ELECTRICITY RESTRUCTURING: IMPACT ON 'REMAINING' MUNICIPALITY

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1. Document Objective and Key Assumptions

The objective of this paper is to highlight:

a. the possible impact of the National Electricity industry restructuring in the Local Government (Municipal) sector; and
b. to explore selected impact mitigating strategies.

This paper approaches the Municipal sector from a commercial business view in its application of commercial principles in the evaluation of municipal organisations. The use of commercial principles does not constitute a requirement to commercialise the municipal organisation but rather serves as a view on best practices in commercial business operations that could be utilised to the benefit of municipal service delivery.

Key Assumptions:

1. The EDI Holdings 6 RED model is the base model for future industry restructuring.
2. Municipal electricity services will be absorbed into future REDs (Regional Electricity Distributors).
3. The RED will be an ME (Municipal Entity).

2. Introduction

2.1 Municipal change

Change in the South African local government to date has primarily been driven from a 'bottom-up' approach due to the change in the electricity distribution industry (refer Figure 1 below). The national electricity restructuring programme has necessitated municipalities to review their 'businesses' from the 'bottom-up' as the threat of losing the primary municipal revenue generator requires the evaluation of the potential impact thereof on the 'remaining' municipality.

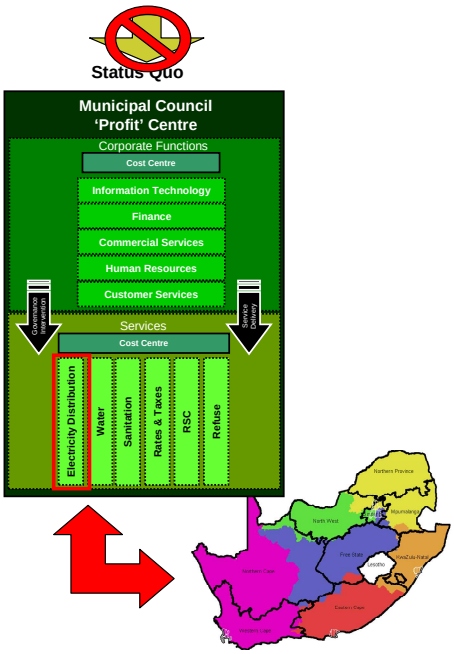

Figure 1 - Change driven from 'bottom-up'

Ring-fencing is the act of financial, operational and, if so required, legal separation of a business unit from the larger organisation. Figure 2 conceptually illustrates the interim structural change that a municipality must go through in order to prepare its electricity unit for future absorption into the RED. Preparation for RED is encapsulated in the ring-fenced transformation of existing municipal 'wires only' electricity departments into a fully fledged 'wires and retail' electricity service delivery mechanism.

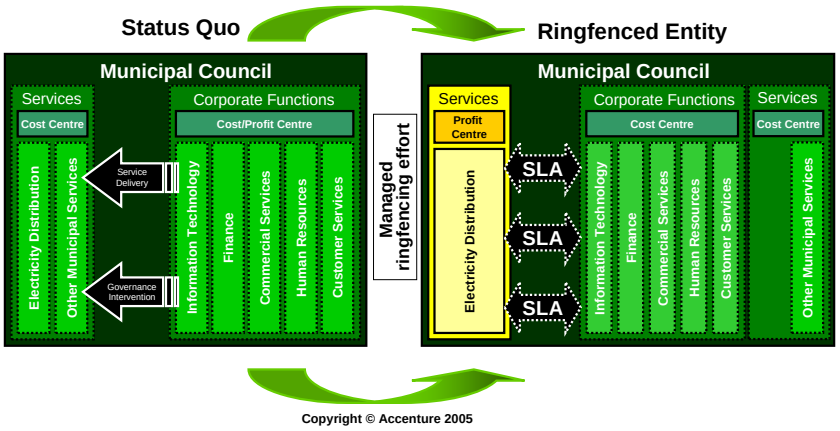

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Figure 2 - Organisational change imposed on Municipalities through preparation for REDs

The outcome of the industry restructuring will be the merging of the municipal and Eskom distribution businesses into a specific RED that will, in its simplest form, provide the municipality or its customers with electricity [1] (Refer Figure 3).

[1] Service authority issue overcome through the use of Service Delivery Agreement with the RED

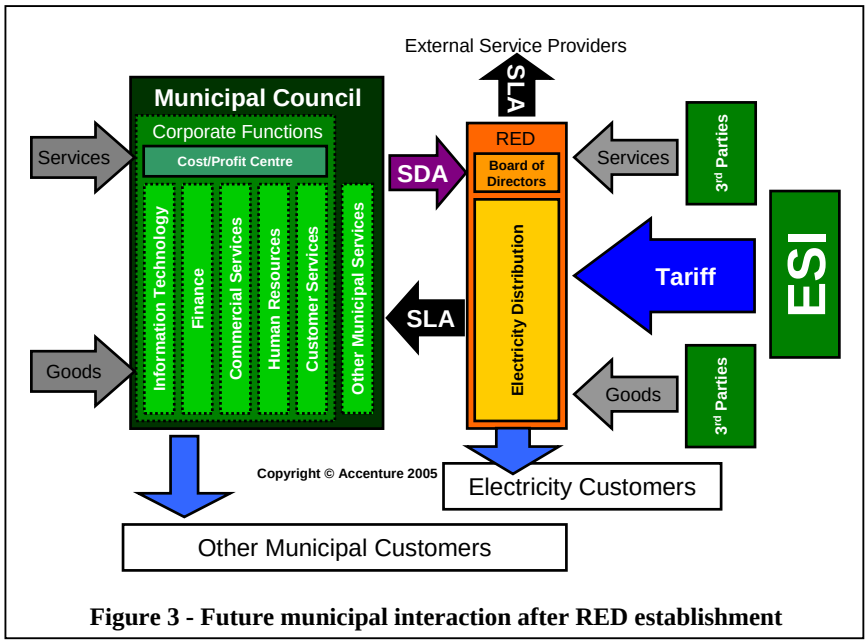

Figure 3 - Future municipal interaction after RED establishment

The ring-fencing process has created an awareness of possible structural inefficiencies within municipality operations and over-reliance on electricity funding as a source of cross-subsidisation for other underperforming services and the larger municipality in general.

2.2 Structural change to electricity businesses

The Status quo [2] in the municipal financial structure records surpluses (Income statement) and balance sheets on an overall municipal level and not on a specific municipal service level.

Electricity departments currently operate as 'cost centres' (commercial term used to describe a business unit collecting expenditure information only) which has to transform into 'Profit centres' (commercial term used to describe a business unit collecting income, expenditure, asset and liability information per unit) in order to constitute a financially ring-fenced entity.

The ring-fenced change will thus require the municipal electricity service to have its own income statement, balance sheet and cash flow statement on completion. This seemingly small change has a large impact on the business operations of the electricity unit going forward as management has access to accurate, detailed information. This information will be utilised to inform better future decision making.

3. Impact of the removal of Electricity from the Municipal service portfolio

3.1 Primary Impact on Municipalities

The quantitative impact has been a source of protracted debate with various models being used by different lobbying parties in the restructuring initiative. Some define the impact as the loss of the actual 'surplus only' and others see it as the 'loss of the turnover/revenue plus …'. The only patent conclusion from this debate is the fact that there is a major gap between the two arguments.

The true quantitative impact, of electricity migration to RED, can not be accurately determined and will remain open to speculation [3] and debate until all MEDs (Municipal Electricity Distributors)

[2] Refer Figure 2

are ring-fenced and operational under the ring-fenced structure for at least one reporting period/financial year.

In order to quantify the impact and to prove or disprove the hypothesis that there is an over reliance by municipalities on electricity funding an alternate data source, in the form of the Municipal Demarcation Board, was used for the purposes of this paper.

The municipal Demarcation Board [4] publishes municipal statistics and financial information on their website on an annual basis. The TOP 30 municipal electricity distributor's financial data was obtained from the website and analysed.

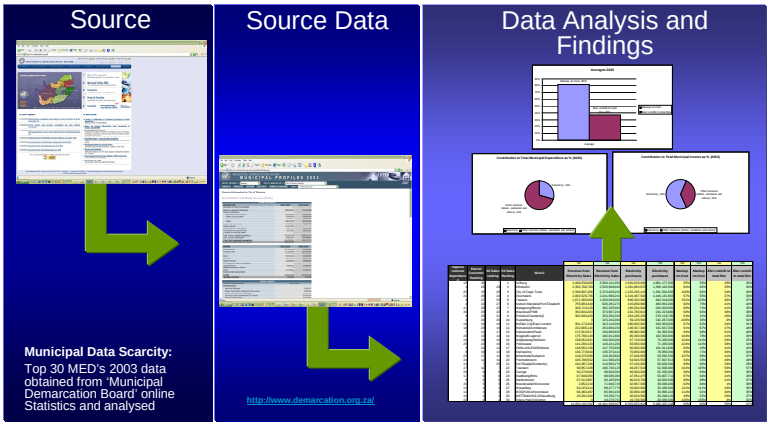

Figure 4 - Research approach

The study produced the following summary findings:

1. Top 30 MED's:
    - Electricity contributes on average 37% to total Municipal Income [5]
    - Average mark-up on cost of purchases of 82% [4]

2. Six Metropolitan Municipalities:
    - Electricity primary input cost (purchases) accounts for 18% of total municipal expenditure. [5]
    - Electricity contribution to total income accounts for 33% of total [5]
    - Other services (Water, Sanitation and Refuse) primary input cost accounts for 44% of total municipal expenditure. [5]
    - Other services (Water, Sanitation, Refuse) contribution to total income is limited to 19% [5]

The above (in the absence of ring-fenced data) is thus a clear indication of the gross average:

1. deficit on 'Other services' of 25% compared to
2. the gross average contribution of 15% for Electricity services.

Electricity is thus a clear leader in the gross and net contribution to the municipal coffers. The actual contribution of electricity to total municipal net surplus, or reduction of net deficit, far outweighs the contribution of the other services.

Conclusions:

1. There is major reliance on Electricity income to fund other Municipal operations;
2. That there is low collection rate and possible under-charging for other services; and

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[3] The obvious alternate source of MED data would be the NER D-forms (D1 financial information). The D-forms are however at best an inconsistent annual view of the municipal finance department on electricity services and thus not a reliable source of information.

[4] Please refer to the Municipal Demarcation Board website for source of information **http://www.demarcation.org.za/**

[5] Average contribution to total municipal income for top 30 MEDs

[5] Average for the six Metropolitan Electricity Distributors

3. That there are ‘pockets’ of inefficient operational management within the larger municipal businesses.

3.2 Secondary impact on municipalities

The removal of electricity from the municipal service portfolio also translates into indirect financial loss for the municipality. The items listed below highlight a few of the key secondary impacts:

1. Loss of electricity as a Credit management instrument.
   Municipalities are reliant on electricity service provision as a tool in the fight against the culture of non-payment for services. Non-payment of electricity services translates into a legal, unregulated cut-off of the service as apposed to water and sanitation services. The ‘loss’ of this tool could have a significant impact on future collection rates if not properly mitigated.

2. Impact on municipal credit rating and access to future external debt funding.
   The loss of a significant cash generator as well as the assets utilised to generate the cash will have a significant impact on future municipal credit ratings. The lower the credit rating the higher the risk of providing capital and the higher the price of capital provision. It will thus cost more to borrow the same amount of money in the future.

3. Electricity is a major source of cash-flow and thus day-to-day operational funding for the larger municipality.
   The removal of 40% [6] of cash flowing into any business will have a significant impact on business operations as the access to the same quantum of cash to pay vendors, employees, etc will not be available.

4. Municipalities funding ‘own-use’ at cost.
   Municipalities are currently funding its internal use of electricity at cost. This benefit will not be available in the future RED model as the municipality will be treated as a customer. The quantum of the impact can be calculated as (current use x current mark-up).

4 Impact mitigating strategies

As stated, the objective of this document is not solely to raise awareness on the possible future impact on municipalities, but also to highlight alternative solutions for these risks.

Figure 5 illustrates two possible holistic approaches for mitigating the primary and secondary impacts of the loss of electricity revenue on the municipality.

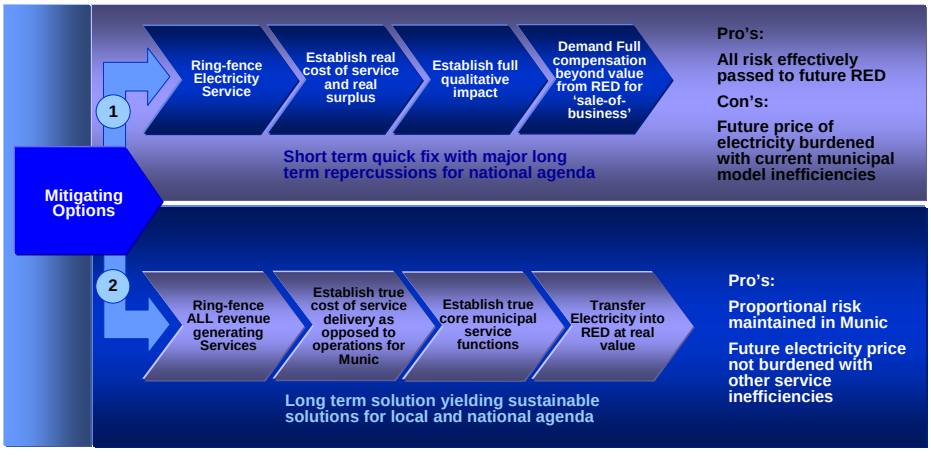

Figure 5 - Simplistic view of two risk mitigating strategies

4.1 Option 1: Transfer all risk to the future RED

Option 1 in Figure 5 refers to the existing approach of ring-fencing the electricity business and in so doing quantifying the real contribution to municipal operations. The outcome of this process can be used to 'demand' full compensation of possible losses from the future RED in the current negotiated RED process. This will in its simplest form mitigate all risks for the municipality but will have a significant impact on future national electricity prices as the current inefficiencies will be encapsulated in the future price.

This is a short term view and an approach followed by a large number of municipalities to date. This solution serves the local but not the national electricity transformation agenda. Existing inefficiencies should be addressed on a case by case basis, to ensure the long term sustainability of the remaining municipal services, rather that the wholesale transfer thereof into alternate future structure.

4.2 Option 2: Restructuring of remaining municipal operations

Option 2 refers to a more holistic long term solution for risk mitigation in as far as it deals with the issue of imbedded service inefficiencies within the municipality through the restructuring of the remaining municipal service portfolio.

This option suggests the ring-fencing of all municipal services into 'profit centres' (refer Figure 6) which will:

- deliver valuable measured information on the operations of the remaining services which can, as with option 1, be used by the municipality to negotiate alternate arrangements with provincial and national government to augment current regulatory requirements imposed on municipal services;
- highlight the basic principle that total expenditure can not outstrip total income and that the assets generating the income has to be maintained in order to ensure long-term sustainability of the services; and
- illustrate that the cost of support services (HR, Finance, legal, IT, etc) should be competitive and not burden the 'core business' of a municipality with costs that far outweigh the value thereof.

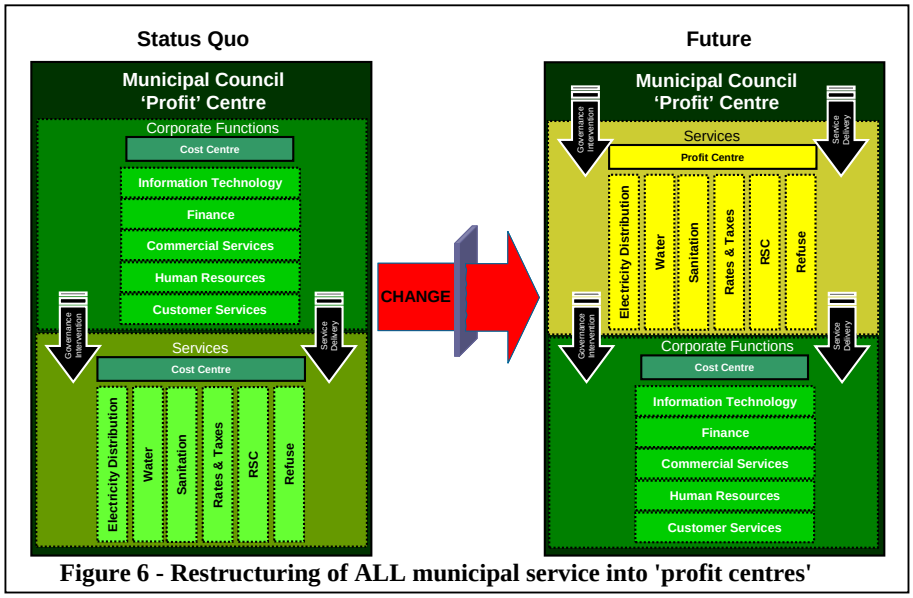

Figure 6 - Restructuring of ALL municipal service into 'profit centres'

This option has the benefit of ensuring long-term sustainability without burdening the future national electricity price with current inefficiencies and thus serving the interest of the nation at large.

5. Conclusion

It is fact that the electricity transformation process will impact municipalities on a financial and non-financial level. The approach in dealing with these risks will however determine the success of the national electricity restructuring process and the long term sustainability of the remaining services provided.