Water) referred to the costs associated with a regulatory body and suggested that the project take into account the additional costs of meeting the reporting requirements of the regulatory body.

Mr Fleet said that if pricing was regulated, tariff collection should possibly also be regulated. If municipalities were not paying the water boards, a system of sanctions should be considered.

The chairperson did not believe that the water sector was ready for self-regulation. Regulation was required to address the current problems.

Mr Flowerday supported Mr Moraka's comment on terminology. He felt that 'economic' should be omitted. The issue of backlogs was critical and would be a factor in the regulation of the water industry. If it was agreed that backlogs should be included in the scope of regulation, social factors would also have to be taken into account.

The chairperson said that from the water resources perspective, the driver of regulation was the protection of the resource. If that was achieved, by implication the mandate of the National Water Act (NWA) was achieved. From the water services perspective, the health of consumers and protection of consumers from exploitation by service providers could be facilitated by regulation. There was a need to decide whether to only consider economic regulation or to include other types of regulation as well. Considering only economic factors would narrow the scope of the study.

Ms Schreiner referred to the conceptual model, and said that there was a need to identify which functions were to be considered across the value chain. Those functions could differ substantially across water resources and water services. She said that thinking and brainstorming by the work stream members needed to take place, followed by a working session.

Mr Moraka said that some work had been done on regulation strategy and he would try to locate the relevant document and make this available to the work stream for context as well as an indication of some of the possible key functions of an economic regulator.

Action: Mr Moraka

Mr Moraka mentioned the deliverables and asked whether the second deliverable (Develop institutional and financial models), due in April 2013, could be brought forward to November 2012 when the models were finalised.

Ms Schreiner said that some of the interim ideas around functions could be looked at in November 2012. She explained that the reason for scheduling the deliverable for April 2013 was to allow the work on economic regulation to run in parallel with work on the pricing strategy, as the three projects (on the funding model, pricing strategy and economic regulation) had to engage and interface with one another. She said that it would be possible to do some of the initial thinking in November 2012 and to look at some of the parameters. She suggested the need for a working group meeting to look at economic regulation functions, possibly in November 2012.

Mr Muller referred to a comment made earlier about whether to adopt an incremental or 'big bang' approach. He favoured an incremental approach that started with the regulation of key elements. He hoped that the steps for incremental regulation would be detailed in the Inception Report.

Mr Muller said that the raw water tariffs provided by the department should be regulated. He felt that the issue of transparency was key, and regulators should enforce transparency in institutions. He agreed that a working session was necessary, and suggested detailing topics for consideration in a discussion document.

The chairperson asked when the proposed working session would take place. Ms Schreiner had suggested November 2012. The Project Management Office would communicate the date to members.

Action: PMO

Mr Mqina proposed that all issues that had arisen during the work stream meeting discussion be included in the comments register, so that all the issues could be followed up.

Action: Project Management Office

4. MATTERS ARISING FROM MINUTES OF THE PSC MEETING

Ms Sigwaza reported that the group had been well received at the PSC meeting. With respect to the economic regulation work stream, the definition of economic regulation had been debated, and it had been agreed that further clarity was required in terms of the meaning of economic regulation.

Ms Sigwaza said that there was a need to finalise the Inception Report, and to reach a decision on the inclusion of social regulation, and regulation of service and quality standards.

A discussion had taken place around the drivers of economic regulation, and it had been debated who should set those drivers – the department or all involved stakeholders. Drivers had been mentioned in the Inception Report, but there was a need to more clearly define which drivers would apply to economic regulation in South Africa. The drivers would include service delivery, investment and competition.

There had been a key discussion on moving to cost-reflective tariffing. The PSC endorsed taking the entire water value chain into account, but had realised that the constitutional mandates of local government would present challenges in that regard. The PSC felt that principles, norms and standards needed to be clearly defined in relation to municipal tariffs.

It was understood that other forms of regulation should continue within the department alongside economic regulation; that was one of the motivations for adopting an incremental approach. Work on economic regulation had begun in the department, and water services and water resources would be aligned in that respect. Water resources was seen as a sound starting point, as there were already water resource institutions that were regulated by DWA, such as the water boards and CMAs.

Ms Sigwaza said that there had also been discussion around the professionalisation of the entire water sector. Although not related directly to economic regulation, it would be important for the economic regulator to be staffed with skilled and competent people if it was to succeed.

The PSC recognised that incentive-based regulation was effective, as the Blue Drop/Green Drop reports had shown.

5. STUDY TOUR AND FEEDBACK FROM AFUR MEETING

The chairperson asked Ms Roets to provide some background on the African Forum for Utility Regulators (AFUR), and to explain its relationship with the PERR project.

The chairperson explained that at a meeting held the previous week, she had indicated to Ms Roets that DWA was not yet ready for an exchange programme with AFUR. She had instead suggested a study tour, in which members of the department would be hosted by colleagues from other parts of Africa.

Ms Roets said that AFUR had been formed in 2002 under clause 110 of the NEPAD framework, together with the Regional Economic Councils (RECs) and Regional Regulatory Associations (RRAs). AFUR was regarded as a key ‘building block’ in the African Union’s social development programme, and focused on issues related to the regulation of energy, telecommunication, transport, water and sanitation.

Ms Roets said that AFUR’s mission was to facilitate the development of effective utility regulation in support of Africa’s infrastructure development. AFUR facilitated cooperation and information-sharing among regulators in Africa. AFUR assisted with best practices, capacity building, good governance and the promotion of sound relationships with stakeholders.

AFUR provided a forum for the exchange of information among members and relevant organisations. AFUR also acted as an advocate for members by coordinating activities and increasing members' influence with continental, sub-regional and national decision-makers.

AFUR currently had 33 members, four utility regulators and four observers from 27 African countries. Ten of the members were from the water sector. Most of the water regulators were multi-sectoral. Forty per cent of them were independent regulators. These include the Water Services Regulatory Board (WASREB) in Kenya, the National Water Supply and Sanitation Council (NWASCO) in Zambia, and the Water Regulatory Council (CRA) in Mozambique.

AFUR was working closely with the newly formed SADC regional water regulator, coordinating projects and ensuring common objectives.

AFUR was also working closely with DWA, which was a founding member of AFUR. DWA was the sectoral chair of the Water and Sanitation Committee.

AFUR had published guidelines on the principles of utility regulation in Africa; regulatory transparency; regulatory accountability; and minimum quality of service for water and sanitation.

In terms of capacity building, AFUR offers numerous training programmes and a one-week exchange programme for sharing best practices. As DWA was involved in the early stages of implementing economic regulation, WASREB, NWASCO and the Energy and Water Utilities Regulatory Authority (EWURA) from Tanzania had each agreed to host five staff members from DWA. No reciprocation from DWA was required at that stage.

An AFUR project was under way looking at the policies and management tools relevant to the regulation of water and sanitation. A round table meeting was planned for regulator members to share their experiences and best practices. The envisaged outcome was a guideline for regulators in the water and sanitation sectors.

Ms Schreiner asked Ms Roets what AFUR's deadline for the round table meeting was, and Ms Roets replied that the deadline had shifted several times. The first round table was supposed to have taken place in March 2012.

Ms Schreiner asked whether it would be possible to align the PERR project with AFUR, and Ms Roets replied that PERR could definitely be part of the AFUR project. AFUR hoped that all regulator members would participate in the round table meeting.

Ms Roets said that a three-year business plan was in place for each sector, and AFUR was currently dealing specifically with the water and sanitation sector plan, which considered training needs, capacity building, project requirements (soft projects as opposed to infrastructure development) and regulatory issues.

Ms Roets said that one of AFUR's projects was investigating the effects of climate change on the regulation of the water sector in Africa. To date, the implications of climate change had not been sufficiently recognised in Africa, but would have a huge impact on the way that water would be regulated in the future.

6. WAY FORWARD

The working group meeting would be held in November 2012, and the PMO would set the date and prepare the agenda. The next economic regulation work stream meeting would take place on the same day as the working group meeting.

Action: PMO

The chairperson asked when the Inception Report would be finalised. Mr Mqina said that the deadline for the submission of comments on the Inception Report was 17 August.

Action: Work stream members

The e-mail address for the submission of comments was PERRprojectoffice@dwa.gov.za.

7. CLOSURE

Mr Muller thanked work stream members for an interesting and challenging discussion. The chairperson thanked everyone for their attendance and participation. The meeting closed at 12:00.

APPENDIX 1: LIST OF ACRONYMS

AFUR	African Forum for Utility Regulators
Agri-SA	Agri South Africa
AU	African Union
CIPs	Critical Infrastructure Programmes
CMA	Catchment Management Agency
CRA	Water Regulatory Council
DAFF	Department of Agriculture, Forestry and Fisheries
DWA	Department of Water Affairs
EPA	Environmental Protection Agency
EWURA	Water Utilities Regulatory Authority
HR	Human Resources
NEPAD	New Partnership for Africa's Development
NPC	National Planning Commission
NWA	National Water Act
NWASCO	National Water Supply and Sanitation Council
NWRS	National Water Resource Strategy
O&M	Operations and Maintenance
PERR	Pricing, Economic Regulation Reforms
PMO	Project Management Office
PSC	Project Steering Committee
PSP	Professional service provider
REC	Regional Economic Council
RRA	Regional Regulatory Associations
SALGA	South African Local Government Association
SADC	Southern African Development Community
SRS	Special Regulatory Supervision
WASREB	Water Services Regulatory Board
MFMA	Municipal Finance Management Act

APPENDIX 2: ACTION ITEMS ARISING FROM THE PERR ECONOMIC REGULATION WORK STREAM MEETING OF 8 AUGUST 2012

	Task	**Responsible party**	**Due date (where indicated)**
1	Mr Moraka said that some work had been done on regulation strategy and he would try to locate the relevant document for context as well as some of the key functions that an economic regulator could consider.	Mr Moraka	
2	Mr Mqina would communicate the working group meeting date to members, and would prepare the agenda.	PMO	
3	The PMO would include the issues raised during the meeting in a comments register.	PMO	
4	The deadline for the submission of comments on the Inception Report was 17 August.	Work stream members	17 August 2012
5	The technical team would take the following into account in finalising the Inception Report and in future tasks: • Develop steps for an incremental approach to economic regulation • Identify enablers of economic regulation • The cost of services in relation to the rate of return from regulation, and debate whether the costs would be covered from taxes or tariffs • How to achieve independence for the economic regulator • Address the inefficient use of grants • Address the separation between water services authority and water services provision at local government level • Clarity on how CMAs would be regulated whilst performing revenue collection and billing at a regional level • Investigate sanctions and the most effective ways of implementing them • Link economic regulation and technical regulation of the quality of service • Take legislative requirements in relation to the tariff cycle into account • Clarify the extent of the PERR project on economic regulation, in order not to confuse the role of CMAs in regulating water use with that of the economic regulator • Consider how to define 'value for money' in relation to the services provided by local government, water boards and CMAs • Consider appropriate measures of value in relation to water resources management (related to resource quality objectives and water quality) • Consider whether the subsidies and grants made to institutions from public funding were being spent effectively • Consider lessons to be learnt from the experience of Morocco and Mauritania in regulating local government as opposed to utilities • Obtain input from some of the credit-rating agencies • Consider whether to have one central regulator or a regulator per sector • Take into account infrastructure investment, the cost of operations and maintenance (O&M) and the appropriateness of investment in relation to the	Technical team	

	Task	Responsible party	Due date (where indicated)
	government's critical infrastructure programmes • Take the plans of the National Planning Commission (NPC) into account • Consider how cross-subsidisation could be realised in the fiscal system • Consider how action could be taken against a municipality in the context of regulating the service rather than the service provider • Consider the possible role of a tribunal in relation to economic regulation • Consider the regulation of price as opposed to the regulation of standards • Consider the regulatory influence of trusts, grants and subsidies and whether economic regulation would enable financial allocations • Structural constraints within the sector that made it difficult for users to be represented at all levels • Implementation of a system for water resources management similar to the Blue Drop/Green Drop reports for water services • How to address infrastructural backlogs • The role of incentives • Cost of the economic regulator so as to create the smallest possible addition cost burden; taking into account the costs of reporting requirements • Separation of regulatory roles from those of the providers • Penalties for non-performance • Setting benchmarks for comparison purposes; to drive performance; and to assess tariff proposals • Role of the economic regulator in assessing the need for asset replacement • The need for legislative amendments • Consider the option of self-regulation • Creation of an environment to encourage investment • Parameters of the regulatory entity (only economic or including other types of regulation as well) • Consider the need to regulate tariff collection as well as pricing and sanctions for non-payment • Professionalisation of the entire water sector		