

# Memorandum to the Minister of Water and Sanitation

## Ministerial Memorandum #2

### **Subject: Setting tariffs in the water sector – are annual tariff increases necessary?**

#### **1. Purpose and context**

The purpose of this memorandum is to brief the Minister on the setting of raw water and bulk water tariffs in response to the Minister's query asking if annual tariff increases in the water sector is necessary.

The Regulator Commission was established in terms of Section 99 of the National Water Act and Section 76 of the Water Services Act with the purpose of advising the Minister on aspects related to the economic and social regulation of the water sector. The Commission has been requested to attend a meeting with the Minister and key water sector institutions on 7th February 2023 to discuss the process of tariff review in the water sector, so as to better understand whether tariffs should increase or decrease and the impact of such decision-making process. Noting that decisions about tariffs is administrative action, it must therefore be lawful, reasonable and procedurally fair. In other words, carefully considered and justifiable.

In preparation for the engagement, this note presents the initial views of the Commission on tariff increases in light of the state of the sector and relevant national policies and legislation governing water sector institutions and tariff setting, for the purpose of briefing the Minister prior to that meeting. It may be supplemented after the engagement, if required and appropriate.

#### **2. The state of the water sector**

##### **The water sector is in crisis as a result of a destructive and reinforcing cycle of decline.**

Water services are almost universally poor and declining. Customers have a low willingness to pay for a poor service. The institutions responsible for the service are under-resourced as a result of low levels of payment and various levels of dysfunctionality, with high levels of inefficiency. Unviable, poorly performing institutions are unable to maintain and invest in the rehabilitation and expansion of services, resulting in further deterioration, and leading to even lower willingness to pay, reinforcing the cycle of neglect and decline. The decline has been evident for more than a decade; however, the accelerated decline has been particularly noted over the last five years.

There is an accelerating and unsustainable build-up of debt in the water sector threatening the viability and functioning of key sector institutions, particularly water boards, the Water Trading Entity (WTE) and TCTA. For example, money owed to the Water Trading Entity increased from R6.6 billion in March 2017 to more than R17 billion in August 2022, an increase by a factor of nearly three. The principal cause of this debt build-up is dysfunction at the municipal level. Municipalities are failing to bill and collect revenue for the provision of water and sanitation services from customers and are failing to pay water boards and the WTE. Making matters worse, almost all municipal water services, water boards, the WTE and TCTA are highly inefficient, resulting in losses, high costs and poor value for money. The cost of inefficiency for water services in the eight metros alone is R13 billion a year.

#### **3. The essential role of water tariffs to support financial viability of water sector institutions**

Within this context, there are understandable pressures to keep tariffs low. **However, revenue from water tariffs is a critical component of sustaining the financial viability of these institutions.** Customer revenues amount to about R40 billion at municipal level, of which about R20 billion is paid to water boards for bulk water. WTE revenue from the raw water charges is about R22 billion a year. **National government supplements these revenues with grants.** It provides about R40 billion a year in grants directly to local government to support the provision of water services (capital and operating), and a further approximate figure of R15 billion a year in capital grants to support the water sector through other institutions (DWS, the water boards and TCTA).

**The fundamental underlying principle is that revenues must be sufficient to meet (reasonably determined and efficiently expended) costs, including reserves (savings for investment).** Where revenues are less than costs, services will deteriorate as a result of inadequate maintenance and low levels of investment. We are witnessing the effects of this across the water sector.

**Any adjustment to a tariff that does not meet the revenue requirement (when combined with the available grants) will contribute to the decline in the sector** unless this revenue loss is compensated by an increase in government grants.

#### **4. Tariff setting: TCTA**

TCTA is mandated to finance economically viable water projects (or components of projects) by raising commercial debt. This requires TCTA to have revenues that meet its (efficient) expenses, including the repayment of debt. This revenue comes primarily from tariffs. Tariffs for water projects that have a commercial finance element must be set at a level to fully cover the costs of this commercial finance and the underlying operating costs. Failure to do this jeopardizes the credit rating of TCTA. A downgrade in the credit rating of TCTA will directly affect the cost of the debt finance. The ultimate effects of this would be increased costs and reduced levels of investment.

**Tariffs for TCTA-funded water projects must therefore be set at a level to recover (efficient) costs.** These tariffs are typically agreed through the signing of an off-take agreement between TCTA and the institution receiving the water. In terms of this agreement, costs are typically reviewed annually to ensure that the tariffs continue to recover costs.

#### **5. Tariff setting: Water Trading Entity (raw water pricing)**

Tariffs for projects funded by the Department through the WTE are set in terms of the Raw Water Pricing Strategy. In terms of the approved Pricing Strategy, these tariffs are, in general, intended to fully recover the operating costs, asset depreciation and provide a return to government to support further investments in water infrastructure. Various exemptions are made to support agriculture and emerging farmers in particular. For example, exemptions from the return on assets component. Where tariffs are below the tariff set out in the Policy, a 'glide path' is set with a view to reaching the required tariff over a defined period of time.

**Tariffs should therefore be based on actual (efficient) operating and maintenance costs, the allowed depreciation of the asset and a defined return on assets, adjusted for the exemptions and glides paths defined in the policy for different categories of user.** Our previous memorandum (Memorandum #1) indicated that this process is both complex and opaque, and made recommendations on how the process could and should be improved. See Memorandum #1 and Paragraph 14.

#### **6. Tariff setting: water boards**

Water boards have two broad mandates: a primary function to supply bulk water to municipalities (and sometimes directly to industries), and a secondary function to provide services to water services authorities (supporting municipalities in their role of providing services, or providing water services on behalf of the water services authority). In addition, a water board may be directed to undertake tasks by the Minister of Water and Sanitation. In the case of secondary activities, these need to be fully recovered through the recovery of the costs from these activities (typically through a contractual arrangement with the entity benefiting from the service). In the case of directives, the resultant costs need to be paid for by the Department of Water and Sanitation. Secondary activities, including directives, need to be accounted for separately from the primary activities.

The **bulk water tariff** must be set so as to recover the actual (efficient) full capital and operating costs of a Water Board's primary activity of supplying bulk water, less any subsidy provided by the national fiscus.

## 7. **Tariff setting: municipalities**

Municipal Councils' have the Constitutional right and responsibility to promulgate the tariffs for water services in their jurisdiction. The Municipal Systems Act (Act 32 of 2000) states that **municipal tariffs for water services must reflect the costs of rendering the service**, including operating, maintenance and capital costs, and including the costs of rehabilitating and replacing assets, taking into account available grants from national government.

The Minister of Water and Sanitation has three primary roles with respect to municipal water services tariffs: to set, monitor and enforce minimum norms and standards with respect to the setting of tariffs, as set out in the Section 9 and 10 regulations of the Water Services Act.

At part of this role, there is a need for the Minister to consider mechanisms to increase transparency with respect to the financial and institutional performance of water services providers. In the view of the commission, this requires that separate financial statements are prepared for the water services function i.e. making it critical for ring-fencing to be undertaken at local government level, supporting transparency and informed decision making. This could be enforced by the Minister through regulations with the concurrence of the Minister of Finance.

## 8. **Addressing the dysfunction and inefficiency of municipal water services**

The dysfunction and inefficiency of municipal water services provisions is the core underlying issue facing the sector, and the primary cause of debt build-up in the water boards and the Water Trading Entity. Without addressing the dysfunction of water services at the municipal level, it will not be possible to create a financially viable and sustainable water sector with increasing levels of investment and with improving levels and quality of service.

The Minister of Water and Sanitation has the following primary roles with respect to regulating municipal water services:

- To set, monitor and enforce minimum norms and standards for the provision of water services, as set out in Section 9 and 10 regulations of the Water Services Act.
- To monitor adherence to water services legislation and to intervene in cases where municipalities are in breach of their legislative obligations.

The Water Services Improvement Programme sets out an approach in which the Minister and Department will play a stronger regulatory role, particularly with respect to enforcing adherence to legislation and the minimum norms and standards set out in related regulations, including the publishing of an annual dashboard of regulatory compliance by water services authorities.

Beyond this, there is a need to introduce stronger mechanisms for enforcing adherence to legislation and regulations.

## 9. **Annual setting of tariffs in the context of inflation**

Inflation results in input costs increasing irrespective of any other changes. In the context of inflation, therefore, it is necessary that tariffs are indexed and adjusted each year. All other things being equal, this should be an automatic tariff adjustment. **Failure to increase tariffs in the context of inflation will result in revenues reducing relative to costs, resulting in under-resourcing and a decline in the sector as a result of inadequate maintenance and lower levels of investment.** One way to achieve this is to index tariffs to inflation. This would allow tariffs to be reviewed and adjusted only every few years, instead of every year. See the recommendation on multi-year price setting in Section 14.

**Where efficiency improvements are greater than the increase in input costs as a result of inflation, and there is sufficient investment, then tariffs can justifiably be adjusted downwards.** See Paragraph 14.

## 10. Improving the efficiency of water sector institutions

There are also serious efficiency concerns in relation to other sector institutions, particularly the water boards, the Water Trading Entity and TCTA. The water boards, the Water Trading Entity and TCTA are all public-owned monopolies that do not face competitive pressure. **There is little or no incentive for these institutions to be efficient without strong measures to drive efficiency improvements. High levels of inefficiency add unnecessarily to costs and reduce the resources available for investment in the rehabilitation and expansion of assets.**

**There is a need to introduce, support and enforce strong measures to drive efficiency improvements in these institutions, as well as in water boards.** This is within the mandate of the Minister, both as shareholder and regulator. Recommendations are made in Section 13.

## 11. Improving the robustness of tariff setting processes in South Africa

As noted in our first memorandum, **raw water tariffs suffer from a problem of legitimacy.** This is a result of the poor financial management of the Water Trading Entity; the inability to spend budgeted amounts; and low levels of transparency. Users have little knowledge and confidence in how and where their money is spent. There are also low levels of accountability across the system. There is no tracking of revenue and expenditure at a scheme level, together with scheme-level 'performance' (status of infrastructure, risks etc.). Institutional dysfunction at CMA level is also apparent. While this may be less practical in the case of the many small schemes, these items should be tracked for at least the nationally significant and strategic schemes, on which South Africa's economy is highly dependent. Recommendations are made in Section 14.

## 12. Addressing sector debt

The sector has unsustainable debt, and this debt is increasing. Without addressing the issue of payment, billed revenue from tariffs will not translate into cash available for investment. The data suggests that **no money was available for investment from raw water tariff revenue** in the previous financial year because the increase in sector debt exceeded the budgeted revenue contribution from tariffs to investment (from the depreciation and return on asset charges). Low payment levels have been allowed to persist without consequences, therefore undermining the willingness of 'users who continue to pay' and inadvertently creates a negative impact of the entire system.

## 13. Recommendations for improvements in institutional efficiencies

The Minister should consider the following regulatory activity with a view of improvement in institutional efficiencies in the sector:

- Reintroduce benchmarking for water boards; water services authorities and providers.
- Publish a report annually with the performance and ranking of municipal water services providers, ranked by category (metros and cities, towns, rural districts), based on a set of key performance indicators, including financial and institutional efficiency indicators in addition to service standard and quality indicators.
- Implement the CMA model as intended in the legislative framework.
- Undertake an institutional efficiency audit of TCTA that makes recommendations for internal operational efficiency improvements, with the Minister including these in his shareholder compact and performance agreement.
- Carefully consider the impact on the credit rating of private sector investment in the water sector with the proposed combining of TCTA and the WTE in the Water Infrastructure Agency.
- Investigate the introduction of incentives into price setting, with price increases linked to enforceable commitments related to efficiency improvements (applied to water boards and later to catchment management agencies).

- Engage with the Ministers responsible for local government and finance on the establishment of a city water reform programme that makes use of regulatory and financial incentives (both stick and carrot) to drive performance improvements across the metros and cities where the economic costs of dysfunction and inefficiencies are greatest. Consider the development of parallel programmes oriented to towns and rural areas.

#### 14. Recommendations for improvements to raw water tariff setting process in future years

(From Memorandum #1)

1. **Indexed tariffs.** Tariffs need to be indexed to inflation and tariff increases presented net of inflation.
2. **Simplify capping.** The application of price caps is complex and opaque. The system needs to be simplified and clearly communicated through national engagement process.
3. **Multi-year price path.** It is onerous to review and consult on 557 tariffs every year. It is strongly recommended that Tariffs and a price path should be agreed for a period of a minimum of three years (ideally longer).
4. **Agreed time period to reach target cost-recovery level.** There needs to be a clear commitment to achieving the target cost-recovery goal within an agreed time period.
5. **Improve transparency.** A strong recommendation is made for the Minister to accelerate the establishment of the national water resource infrastructure agency and the catchment management agencies. Audited Financial Statements of these entities (and for the department itself) need to be published timeously. Data on budgets and actual expenditure and revenues by water resource management area, and by scheme (especially for the major schemes) need to be published.
6. **Improve presentation of tariffs.** Tariffs should be presented in categories in terms of the economic significance and scale of the scheme, and also communicated in the context of inputs costs to users. (Raw water costs are often a very small fraction of total input costs for a user. This should take out the heat from tariff proposals.)
7. **Attend to non-payment.** The sector has unsustainable debt, and this debt is increasing. An agreement must be reached on a debt write-off in return for clear, enforceable commitments to payment (and clearly specified consequences of non-payment).
8. **Improve process.** The current process is too rushed and does not allow adequate time for analysis, review, verification and consultation. The process needs to be revised and improved. This will be easier if a multi-year price path (as per #3 above) is agreed so that tariffs do not have to be approved every year.
9. **Improve methodology and set out in a manual.** The price setting methodology is not clearly specified and is not set out in a written document. It is overly complex, not transparent and at risk of being implemented with errors. A manual is needed to guide an improved, simplified and more robust tariff setting process.

(Detailed recommendations with respect to the setting of bulk water tariffs will follow following the observation and review of the process during February and March 2023.)

Signed



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Chairperson, Water Regulatory Commission

for the Water Regulatory Commission