

PREPARING FOR REDS AHEAD

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Synopsis

This paper deals with the required groundwork for preparing for the formation of REDS. It describes the imperatives influencing this decision for municipalities on the way ahead and the necessities why a municipality needs to prepare. Attention is given to the requirements of the Systems Act. In conclusion examples are given for rationale change to MLM.

1. Background

The restructuring of the Distribution Industry in South Africa is well debated since the process started in 1992, but has yet to deliver definite changes on the ground. The Cabinet's approval of the ERIC report in 1997 was preceded by various studies. This was followed by the Energy White Paper approved by Cabinet in December 1998. A clear indication on the stance of government was given with the approval of the six independent regional undertakings in June 1999 paving the way for a R25bn industry overall .

.1. Energy White Paper

To understand some of the imperatives on the way forward one has to reflect on some of the pillars on which the restructuring has to be built. Although the Energy White Paper deals with numerous reasons for the envisaged change and merger between Eskom Distribution and Municipalities , the most crucial statements for municipalities about the EDI restructuring are the following:

*Electricity distribution industry will remain under **public ownership**.*

*Municipalities will continuesetting policy, including end-user tariffs,...**supervising the distribution of electricity**.*

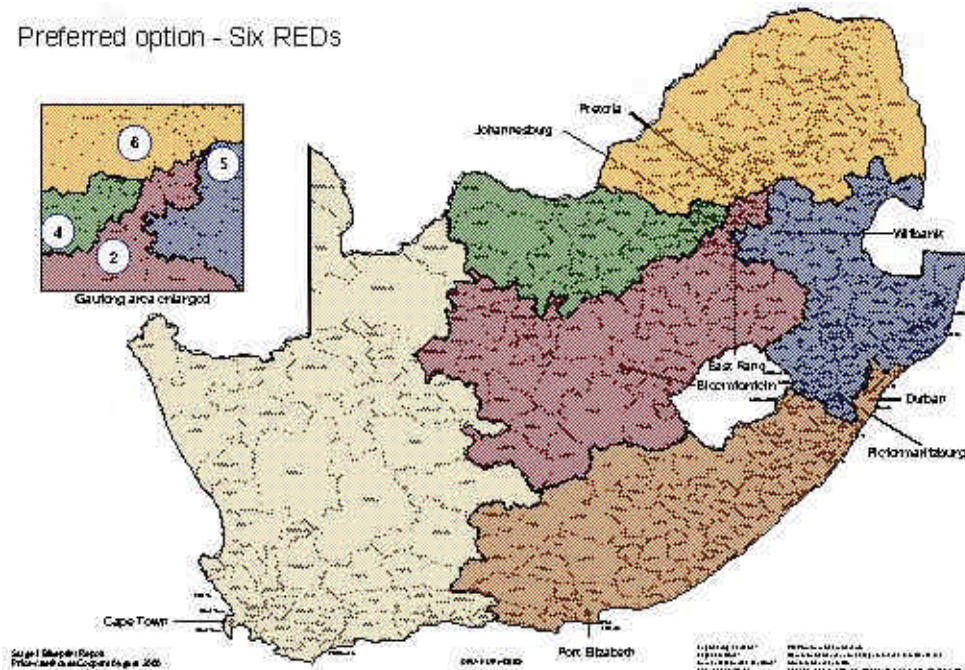
*Municipalities will continue to **fund other municipality services** from the funds generated from electricity.[1]*

It is clear that although the current structure of distribution will change it is envisaged that, public ownership, governance with regard to the distribution activities and an expected revenue stream from electricity will remain unaltered.

1.2 Cabinet's Recommendations

Without condemning the process that was followed to produce the PWC Blueprint , the vision on the way forward (and eventually supported by Cabinet) a number of critical questions remained unanswered. These issues revolved mainly around the influences the envisaged restructuring will have on municipalities. The proposed six demarcated REDS along municipal boundaries is well known as depicted in the following diagram.[2]

Preferred option - Six REDs



[2]

A process of re-modeling to finetune these boundaries are currently underway. The question that remains is what the influence on the municipality will be and what preparations a munic will have to follow to be ready. The following sections deal with some of the most outstanding imperatives influencing this.

2. Strategic Objectives to manage the influences affecting municipalities.

A municipality surely has to consider whether it wants to take a pro-active or reactive stance with regard to the envisaged changes. (Salga has also promote these preparatory work in a national workshop in October 2000 and re-emphasised it in a series of provincial workshops around the country.) If the view is that *if* something happens *little* can be done to influence the process, stocktaking on the impact on the municipality has to be embarked upon to bring the realities of the restructuring on the table! The intention of the authors is not convincing the reader on the impact the envisaged restructuring will have on the electricity business and the remainder of the municipality - that debate has passed - but to evaluate some of the most critical influences having a profound effect on the municipal business since the last phase of the local government democratisation in December 1994. These impacts or uncertainties can be categorised as:

2.1 Impact on Municipal Income

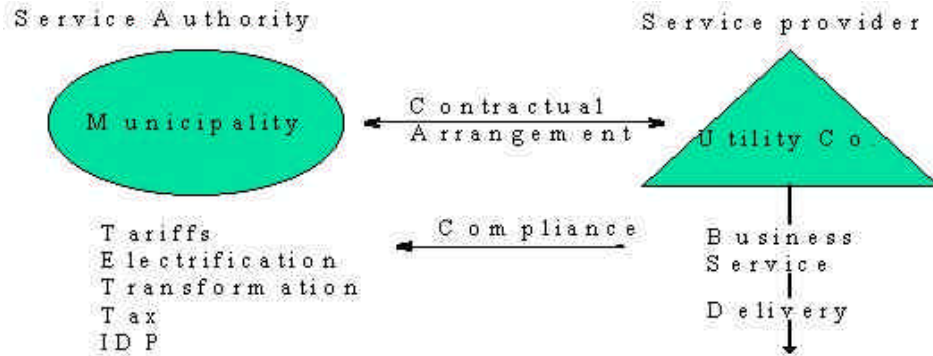
It is envisaged that the future revenue stream will be a combination of a shareholding in the RED and the right to levy a tax on electricity sales. This will replace the current contribution to the relief to the rates fund. However at this stage it is not clear how the shareholding of the future RED is going to be determined and whether this shareholding will yield a dividend especially in the initial years. The scale of the proposed levy is also still an issue of debate and is receiving currently attention from National Treasury.

2.2 Impact on remainder of Municipality

Salga warned in their circulars to the effect of the loss of cash flow, credit rating and influences on business systems and processes etc. The exact impact will be different for each municipality and necessitates a process of ringfencing and pro-active strategising to continue to effect efficient delivery. It is unlikely that the assistance that might be forthcoming from the national restructuring process will develop the necessary wisdom to quantify of the impact within the municipality.

2.3 Ownership and Control (Governance)

It is well known that the Constitution (Schedule 4B) empowers a municipality to the function of reticulation. Both Municipal Structures and Systems Act confirm this with further detail on what reticulation means and how this service has to be rendered. An important concept that came to the fore is the splitting of the roles of the service authority and service provider. [3] The concept is taken up in the PWC Blueprint and accepted by Cabinet. It can be described as below:



[3]

Due to the impact it can be concluded from the above that it will be shortsighted from a municipality not be alerted by these external pressures. Even worse, if a municipality does not strategise in order to be ready. It then follows that a municipality have to have understanding of the future role and the structures it is going to operate in to gain the maximum leavage.

This in practice means that in future a municipality will be able to fulfill its Constitutional obligations and responsibilities by using a service provider to render such functions. Before choosing such a provider, it is necessary to follow a particular process.

4. Municipal Systems Act (MSA) requirements

4.1 Internal vs. External service delivery options

The MSA states at a municipality may render a municipal service in its area, by means of either an *internal* or *external* service delivery option. Some examples of the two options are defined as follows:

Table X Service delivery options defined in the Municipal Systems Act.

Internal options	External options
<ul style="list-style-type: none"> • a department or other administrative unit within its administration; • any business unit devised by the municipality, provided it operates within the municipality's administration and under the control of the council in accordance with operational and performance criteria determined by the council; or • any other component of its administration. 	<p>Effected by entering into a service delivery agreement with:</p> <ul style="list-style-type: none"> • a municipal entity • another municipality; • an organ of state, including a water committee established in terms of the Water Services Act; • a licensed service provider registered or recognised in terms of national legislation; and a traditional authority; • a community based organisation or other non-governmental organisation legally competent to enter into such an agreement; or • any other institution, entity or person legally competent to operate a business activity.

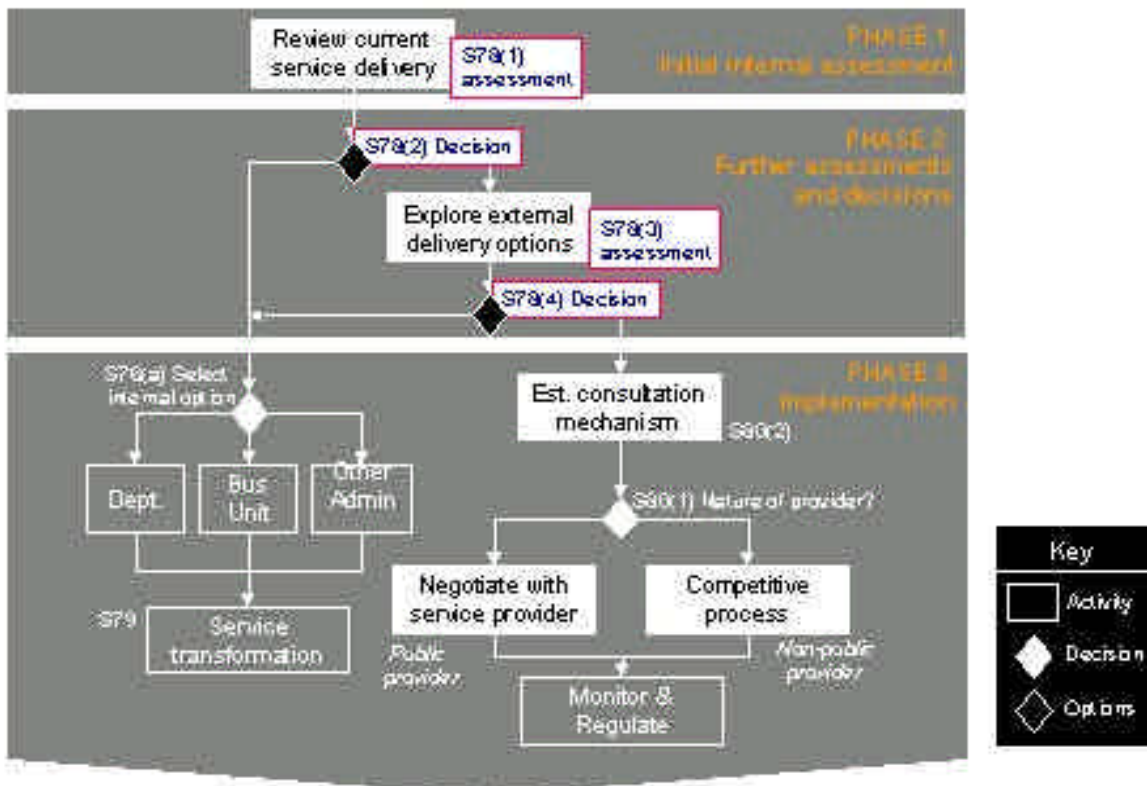
4.2 The process to be followed to decision a service delivery option?

Section 78 of the Act specifies the criteria to be applied and the process to be followed when deciding on a option to provide a municipal service in of the municipality, or to review any existing mechanism. For convenience the process may be understood as taking place within *three distinct phases*, each separated by a Council decision.

No municipality is thus allowed to follow any of these options or pre-empt the outcome without following the prescribed process.

There has been efforts to revoke this section with regard to electricity, but it did not take place as yet. It is thus important for municipalities to follow the route suggested by the MSA in order to prepare for the envisaged changes.

Section 78 - The Process



[4]

5. Preparing for REDS Ahead

5.1 Influences on Mangaung(MLM)

In preparing for the envisaged REDS it is necessary to consider some of the uncertainties for the proposed changes when the municipal electricity service is transferred into the RED. Some of these impacts on Mangaung and other municipalities will be:

- 5.1.1. Future revenue stream uncertain: If compared with the current contribution the future revenue stream from the RED is uncertain. It will be in any municipality's advantage to define the true business value of the utility to determine the future shareholding portion in the RED. Ringfenced values of the full assets and liabilities in a discounted cash flow (DCF) or depreciated replacement value(DRV) will be necessary to prove the value of the undertaking

- 5.1.2. Governance role of MLM in RED :The incorporation of the municipal entity into REDs, will change the current combined shareholder and governance role of the municipality to the proposed service authority, service provider role. In order to execute the Constitutional responsibility of the municipality it will be essential to manage this role efficiently. Experience in executing governance will be beneficial to municipalities.
- 5.1.3 Red's HQ issue: Economic growth is one of the essential elements of the development of cities. The question on whether people will move away is an issue that needs careful planning and preparation.
- 5.1.4 Non-core electricity functions: It is well known that many municipalities operate a variety of other functions for the remainder of the municipality often at a reduced cost to the core administration. It is advisable that municipalities consider these changes in their new macro and micro designs and plan in time to re-allocate costs and functions correctly.
- 5.1.5 Stranded assets: Various assets might be stranded in the envisaged merger between Eskom and municipalities. Pre-planning is a prerequisite to enable the remainder of the municipality to ensure cost effective and transparent services to the community.

Following from the IDP process, various workshops and investigations the following rationale for change for MLM were developed.

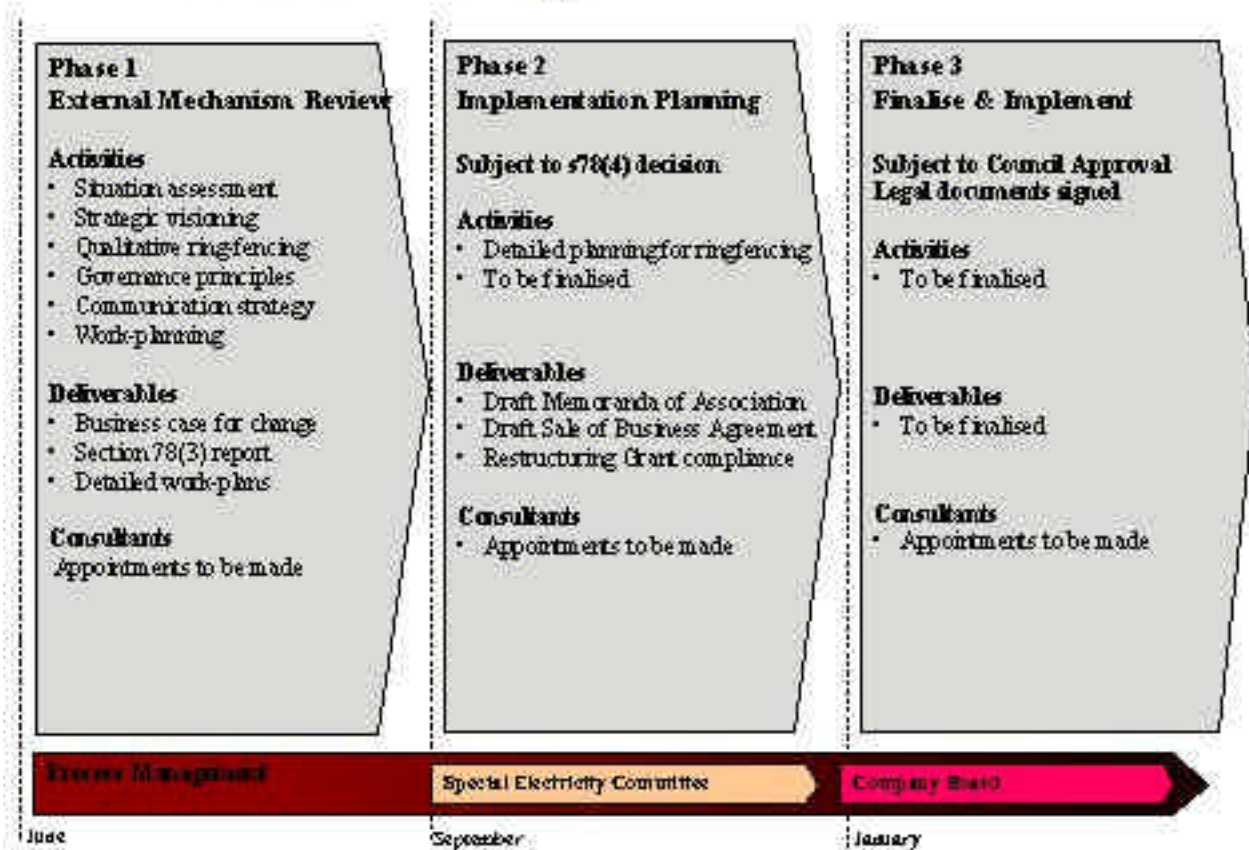
5.2 Rationale for change

- Organise as a business unit for greater efficiency and optimum service delivery to community
- Demonstrate capacity and competency in delivery, to facilitate process in becoming a Metro
- Give leadership in area and province to optimise service delivery
- Ensure definite future revenue stream for Municipality.
- Obtain experience in governance and service delivery processes in future RED
- To collude with other municipalities to strengthen municipal definition in RED's to come
- Transform electricity supplies as part of restructuring and transformation in municipality

5.3 The process

MLM embarked on a process as prescribed by the Systems Act. After the initial 78(1) process a 78(2) decision was taken to explore an external option. A definite process was then mapped in three distinct phases as depicted in diagram 4. It then deals with the external review, planning and implementation phase. The first part namely 78(3) is completed

Process Map



[5]

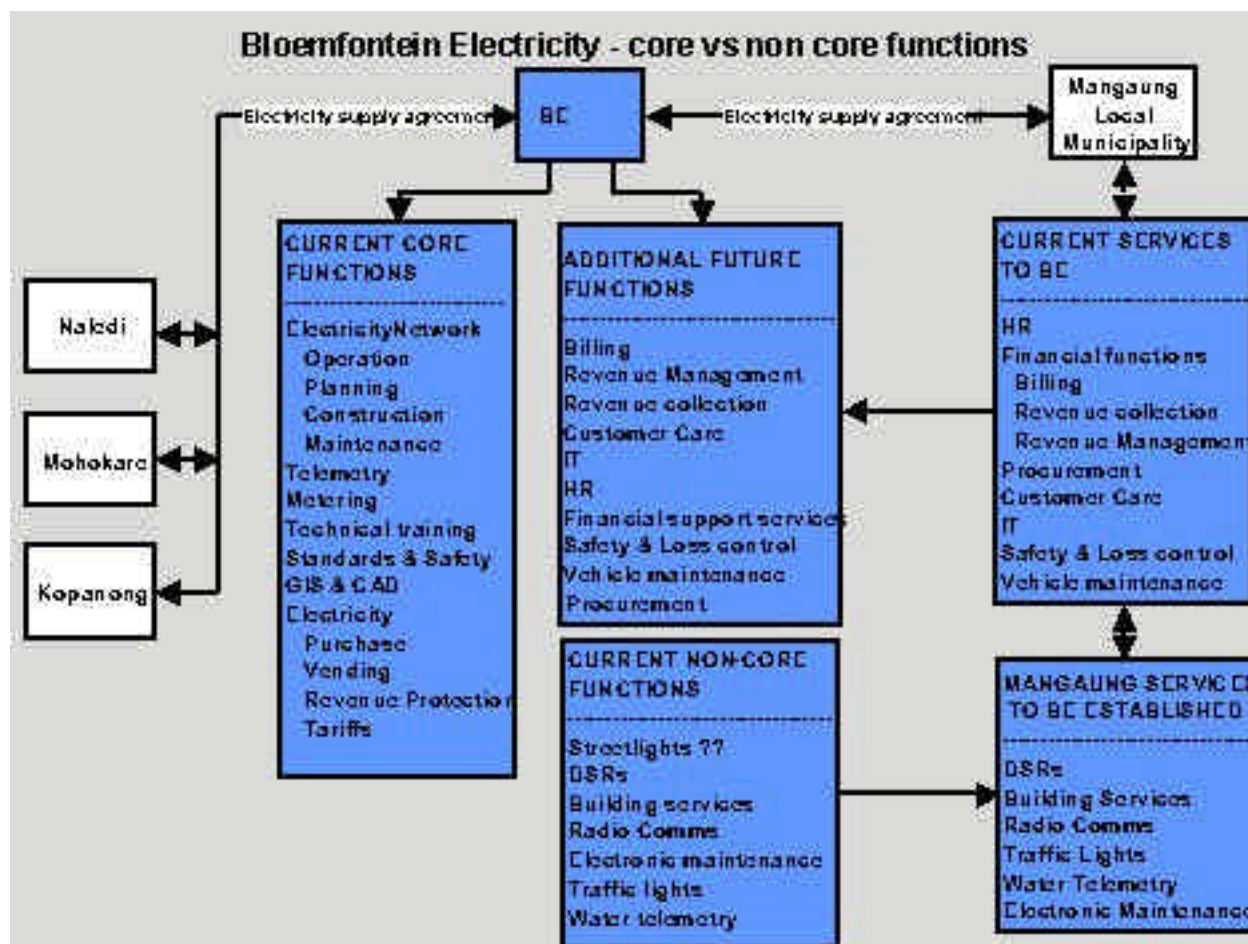
5.4 The SOE vs MBE investigation

The MSA 78(3) process requires from a municipality to follow a methodology that amongst others consider a business case for change and decide in the 78(4) stage on the appropriate internal and external mechanism. The investigation into the change management process for MLM is pictured in the following diagram.



The advantages of a municipality (MBE) vs the external business unit (SOE) was investigated in order to make recommendations to the MLM Council as to the best service delivery option. Important to understand that a MBE is neither privatization nor commercialisation. It is a process of legal separation to enable the utility to achieve strategic financial and operational leverages to achieve the desired readiness in terms of the goals.

5.5. Non-core electricity functions



As part of the ringfencing process core and noncore electricity functions needs to be identified and be placed appropriately. The following diagram gives an overview of the process currently been followed in MLM. Non-core is replaced in the design of the micro structure and the additional future functions is being evaluated as part of the SOE/MBE investigations. It is foreseen that the majority of these placements will be completed in the current financial year in order to move forward to embrace the changes to come.

5.6 Legal Separation

The process of legal separation from the municipality is the conclusion of the sale of business agreement, the compilation of the memorandum and articles of association and the registration of the entity. According to the investigations legal separation will allow a municipality to ensure commercial viability via a governance process as stated in the Companies Act. Without legal separation prospects of commercialization and efficiency gain is slim. However a MBE will be 100% owned by the municipality and service delivery will be managed through a service delivery agreement.

6. Conclusions

In order to be ready for the envisaged restructuring of the EDI MLM embarked on a process to evaluate current service delivery practices as stipulated by legislation. The investigation suggests that there is sufficient institutional and efficiency reasons why these changes should be. For MLM it is clear that these envisaged electricity transformations ties with the IDP visions of:

- Community resilience;
- economic growth;
- service excellence.

As the Executive Mayor of MLM (Papi Mokoena) has put it. “We would like to have a hand in the change, a place in the leadership in the Free State and SA. These preparations will position us to do so.

Bibliography

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