Securing municipal finance in Southern Africa



South African CitiesNetwork

Acknowledgements

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South African CitiesNetwork

The world at night: a picture of development

This satellite photograph provides a vivid illustration of the infrastructure challenges facing Southern Africa. In 2007 about 748 million people lived in Africa south of the Sahara, yet this area remains one of the world's least-electrified regions.

About the South African Cities Network

The South African Cities Network (SACN) is a non-profit network organisation established in 2002 by South Africa's Minister of Provincial and Local Government, in collaboration with the mayors of the country's nine largest cities and the South African Local Government Association.

SACN's founding member municipalities are Buffalo City (East London), Cape Town, Ekurhuleni (East Rand), eThekwini (Durban), Johannesburg, Mangaung (Bloemfontein), Msunduzi (Pietermaritzburg), Nelson Mandela Bay (Port Elizabeth) and Tshwane (Pretoria).

The network aims to support urban progress and prosperity in South African cities and urban centres by supporting learning and knowledge sharing among network members.

The SACN's goals are to:

- Promote good governance and management of South African cities
- Analyse strategic challenges facing cities, particularly in the context of global economic integration and national development
- Collect, collate, analyse, assess, disseminate and apply the experience of large city government in a South African context
- Promote a shared-learning partnership across national, provincial and local government to support improved governance.

The SACN promotes the four strategic building blocks for successful cities: productivity, inclusiveness, good government and sustainability.

The learning strategies employed by the SACN are designed to update leaders on trends in urban policy internationally; promote innovation and strategic thinking between cities and other levels of government; foster cooperation and exchange of best practice; generate options and make recommendations to network members; mobilise the capacity of cities to support local government and national development; and strengthen linkages between cities, towns and rural areas.

The SACN works on the full scope of urban development and management issues, including promoting sustainable cities, economic growth and poverty reduction, urban renewal, good governance, integrated land management, and service delivery and city development strategies.

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Preface

How can Southern Africa – one of the world's poorest and least-developed regions – achieve the broad economic and social objectives to which its people aspire? While there is no one answer to this question, part of the solution lies in building up the basic infrastructure required for growing economies and expanding cities throughout the Southern African Development Community (SADC).

Municipalities are no longer just revenue-generating entities: these public institutions are essential for good governance and service delivery. Our cities are responsible for providing many of the basic services essential to modern life and health, from water and electricity distribution to sanitation, transport and the upkeep of local roads. Yet we cannot provide such services without the ability to fund them on a sustainable basis, and that challenge is the subject of this publication.

In October 2008, the SACN convened a workshop to build municipal finance capacity among key public and private-sector personnel and institutions in Southern Africa.

More than 60 participants attended the meeting (see Appendix A). They included representatives of local governments from Lesotho, Malawi, Mozambique, Namibia, South Africa and Swaziland; international institutions; provincial and national governments in the region; and public entities with an interest in municipal finance and infrastructure investment. Municipal finance experts, analysts and practitioners participated, as did representatives from the banking and investment sectors.

Their deliberations form the basis for this booklet, which provides a snapshot of the state of municipal finance in Southern Africa, reviews the scope of infrastructure investments required over the period ahead, and provides municipal officials and other practitioners with a common knowledge platform and practical tools to strengthen their capital investment programmes.

The workshop aimed to:

- Create a broader awareness of municipal finance
- Allow municipal finance officers to network and share knowledge with institutional investors and practitioners from the region and international institutions
- Showcase leading practice in municipal financing and infrastructure investment.

Moses Maseko
Acting Chairperson, SACN

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Foreword: Towards sustainable municipal finance

The SACN is publishing this booklet to give impetus to the development of sustainable municipal financing strategies throughout Southern Africa.

Our municipal finance project aims to create a regional city learning network throughout the SADC. We want to help develop a collective voice for African cities, and to enhance the existing partnerships between international support organisations and regional players. And above all, we seek to support the emergence of financially viable municipalities, reaching from the Sahel to the southern tip of the continent, with significant infrastructure development programmes.

The programme is initially supported by a one-year grant of R2.6 million from the Public-Private Infrastructure Advisory Facility (PPIAF) to foster the emergence of a sustainable municipal finance market in the region by promoting effective planning and management of financial activities, better credit ratings, and the ability to access capital for investment purposes from banks or capital markets.

The project will do this by providing knowledge, technical assistance and credit advice to sub-national government entities in Southern Africa to a) build their capacity to better manage their financial affairs; b) facilitate the entry of the region's creditworthy cities and sub-national entities into the regional municipal finance market; and c) assist other sub-national entities and local governments to achieve creditworthiness. This process will result in a number of outputs, including a report on the State of municipal finance in Southern Africa (see Section 2) based on an in-depth analysis of 29 SADC cities. In addition, a number of country or project-specific advisory assignments will be available to strengthen approaches to municipal capital investment.

This work is being directed by the SACN, advised by a project steering committee that includes partner organisations and guided by advice from experts in a project reference group.

We proceed from the standpoint that Southern Africa's cities have a range of large and urgent infrastructure requirements that need to be funded; that there is a great deal of commercial money potentially available to support these objectives; and that by improving their creditworthiness and taking other steps to strengthen their financial position, cities throughout Southern Africa can obtain finance to meet the needs of their citizens.

Sithole Mbanga
CEO, SACN

1. Introduction

The importance of sustainable municipal finance

If Southern Africa's rapidly growing urban population is to experience more rapid economic and social development, the cities of the region need to rise to the challenge of upgrading and expanding basic infrastructure. Such infrastructure is not only essential to support economic growth, but also supports the kind of progress envisioned in the United Nations Millennium Development Goals: ending poverty and hunger, providing universal education, achieving gender equality, child and maternal health, combating HIV/AIDS, environmental sustainability and global partnership.

Like the rest of the developing world, Africa south of the Sahara is contending with the effects of rapid urbanisation, supported in recent years by higher global commodity prices and, consequently, international investment flows that have sought to cash in on the resource boom.

In 2008, according to the United Nations *State of World Population 2007* report, for the first time in history more than half of the world population, 3.3 billion people, will be living in urban areas. The report notes that between 2000 and 2030, "Africa's urban population will rise from 294 million to 742 million. Many of these new urbanites will be poor. Their future, the future of cities in developing countries, the future of humanity itself, all depend very much on decisions made now."

The question is how to fund such development.

Decentralisation and development

Internationally, there is a strong correlation between underdevelopment and lack of sustainable municipal finance. A lack of adequate infrastructure contributes to higher levels of disease, making economic growth all the more difficult. Essential infrastructure/services are required to provide sufficient water, basic sanitation, refuse removal, environmental health, basic energy, health care, housing, food and clothing.

Southern Africa is one of the world's poorest, most underdeveloped regions, as graphically demonstrated in Figure 1 below, which shows GDP density – a measure of the total amount of economic activity that takes place in different parts of the planet. This is calculated by multiplying GDP per capita by the number of people per square kilometre.

Figure 1: Global GDP density

***Source:** Gallup, Sachs and Mellinger*

It is a safe assumption that worsening maintenance backlogs throughout the region will lead to system failures such as water leakages, pollution, power failures and rapidly deteriorating roads. A greater focus on infrastructure management and maintaining existing assets will improve the reliability of municipal services and their ability to contribute to economic growth at a local and national level. Asset maintenance is ultimately about discipline and, as the box on Windhoek's maintenance programme on the next page shows, there are substantial rewards associated with such focus.

In line with decentralisation of service delivery responsibilities, municipalities are increasingly responsible for infrastructure investment. In the late 1990s a study conducted by the World Bank showed that about two-thirds of infrastructure spending in OECD countries took place at sub-national level, but in Southern Africa the share of sub-national share of such expenditure fell to 10 percent or less. This study also indicated a problem with the way things were being done: by substituting for domestic financial market development the World Bank was in fact impeding the development of local markets.

Maintaining infrastructure in Namibia's capital

Windhoek, the capital city of Namibia, provides a compelling example of how a properly planned and resourced asset management programme can lead to improved service delivery for residents by reducing risk and unnecessary expenditure. The city believes that by continuing to maintain existing infrastructure it will be in a better position to enhance the quality of life of its residents.

Windhoek has a population of about 400 000. Since 1994 the rural-urban migration rate has averaged about 4.4 percent. Unemployment is high (38 percent) as is underemployment (20 percent). Given these conditions, it is particularly important for the city to carefully manage its N$2.56 billion asset base and an annual budget of N$1 billion. The city receives no subsidies from the central government and no grant funding from donor agencies.

The city has identified a clear set of risks associated with not maintaining its assets. These include:

- Low life span of assets
- Service disruptions
- Loss of income
- Low expansion capacity
- Accidents and injuries
- Public liability
- High replacement costs
- High insurance costs.

In contrast, the benefits of maintaining infrastructure and equipment include:

- Extended asset life
- Reduced down time
- Limited loss of income
- Expanded capacity
- Limited accidents and injuries
- Minimal public liability claims
- Relative cost of replacement
- Reduced insurance premiums
- Minimum tariff increases.

Windhoek performs scheduled maintenance on vehicles, equipment, roads, water and electricity, as well as non-scheduled (unforeseen) maintenance on vehicles, equipment, water and electricity infrastructure.

The city spent 4.6 percent of operating expenditure on maintenance in 2005/06, 3.95 percent in 2006/07, 9.2 percent in 2007/08 and a budgeted 7.35 percent in 2008/09.

This has been a worthwhile investment. Recent projects included the refreshment of 600 computers; continued maintenance on a 50-year-old fire truck that is still in running condition; bus refurbishment (30 years old and still in running condition); a water reticulation project (pipe replacement); a landfill upgrade (life span extended by another 20 years); and resealing surfaced roads.

Part of the reason that Windhoek values maintenance is that it does not receive any national subsidies. The Windhoek experience emphasises the need to establish political will and buy-in for an active maintenance programme, to develop maintenance policies and master plans, to build proper organisational structures, and to incorporate maintenance into performance management systems.

Building local capacity

Sound local financing systems are required for sustainable local development. It is often said that local governments don't have capacity. But this is a chicken-and-egg problem. The problem is not lack of funds. There is ample commercial money; the challenge is accessing these funds and becoming self-reliant.

The World Bank has consequently made a number of important changes in the way it does business:

- There has been a shift from lending to knowledge and capacity building.
- The sustainability of investment is emphasised. Cities need to operate and maintain what they have before they roll out new capital expenditure.
- Intergovernmental frameworks are clarified at the outset.
- Financing should support development of local markets, not substitute for them. The Bank is co-financing municipalities so that they can access the market. This provides some comfort to both borrowers and lenders.

Flowing from this approach, the programme aims to get municipalities working together to become creditworthy, obtain credit ratings (which serve as an indicator of good governance) and access the markets. There are large flows of commercial money in a range of African economies. If municipalities can find a way to access these funds, they can employ them for infrastructure development. However, this implies becoming more self-reliant, which in many cases requires a change of mindset. It is one thing to recognise the benefits of decentralisation. However, such benefits will not materialise if city managers fail to address how decentralised cities will be funded.

2. The state of municipal finance in Southern Africa

Infrastructure and the urban challenge

During 2008 the SACN initiated a multi-year review of the state of municipal finance in Southern Africa. The purpose of this exercise is twofold: to analyse the state of municipal finances, creditworthiness and borrowing throughout the SADC; and to support the emergence of a sustainable municipal finance market. From the initial data compiled, it is apparent that cities throughout the region can learn much from each other.

The study is a work in progress that is being expanded to cover 29 cities throughout Southern Africa. The preliminary results provide a great deal of information about how Southern African cities are financed, and suggest important reference points for securing additional finance.

Developing a comprehensive picture of municipal finance in the SADC region

The financing of South Africa's nine largest cities was reviewed in 2007 (see the *State of City Finances Report*).

In 2008 the SACN expanded this work to study 10 cities in the SADC region:

- **Blantyre, Malawi**
- **Dar es Salaam, Tanzania**
- **Lilongwe, Malawi**
- **Lusaka, Zambia**
- **Manzini, Swaziland**
- **Maputo, Mozambique**
- **Maseru, Lesotho**
- **Mbabane, Swaziland**
- **Nampula, Mozambique**
- **Windhoek, Namibia**

A further round of research, to begin in 2010 is intended to cover:

- **Antananarivo, Madagascar**
- **Beira, Mozambique**
- **Bulawayo, Zimbabwe**
- **Gaborone, Botswana**
- **Harare, Zimbabwe**
- **Kinshasa, Democratic Republic of Congo**
- **Luanda, Angola**
- **Ndola, Zambia**
- **Port Louis, Mauritius**
- **Swakopmund, Namibia**

Figure 2: Location of cities surveyed for this analysis

The review is based on both desk work (reviewing financial statements, management information, budgets, strategic plans and so on) and field work, including site visits and interviews with municipal officials. The review collects data and presents comparative information on operating and capex spend and expenditure per person, and provides a breakdown of revenue sources and current debt position.

A credit assessment tool has been developed that takes into consideration financial, political, economic, management and strategic factors. It is intended to generate both an assessment of creditworthiness and a reform agenda to improve creditworthiness.

Services, revenue, expenditure and debt

The cities covered in the first round of the review range in size from 1.4 million inhabitants (Lusaka) to 60 000 (Mbabane).

Figure 3: Basic information on SADC cities studied in 2008[1]

		Population served	Area served (Ha)	National GDP/capita
1	Blantyre	1 000 000	220	5 962
2	Dar es Salaam	2 600 000	1 591	8 606
3	Lilongwe	700 000	456	5 962
4	Lusaka	1 300 000	360	9 543
5	Manzini	80 000	20	38 993
6	Maputo	1 100 000	383	7 194
7	Maseru	230 000	136	17 078
8	Mbabane	60 000	80	38 993
9	Nampula	475 000	402	7 194
10	Windhoek	300 000	645	47 370

Source: *Roland Hunter workshop presentation*

Windhoek, the largest municipality in the study group, is responsible for a full suite of services, including:

- Bus and taxi ranks
- Bus services
- Business registration and licensing
- Cemeteries
- Electricity distribution
- Environmental health services
- Housing rental
- Markets
- Other transport infrastructure
- Parks
- Policing – general and criminal
- Refuse collection
- Refuse disposal
- Road and stormwater construction
- Road and stormwater maintenance
- Sanitation (sewerage)
- Street sweeping
- Town planning and building control
- Traffic policing and traffic lights
- Water reticulation
- Water production (e.g. pumping from rivers).

Smaller municipalities have a much more limited range of responsibilities, which may include:

- Bus and taxi ranks
- Business registration and licensing
- Cemeteries
- Civil administration
- Environmental health services
- General health services
- Markets
- Parks
- Refuse collection
- Refuse disposal

[1] *At the time of publication, information about Dar es Salaam was not yet available. To round out the number of cities to 10, and to broaden the experience somewhat to include a smaller town, we have included comparative information on Ezulwini, Swaziland in a number of the figures that follow.*

- Road and stormwater construction
- Road and stormwater maintenance
- Sanitation (sewerage)
- Street sweeping
- Town planning and building control.

The services that are charged for vary from city to city. For example, some municipalities do not charge for sanitation. Some innovative practices are being explored. It has been reported that the city of Beira, Mozambique is asking the local water company to bill for sanitation. In Maputo, some nongovernmental organisations collect service fees.

The primary sources of municipal revenue in the region are property taxes, personal taxes, business licensing and taxes, service charges and operating grants. For most of the cities studied, the share of revenue from each of these categories is roughly equal. The exception is Windhoek, where the vast majority of revenues is in the form of business taxes, service charges and license fees. The main sources of infrastructure financing are capital grants, donor grants, government loans, private loans and operating revenues. Annual capital expenditure in 2007 ranged from the equivalent of R187 million (Windhoek) to R120 000 (Lilongwe).

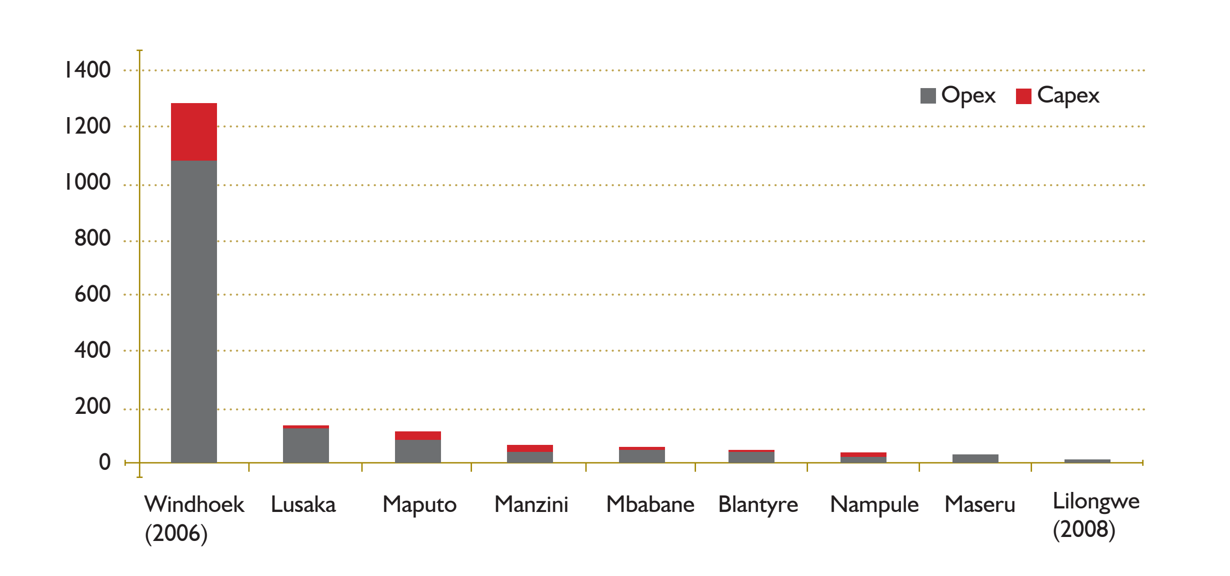
Figures 4 and 5 provide an overview of expenditure in the cities studied.

Figure 4: Selected cities, annual expenditure by category (R million)

		Annual operating expenditure	Annual capital expenditure	Total annual expenditure
1	Blantyre	44	2	46
2	Lilongwe (2008)	20	1	20
3	Lusaka	121	10	131
4	Manzini	44	18	62
5	Maputo	83	35	118
6	Maseru	29	2	31
7	Mbabane	47	10	58
8	Nampula	21	19	40
9	Windhoek (2006)	1 085	199	1 284

Source: *Roland Hunter workshop presentation*

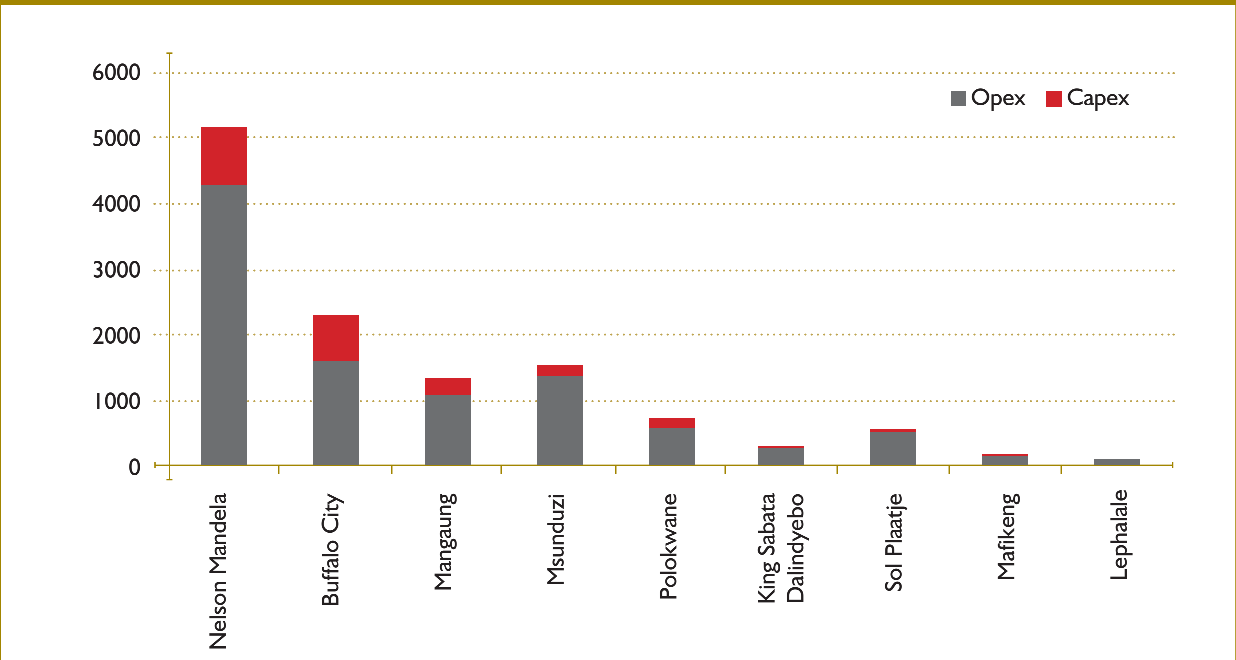
Figure 5: Expenditure comparison of selected SADC cities (R'000)



Source: *Roland Hunter workshop presentation*

Figure 6 presents expenditure figures for the nine largest municipalities in South Africa, where expenditure by the smallest city in the group (Buffalo City) exceeds spending by all the non-South African SADC cities covered in the review. Taken together, these nine cities account for two-thirds of all municipal expenditure in South Africa.

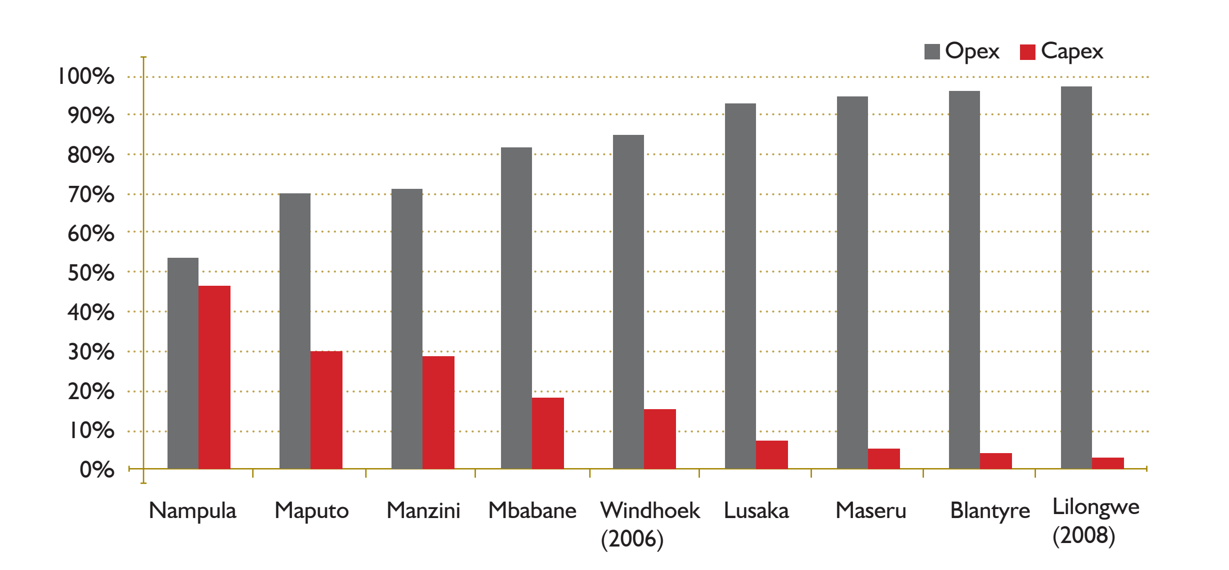
Figure 6: Expenditure of selected South African cities, 2005/06 (R '000)



Source: *Roland Hunter workshop presentation*

Figure 7 shows a wide variance in the share of capital expenditure in total annual spending.

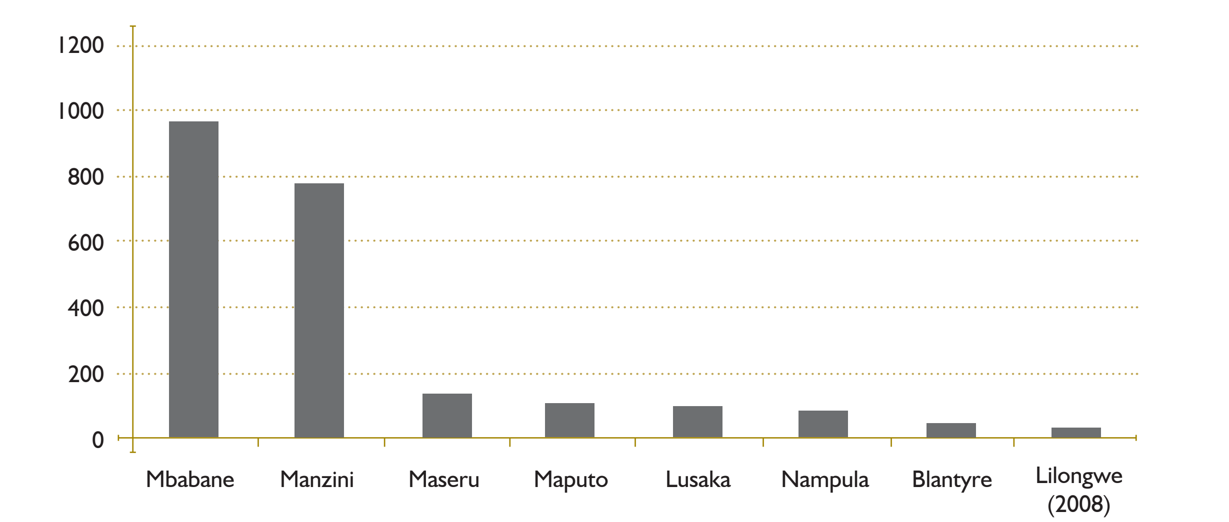
Figure 7: Share of capex in total spending in selected SADC cities



Source: *Roland Hunter workshop presentation*

Per capita municipal expenditure varies substantially across the region, as shown in Figure 8.

Figure 8: Expenditure per person in selected SADC cities



Source: *Roland Hunter workshop presentation*

As Figure 9 shows, on average, personnel expenditure accounts for 48 percent of total spending.

Figure 9: Share of personnel expenditure in total cash operating expenditure of selected municipalities

		Personnel expenditure (R m)	Other operating expenditure (R m)	Total cash operating expenditure (R m)	Personnel %
1	Lusaka	59.059	64.696	123.755	48%
2	Maputo	46.064	36.635	82.699	56%
3	Mbabane	25.845	24.150	49.994	52%
4	Manzini	25.349	21.046	46.395	55%
5	Maseru	15.026	14.287	29.313	51%
6	Blantyre	10.803	18.099	28.902	37%
7	Nampula	11.942	8.228	20.171	59%
8	Lilongwe (2008)	16.478	3.343	19.820	83%

Source: *Roland Hunter workshop presentation*

As Figure 10 shows, most of the cities studied, with the exception of Windhoek, hold very little debt. This suggests substantial room for more borrowing to fund crucial infrastructure investment.

Figure 10: Current debt position in selected SADC cities

		Non-current liabilities (R m)	Interest & redemption costs (R m)	Debt servicing as % of cash operating income
1	Blantyre	6.226	2.219	4.8%
2	Lusaka	0.840	2.315	1.9%
3	Manzini	11.076	2.026	2.5%
4	Maputo	-	-	0.0%
5	Maseru (2008)	-	-	0.0%
6	Mbabane	7.140	2.519	5.3%
7	Nampula	-	-	0.0%
8	Windhoek (2006)	451.466	21.195	1.9%

Source: *Roland Hunter workshop presentation*

Snapshots from the region

A brief look at the infrastructure requirements and financing challenges in a number of Southern African municipalities provides some idea of the range of needs that have to be met.

Nampula, Mozambique

Nampula is the third-largest city in Mozambique, with an estimated population of 475 000. The city is undergoing rapid development and the administration feels there is strong potential for increasing revenue to support development, but it is grappling with how to do this. The city needs to improve the municipal structure to become more efficient. Of particular concern is finding a way to collect municipal taxes for operations offered. Collection is weak, and without this the city cannot approach the banks and other financial institutions. Mozambican cities can borrow provided that they receive approval from the finance minister.

The system of property valuation is very old and based on land value. It tends to be undervalued and there are commercial properties that are not paying rates. There is potential here to start raising operating revenue, which is a prerequisite for capital borrowing. Even if the municipality is able to collect 6 percent of these rates it will provide much money for investment. Other options that may be available more broadly within Mozambique are to see electricity and water as potential revenue sources.

Lilongwe, Malawi

Lilongwe is a city of about 700 000 people. It has a collection rate of 40-50 percent on billings and a budget of 1.3 billion kwacha. Most projects are funded by the city's own revenue collection, but the property rating system is not adequate. There are only 50 000-60 000 properties on the municipal database. Many people are not paying their rates and the city estimates that it is owed about 3 billion kwacha. The street system is inadequate and the sewage system is in poor condition. Refuse disposal leaves much to be desired.

If the city can capture more properties on the database it would help to foster expanded revenue collection. For the past four years the city has not had audited accounts, which makes it difficult to access loans from institutions and donor organisations. Cost recovery is not being pursued. For example, the city collects solid waste but does not charge for this collection in residential areas. The municipality lacks skilled personnel in financial management. There is a manual accounting system. The informal sector is not adequately taxed. The city has built some markets and sheds for vendors to boost revenue and improve hygiene, but many of these vendors are not being taxed.

Sedibeng, South Africa

Sedibeng is a district municipality along the Vaal River south of Johannesburg. The municipality can boast of a number of unqualified audit reports which has helped to attract investors, and the district has secured R870 million for regional sewer schemes. However, the municipality needs to develop additional infrastructure and investment to boost employment, including through developing tourist sites.

Blantyre, Malawi

Blantyre is a city of about 1 million people. Most of the infrastructure is quite old and requires replacement. This includes the sewage system, the water system (in which the pipes are more than 50 years old), the road network, refuse disposal trucks and fire engines. The city has a budget of 1.5 billion kwacha but a high level of debt. Collecting funds due to the city – particularly property rates – is a big challenge. The municipality requires stepped up financial skills, especially in accounting, and a new billing system needs to be procured. Like many other municipalities, Blantyre has experienced an exodus of skills to the private sector.

Maseru, Lesotho

Maseru, the capital, has a long list of infrastructure requirements, but needs a collection strategy to address widespread non-payment. A public-private partnership (PPP) is in place for refuse removal. However, the city needs assistance with getting its billing system up and running, because the finances are still performed manually. Training is required, particularly in the area of accounting. The city also has great difficulty in collecting credible data, and data that is not credible is of no use.

Maputo, Mozambique

Maputo is the national capital and the largest city in Mozambique. An issue of concern is personal taxes. Many people who can afford to pay such taxes do not, and the city also relies on a poor database in this regard. An estimated 50 percent of Maputo residents do not pay personal taxes. The city has a plan covering all the infrastructure investments that need to be made, but needs to raise both revenue and capital for investment.

Ezulwini, Swaziland

This small town is Swaziland's tourist capital. It faces a number of infrastructure challenges that are described later in this booklet, but one specific challenge is that water and sewerage are not under the control of the town council, but are run by a parastatal. The town would benefit from technical advice and training to help councillors understand their roles and responsibilities, as well as forging partnerships with other towns in the region.

Common challenges

Based on the initial results a number of common themes and lessons have emerged:

- The financial strength of local government correlates strongly with GDP density. Where there are weak local economies, high levels of poverty and affordability issues, municipal finance is weaker.
- The functions and powers of local government – particularly the interface between spheres of government and borrowing powers – is a complicating factor. In some cases municipal borrowing is constrained by law.
- The relations between the political and administrative functions are often fraught with difficulty, and political and professional mandates are rarely given appropriate separation.
- Billing, credit control and politics –
  - Billing and collection systems are weak and partial, and as a result a great deal of money is not being collected
  - Credit control procedures are expensive and time-consuming
  - There is concern about the political implications of credit control action
  - People are genuinely poor.
- The skills crisis is widely described as "severe", characterised by especially poor skills in technical fields and a lack of systematic training.
- Accounting and controls are weak and assistance is needed to upgrade these functions.
- There is little scope for revenue bonds.
- Informal activity cannot be properly taxed, and this presents a major challenge given the scope of informal trade throughout Southern Africa.
- Knowledge management is crucial yet generally weak.
- The credibility of data is a major issue – from cadastral information to population figures.
- The majority of cities that borrow take on loans. None of the subject cities have issued bonds. This is largely the result of the current structure of capital and credit markets, which are underdeveloped in most of the region. Outside of South Africa, it appears that only Windhoek, Lusaka and some Swazi municipalities have taken on commercial loans.

The pattern that emerges is that not many of the subject cities are ready to enter the debt market. This

indicates a need for a programme of support for turnaround or capacity-building strategies, as well as support for borrowing strategies.

3. Making sound decisions about financing capital investment strategies

Covering the basics

As noted in Section 2, the market for municipal borrowing in Southern Africa remains quite small. The primary practical experience has been developed by cities in South Africa, which on the whole have the largest municipal capital investment programmes in the region. This section consequently highlights the South African experience, drawing extensively on the *Local Government Budgets and Expenditure Review, 2003/04 – 2009/10*, published by South Africa's National Treasury.

While the degree of services required and provided varies greatly throughout Southern Africa, a minimum level of basic infrastructure is needed to ensure the supply of potable water, basic sanitation, refuse removal, environmental health, energy, health care, housing and transport. The cost of eradicating backlogs in municipal basic services in South Africa alone is estimated at about R70 billion.

Moreover, municipalities need to look to the needs of growing economies and expanding populations. Investment in infrastructure is therefore a key component of sustainable municipal growth. While some municipalities receive central government subsidies to assist with capital expenditure, these subsidies, even in combination with locally raised revenue, are rarely adequate to pay for large-scale capital investment. This raises the need for municipalities to explore appropriate levels of private financing.

Effective use of private finance through appropriately structured borrowing and through PPPs can help to support economic growth, while enabling cities to use their own resources to alleviate poverty and improve service delivery.

In general terms, the larger municipalities have the ability to tap into external municipal funding sources to support critical infrastructure. Smaller and rural municipalities are often obliged to place greater reliance on grants and subsidies to finance capital expenditure.

The road to the Jozibond

In April 2004 the City of Johannesburg floated a R1 billion unsecured bond. This was to be the first of four municipal institutional bond issues.

The first bond (COJ01) was issued to diversify funding sources. At the time there were only seven financial institutions willing to lend money to the municipality, with limits on such lending. Proceeds from bond sales went towards refinancing the city's capital debts and recapitalising its ageing infrastructure.

The bond was intended to reduce the weighted average cost of borrowing for the municipality; extend the funding maturity profile; and better match the funding maturity profile to the asset life profile. In other words, the bond allowed the city to spread its debt maturities.

The COJ01 bond was voted the Best Debt Issue of the year at the annual Spire Awards of the Bond Exchange of SA in 2004 because it was "visible, well received and taken up by the market". When it was issued, the COJ01 bond was 50 percent oversubscribed.

In addition to the benefits for the municipality, the bond also helped to establish a credit curve and history for municipal bonds in the South African capital markets; to change market practice by funding municipal capital projects sustainably at reduced carry costs; and to expand the range alternative sources of funding available to municipalities.

To issue the first bond, the city had to take the following steps:

- Calculate the capital expenditure (or investment) backlog accumulated over a number of years
- Obtain investment-grade long-term credit ratings from at least one reputable rating agency
- Work towards a clean audit by preparing and implementing action plans to address the Auditor General's recurring disclaimers and solving the billing problems in the city's revenue unit
- Educate city councillors and managers about bonds
- Undertake investor road shows to publicise the bond.

A number of internal and external factors contributed to the success of the bond issue. These included, at national level, a sound legal framework and public policies, such as prudent fiscal policies, low interest rates and a stable currency; internal treasury capacity; a good long-term development strategy, as well as economic development and long-term capital development plans; and stable leadership and management within the municipality.

City of Johannesburg bond issues, 2004-2007

Bond code	Nominal amount	Maturity	Original credit spread
COJ01	R1 billion	13 April 2010	R153+230bps
COJ02*	R1 billion	15 Sept 2016	R157+ 164bps
COJ03	R0.7 billion	26 April 2013	R157+154bps
COJ04	R1.2 billion	5 June 2018	R203+120bps

** Partial guarantee*

In September 2007 Johannesburg launched a retail bond and, to date, R157 million has been raised. Branded as Jozibonds, these are traded on the Johannesburg Stock Exchange and allow individual investors to buy 2, 3 or 5-year bonds in increments of more than R1 000 at a time.

Jason Ngobeni, former head of the City of Johannesburg's Treasury operations believes that the performance of these municipal bonds should encourage other municipalities to find alternative ways of funding and not just rely on bank loans.

There are four questions a municipality should ask itself in assessing a decision to borrow for infrastructure investment:

1. Why are you borrowing?
2. When are you borrowing?
3. How much are you borrowing?
4. How are you borrowing?

Sources of finance

Beyond national transfers and current revenues, municipalities have a range of potential sources of finance, including:

- Long-term loans
- Short-term loans
- Municipal bonds
- Development charges
- PPPs.

The principal borrowing mechanisms for cities to finance infrastructure development are long-term loans and municipal bonds.

Long-term loans: In a loan, the borrower agrees to pay the lender according to a pre-arranged schedule, at a floating or fixed rate of interest. These loans, typically issued by banks or public-sector lending institutions, are less complicated to administer than bonds. They also do not carry the high initial transaction costs associated with bond issues. In South Africa, long-term loans amount to about 73 percent of total local government debt. In the broader region, such loans are quite low (see Figure 9 above). The inherent disadvantage of these loans is that they may not always be available to fund projects that require financing and construction over a very long period, such as building bridges.

Short-term loans: These loans are not generally issued to fund infrastructure investment. Rather, such instruments tend to be used as bridging finance for operational purposes within a specific financial year. Short-term debt that is allowed to accumulate can rapidly become unaffordable.

Other types of loans include *project loans*, *ring-fenced loans*, *structured loans* and *collateralised loans.*

Municipal bonds: Bonds are certificates of debt issued to raise funds. The issuer of a bond promises to repay the bondholder (the investor) the principal debt and interest (called a coupon) at a predetermined date. Municipal bonds can be ideal instruments to finance large capital projects over several decades. Interest rate payments and the repayment period can be negotiated by the issuer (the municipality) and investors.

There are many types of bonds, including:

- *Vanilla bonds* have no unusual features, pay a fixed rate of interest and are redeemable in full on maturity (the term vanilla derives from their "plainness").
- *Revenue bonds* are municipal *bonds* supported by the *revenue* from specific projects, such as a toll bridge.
- *Inflation-linked bonds* provide protection against inflation.
- *Stepped bonds* have interest coupons that change to predetermined levels on set dates.
- *Variable-rate bonds* pay a variable or floating rate of interest.
- *Zero-coupon bonds* do not pay interest but are traded at a deep discount, rendering profit at maturity when the bond is redeemed for its full face value.
- *Callable bonds* can be redeemed by the issuer prior to maturity, subject to conditions.

Loans versus bonds

In some cases, where lenders (such as development finance institutions) are able to loan at very low interest rates, loans may be cheaper than bonds. But this is the exception, not the rule. Internationally, most infrastructure investment is funded through bonds.

It pays to build relationships with the bond markets over time because over the long term bonds become cheaper than loans. Over time, the cost of capital is reduced.

Outside South Africa and Namibia, Southern Africa's capital markets remain undeveloped. (In South Africa, some issuers, such as the Rand Water Board, have sold bonds since at least the 1920s and continue to do so today.) But there are nonetheless opportunities to raise capital for infrastructure. For example, pension funds in countries such as Burkina Faso, Uganda and Nigeria have built up liquidity and can potentially fund bonds cheaply.

The pricing of bonds varies. The *2008 Local Government Budgets and Expenditure Review* points out that South African banks usually price loans using an amortising profile, rather than a bullet profile:

> **"With amortised loans, monthly repayments incorporate capital and interest until the redemption of the loan. The bulk of initial repayments will comprise mostly of interest and the capital (principal) will be evenly spread during the tenure of loan. For a loan with a bullet profile, the capital is only paid by the municipality when the loan is redeemed and interest will be paid during the tenure of the loan.**
>
> **"Amortised loans result in a higher cost of borrowing compared to a bond issue. This is because the interest is based on what the bank's risk perception is of the municipality rather than the perception of a multitude of lenders in a functioning market."**

Development charges are a way for municipalities to take advantage of growth in residential and commercial property developments. While the ability to levy such charges depends on the pace of economic growth, they can help to unlock potential revenue. Development charges are typically "off-balance-sheet" charges in which a city administration enters into agreement with property owners or developers. The agreement enables the city to recoup some of the cost of the infrastructure development from the individual owners.

Public-private partnerships are one potential avenue to improve municipal service delivery and infrastructure development. These partnerships build on private-sector expertise and the ability of the private party to raise debt and equity to finance large-scale projects. Different types of PPPs provide for different levels of risk sharing between a municipality and its partners. A range of resources are available.

Public-private partnerships

Local governments can help fulfil a vital role in broadening economic participation, as well as meeting their responsibilities to ensure quality basic services and provide essential infrastructure at municipal level. PPPs can provide innovative solutions to help local governments to fulfil these responsibilities.

A municipal PPP is an agreement between a municipality and a private party in which the private party assumes substantial financial, technical and operational risk in the design, financing, building and operation of a project.

The *Municipal Service Delivery and PPP Guidelines* published by South Africa's National Treasury in 2008 provide additional definitions. Three types of PPPs are defined: the private party performs a municipal function; the private party acquires the use of municipal property for its own commercial purposes; or a hybrid of the two.

A PPP is not:

- A simple outsourcing of functions where substantial financial, technical and operational risk is retained by the municipality
- A donation by a private party for a public good
- The privatisation or divestiture of municipal assets and/or liabilities
- The "commercialisation" of a municipal function
- An alternative form of borrowing by the municipality.

A number of resources are available for municipalities wishing to explore PPPs. Among these is the Public-Private Infrastructure Advisory Facility (PPIAF), a multi-donor technical assistance agency, which has traditionally supported reforms that use PPPs to improve infrastructure services. The PPIAF is now conducting a pilot programme to help municipalities improve their creditworthiness so that they can access market-based financing on their own, without sovereign guarantees. The programme's grants are available to qualifying municipalities.

Technical assistance grants can support a range of activities, including:

- Improving internal financial controls
- Developing a capital financing plan
- Improving corporate governance of a public enterprise
- Getting or improving a credit rating
- Structuring a project
- Developing innovative credit structures
- Preparing a bond or share issue.

There are a number of public- and private-sector institutions active in the municipal long-term debt market. These include banks and other financial institutions and, in South Africa, the Development Bank of Southern Africa (DBSA) and the Infrastructure Finance Corporation.

Large-scale borrowing carries risks. Managing credit risk through instruments such as credit enhancements and credit ratings are covered in the next section of this booklet.

Bonds: accountability and transparency

"While bank loans involve only two parties, a diverse pool of investors is involved in bonds.

"As bond issues involve underwriters, credit rating agencies, trustees and the general public, they create an obligation for greater accountability and transparency on the part of the municipality. All stakeholders and investors demand up-to-date knowledge of the financial affairs of the municipality and the issuer is required by the debt disclosure regulations of the Municipal Finance Management Act to obtain an annually renewable credit rating.

"The regulations are aimed at improving transparency to protect investors. For example, investors will know the extent to which changes in local taxes and service charges will affect the servicing of the bond repayments. For a successful bond issue, a municipality must have a good revenue collection and revenue growth rate, as this serves as an indicator of the ability of a municipality to meet its bond repayment obligation.

"The City of Johannesburg and the City of Cape Town are the only municipalities to have recently issued bonds. The benefit of issuing municipal bonds is that they are priced against government bonds, which are a true reflection of the pricing in the market. This can potentially reduce the cost of borrowing for a well run municipality."

Source: *2008 Local Government Budgets and Expenditure Review*

How can municipalities determine which form of borrowing is right for their requirements? What criteria can be used to judge the sustainability of borrowing over a period of time? While the circumstances will vary from city to city, and country to country, an assessment tool developed in South Africa provides a useful frame of reference in which to consider such decisions.

The Municipal Infrastructure Investment Framework

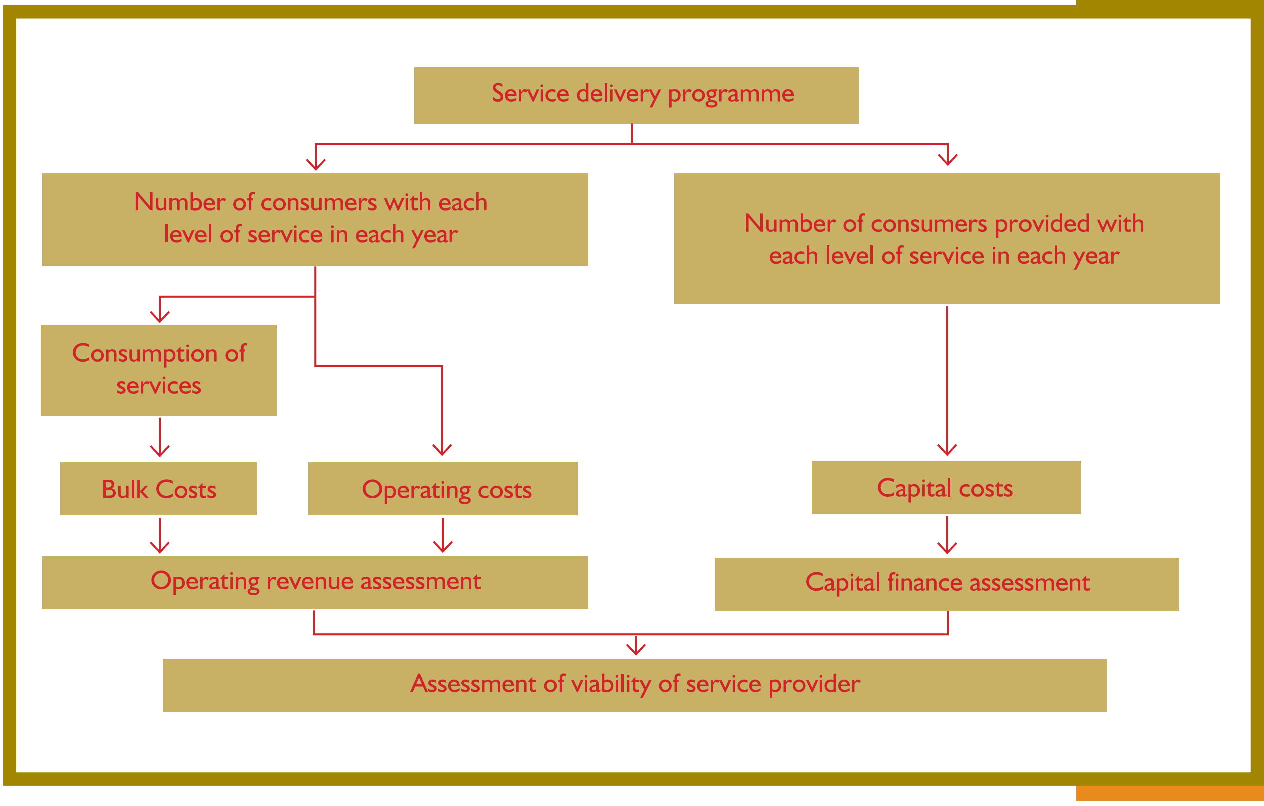
South Africa's Department of Provincial and Local Government, the South African Local Government Association and the DBSA have been developing a Municipal Infrastructure Investment Framework since 1994, emphasising service provision for South Africa's poorest communities. It looks at how much capital is needed to fund investment and whether a given project is viable.

This framework has gone through several rounds of upgrade, and the preliminary results of the fifth round are now available.

The framework is being refined and lage-scale rollout to municipalities is projected.

It includes a municipal services finance model that can be applied to individual municipalities or groups of municipalities. This takes into account factors in a service delivery programme such as the number of consumers and level of service per year; bulk, operating costs and capital costs; operating revenue assessment; and capital finance assessment. Based on these and other factors it provides an assessment of the viability of a service provider.

Figure 11: A framework for assessing service delivery viability in South Africa

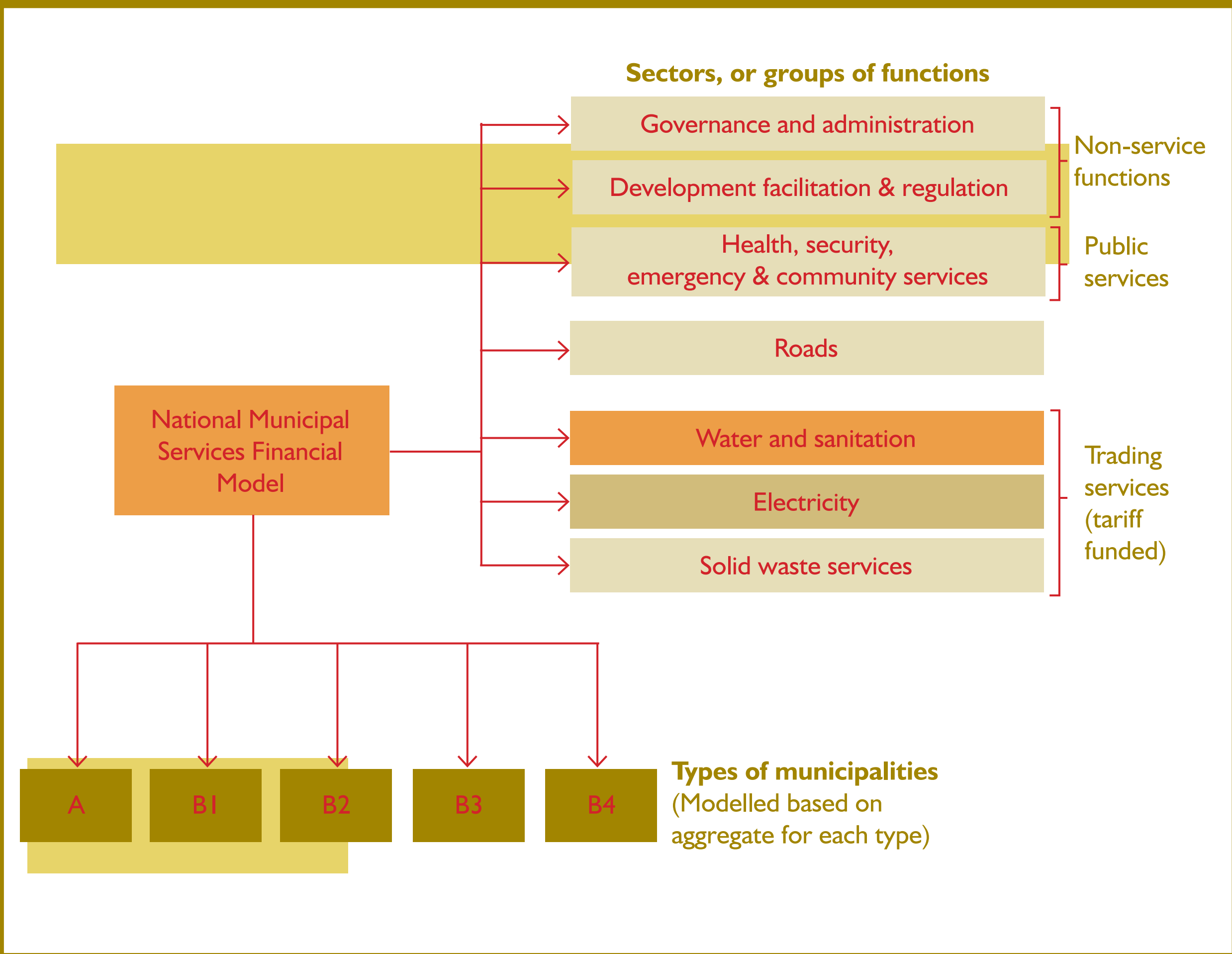


Source: *Ian Palmer workshop presentation*

The framework divides municipalities by category:

- **Category A:** The six large metropolitan areas (Johannesburg, eThekwini, Cape Town, Ekurhuleni, Nelson Mandela Bay and Tshwane)
- **Category B1:** The 21 secondary cities, with George as the smallest
- **Category B2:** Municipalities with large towns at their core (e.g. Worcester in the Western Cape)
- **Category B3:** Municipalities characterised by the presence of small towns such as may be found in the Free State
- **Category B4:** Rural municipalities, mostly in the former Bantustans
- **Category C:** District municipalities.

Figure 12: Structure of analysis at national level

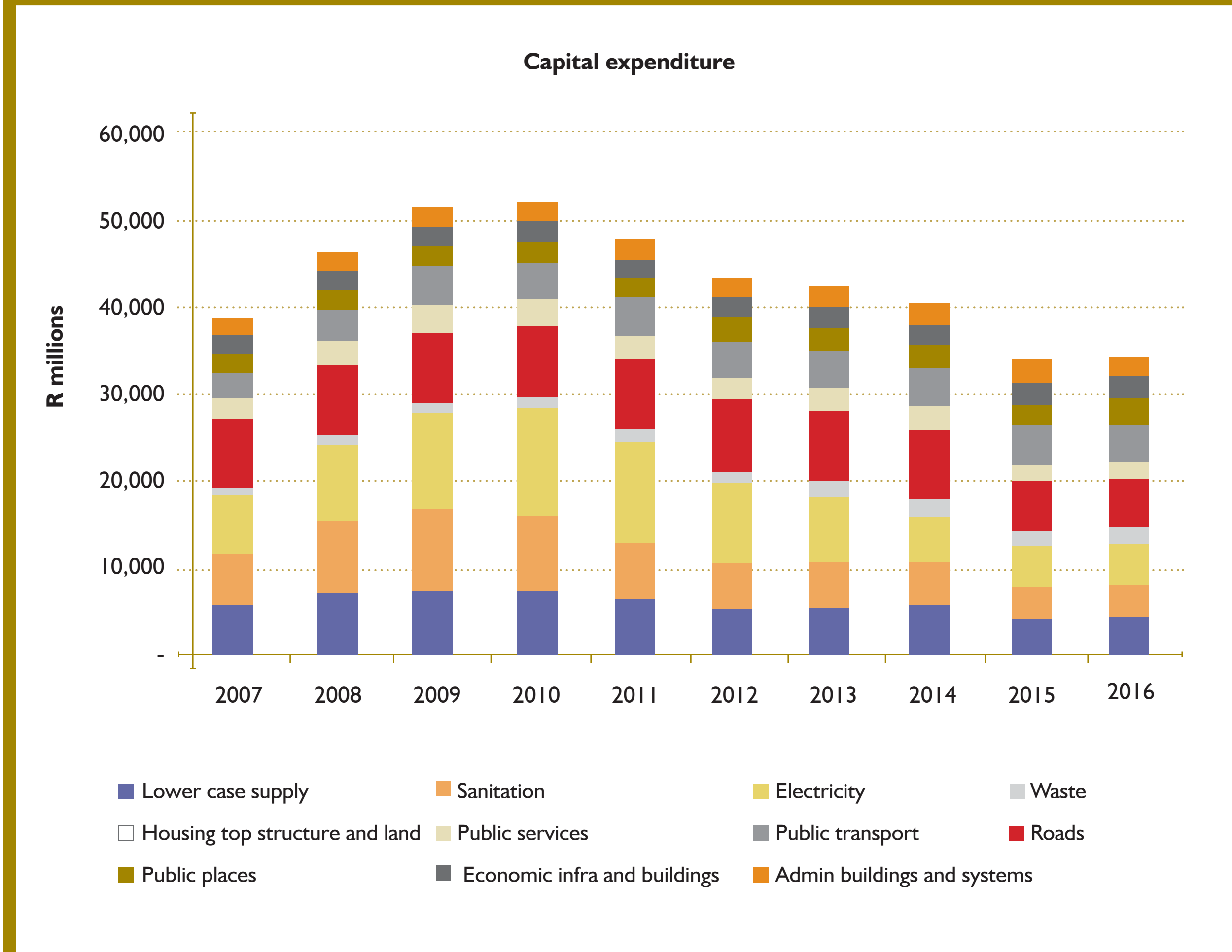


Source: *Ian Palmer workshop presentation*

South Africa has experienced some important shifts over the past three years that affect infrastructure delivery. These include a rapid increase in construction costs (input cost to construction industry increasing at 40 percent, plus greater profit-taking by contractors in an over-traded environment). The rate of increase in grants is far below this. This implies that fewer municipalities will be able to meet infrastructure delivery targets.

The projected scale of capital investment in municipalities over the next eight years is shown in Figure 13. The bulk of investment requirements are found in the areas of roads, electricity, sanitation and public transport.

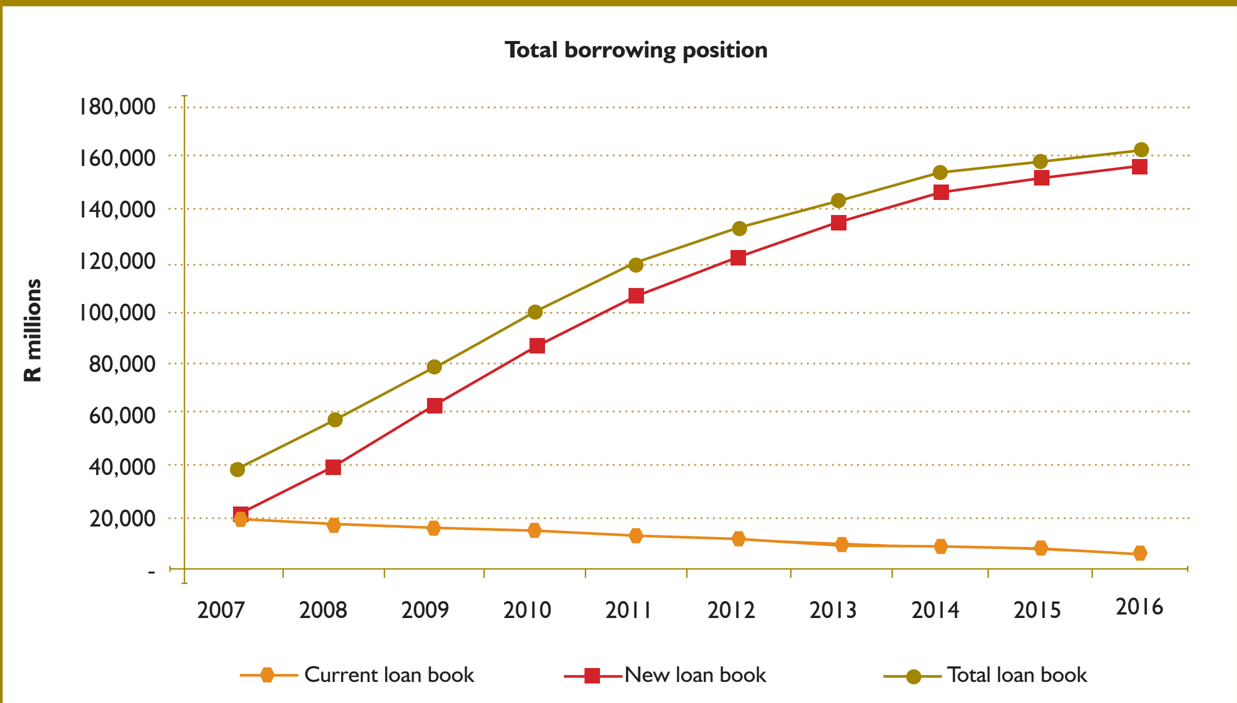
Figure 13: Capex for all municipalities, 10-year trends



Source: *Ian Palmer workshop presentation*

The data demonstrate a substantial increase in the borrowings required for municipal services infrastructure (in particular water, roads, electricity and sanitation) in South Africa. The current municipal loan book stands at about R20 billion. To fund the required infrastructure this needs to increase to R100-R150 billion over the next decade, as shown in Figure 14.

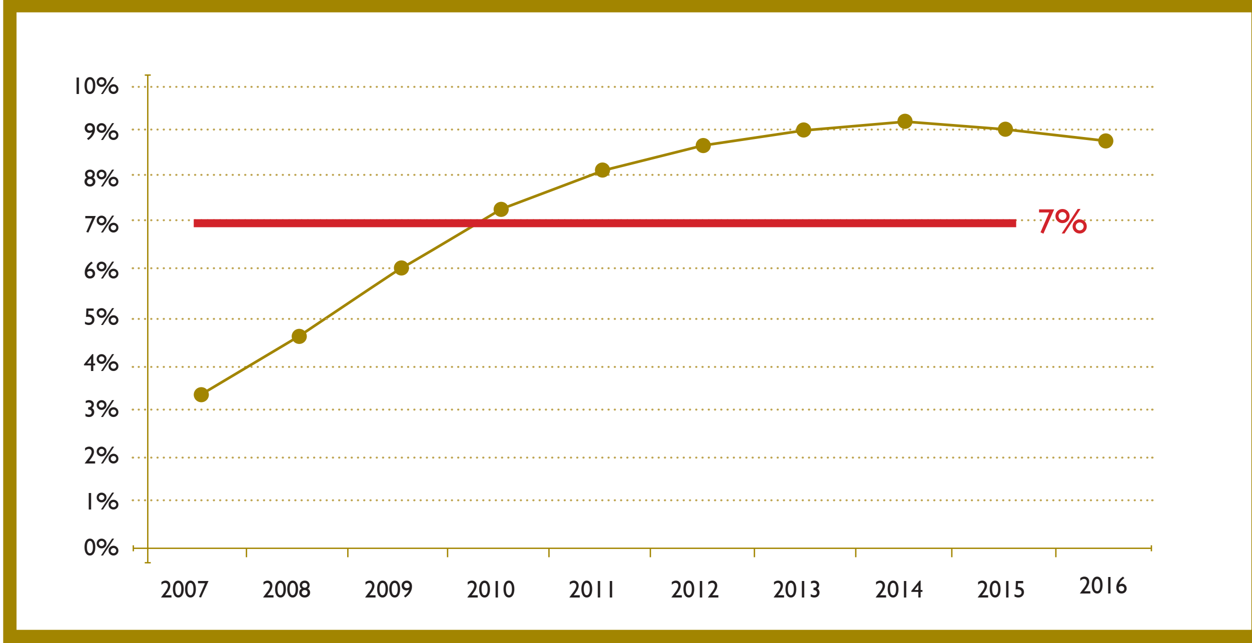
Figure 14: Required borrowing to meet targets in South African cities, 2007-2016



Source: *Ian Palmer workshop presentation*

However, the challenge will be for this to be sustainable, as shown in Figure 15. A useful indicator of "borrowing capacity" is that interest payments on long-term loans should not exceed 7 percent of revenue. The model projects long-term interest payments rising above this level for an extended period beginning in about 2010. There is also a big difference in the ability of metros and rural municipalities to pay.

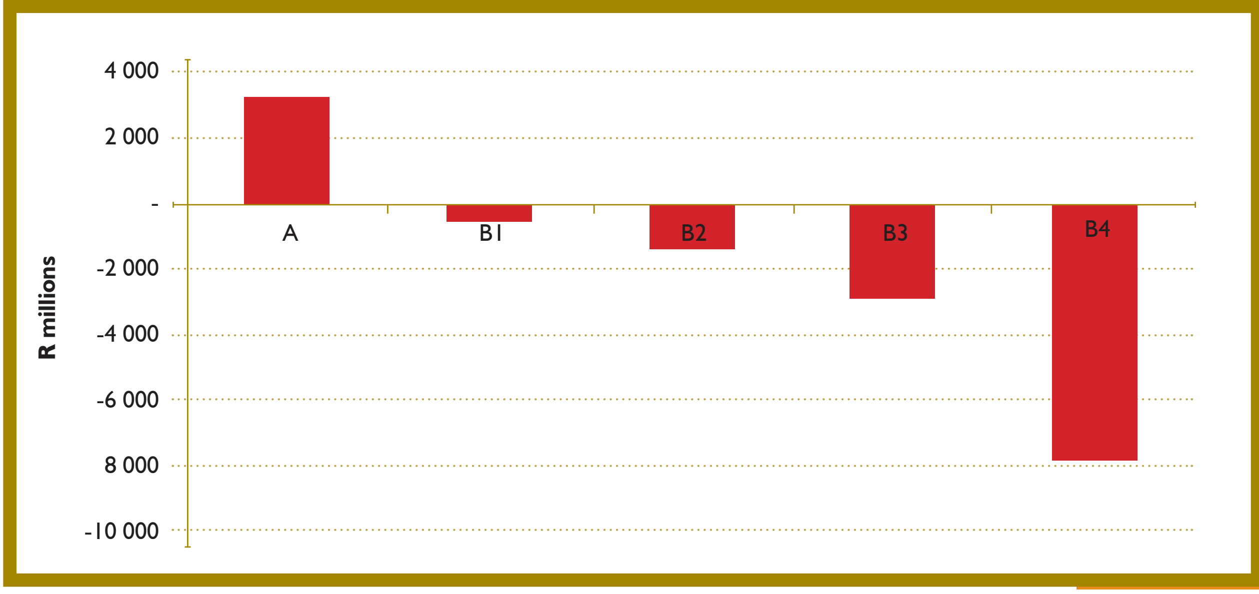
Figure 15: Interest payments as percentage of operating revenue



Source: *Ian Palmer workshop presentation*

Figure 16, a theoretical construct based on what municipalities should be spending on operating expenses and raising in revenue in aggregate, shows that large metros are in a much better position to borrow than smaller and rural municipalities.

Figure 16: Municipal viability by sub-category



Source: *Ian Palmer workshop presentation*

Value of the model for Southern Africa

Several other concerns should also be kept in mind:

- The model does not take into account assets held by a municipality, and these would need to be factored into any investment strategy.
- Some cash-flush municipalities cannot run services; others accept capital grants, not to provide services but to collect interest. While this may look good on the balance sheet, it does not demonstrate good governance.
- Municipalities need to raise their capacity to be coordinators or facilitators of deals, to be able to coordinate services and to serve as facilitators of development pacts.

While this model is designed for South Africa's purposes and is still being fine-tuned, the approach provides useful tools for municipalities throughout the Southern African region to assess borrowing requirements and repayment capacity.

Resources, planning, skills and funding in Gauteng

As international experience has shown, the availability of financial resources is not sufficient, on its own, to ensure successful infrastructure investment programmes. The challenge is to use such resources well. Sustainable municipal finance can only be achieved if a number of other factors are in place. In this regard the experience of South Africa's Gauteng province – the country's industrial and financial heartland – provides a number of lessons for the region.

- *Political stability*. **In Gauteng's experience, cities with relative political stability are better able to plan and commit resources to infrastructure investment.**
- *Skills*. **Municipalities need well-qualified, skilled officials who understand that their role is to serve, not to engage in politics.**
- *Lines of authority*. **Issues in dispute between national, provincial and local government, or coordination failures, cannot be allowed to block development.**
- *Resources and spending*. **Gauteng has struggled to spend its available resources, with a consequent lack of service delivery. Tender delays have been part of the problem. Such negative developments and delivery failures have an immediate impact on people's lives in areas such as sanitation. In this regard Gauteng's cities may wish to look at Windhoek, one of the cleanest cities on the continent, to see what it is doing right.**
- *Planning*. **While local government is developing a medium-term expenditure framework, it has a poor record of planning for infrastructure. This requires**

a change of mindset to make indicative allocations. How, for example, can information technology be used to enhance planning and maintenance? Cities need not wait for infrastructure to break down to perform maintenance. This has a negative effect on growth and productivity.

- *Replacing infrastructure*. **Gauteng's cities experience heavy losses of water (up to 30 percent in some areas) and electricity. Such resources can no longer be taken for granted and losses must be reduced to a minimum through maintenance. While there are challenges in the areas of regulation and pricing, municipalities can find ways to create opportunities for economic growth, including through better information and communication technology networks.**
- *Data collection and management*. **The information on Gauteng municipalities is rarely reliable. The province and cities must improve the reliability of information produced, including financial and debt information. Proper billing systems with better internal controls also need to be put in place to reflect what is consumed.**
- *Reliance on grants*. **Some Gauteng municipalities remain reliant on grants and are reluctant to raise revenue. This must be turned around.**
- *Civil service attitudes*. **If municipal staff don't care, local government service delivery will fail. Civil servants need to be reminded that they are employed to serve the people.**

Learning from the global financial crisis

The origins of the present global financial crisis in the US "subprime" mortgage market, where loans were made to people who could not pay, provides a timely reminder that sustainable finance is only possible when municipalities are able to service their debts over the long term.

The same lessons apply to Southern African cities. Municipalities that cannot demonstrate good financial health will not be able to borrow on the capital markets. To extend infrastructure investment programmes, the emphasis is to enhance creditworthiness and, where there is an opportunity to go to the market, to do so more efficiently, such as by lowering the cost of borrowing.

Finally, any municipality raising large capital funds needs a strategic outlook that informs where and how it is going to invest such funds.

4. Securing municipal finance

Creditworthiness

In the municipal context, creditworthiness is crucial. In line with decentralisation of service delivery responsibilities, municipalities are increasingly responsible for infrastructure investment, and need to access financing for infrastructure improvements from banks or bond markets without relying on sovereign guarantees.

Southern African cities face massive investment requirements in public infrastructure arising from backlogs in access to basic services, the rapid pace of urbanisation, the demands of economic growth and the need to replace old assets. In addition, many financial institutions *want* to lend money to well-run municipalities.

Direct involvement with lenders and investors seems to help professionalise the financial management of cities. However, this demands external accountability, and lenders often have much stricter expectations about capital planning and financial management than central governments do. What is creditworthiness?

Definitions

Creditworthiness can refer to the eligibility of an individual or entity to borrow money based on their credit history, in the opinion of the lender or on the basis of a credit scoring system. Alternately, it can refer to the creditor's measure of an individual or organisation's ability to pay back a loan.

Creditworthiness is a proxy for a well-managed, financially sustainable organisation. It is reflected in either the ability to borrow (market access) or the cost of borrowing (price), so it is not a point to be reached, but a continuum.

Creditworthiness is also a condition of the market itself. In the context of an expanding economy with high levels of liquidity, it will be easier to be considered creditworthy than during a period of contracting credit markets and tightening loan requirements.

Measures of creditworthiness typically include cash flows, credit history and current indebtedness. For long-term loans, lenders will want to know how cash flows will change over time and whether the policy environment is stable, predictable and supportive of growth.

How is it measured?

There are various ways to measure creditworthiness, but they typically include:

- Cash flows –
  - By subtracting all of a potential borrower's normal expenditures from its normal revenues, a lender decides whether there will be enough left over to comfortably repay the requested loan.
- Credit history –
  - A lender looks for evidence of a willingness and history of repayment in full and on time.
- Current indebtedness: Ratio of current debt to income –
  - A potential lender looks at the ratio of current debt to income to determine whether a borrower can reasonably handle another obligation without significantly increasing the risk of default.

In addition, for long-term loans, lenders will want to know how cash flows will change over time:

- Will revenues increase or decrease as residents and businesses move into or out of the city?
- Can city managers meet financial challenges that are likely to occur and make competing demands on resources?
- Is the policy environment stable, predictable, supportive of growth and poverty reduction? Does this affect the financial sustainability and quality of the loan?

Credit ratings

While financial institutions ultimately take their own decisions on a borrower's ability to repay a loan, these decisions are informed by credit ratings. Lenders will often draw on independent credit ratings to inform (but not replace) their lending decisions. The three major ratings agencies (all with country-specific partners) are Moody's Investor Services, Fitch Ratings and Standard & Poor's. There are other agencies, and their acceptability will vary according to the lender. Each ratings firm uses its own rating methods and grading system. This does not ensure that such ratings are free of controversy: for example, while there is generally a low default rate on municipal debt, ratings do not always reflect this reality.

Types of credit ratings

Investment grade

Aaa.za	(AAA) Gilt edged
Aa1.za Aa2.za Aa3.za	(AA) High grade
A1.za A2.za A3.za	(A) Upper medium grade
Baa1.za Baa2.za Baa3.za	(BBB) Medium grade

Speculative grade

Ba1.za Ba2.za Ba3.za	(BB) Speculative elements
B1.za B2.za B3.za	(B) Not desirable
Caa1.za Caa2.za Caa3.za	(CCC) Poor standing
Ca.za	(CC) Highly speculative
C.za	(C) Lowest rating

Source: *Buffalo City workshop presentation*

There are two approaches to enhancing creditworthiness. One is to employ "tricks" that can improve credit ratings or reduce the cost of a debt instrument, but such methods will not ultimately help prospective borrowers unless they address the fundamentals. The other approach is to undertake long-term institutional and fiscal reforms to improve the financial sustainability of an organisation.

If a municipality does not yet believe it is ready for a public credit rating, it may opt to obtain a "shadow" (i.e. one that is not made public) to understand the strengths and weaknesses of its present position and the steps needed to improve creditworthiness.

Making a case for bonds in Cape Town

The City of Cape Town recently decided to diversify its sources of capital funding by issuing a municipal bond.

According to Councillor Ian Nielson, mayoral committee member for finance: "Loan agreement conditions are becoming more stringent, the pool of lenders in the R500 million+ category is extremely limited, and forecasted growth in infrastructural spending is expected to exhaust lending capacity for the municipal sector in the traditional borrowing market."

Preliminary investigations by the municipality indicate that an initial bond issue by the City of Cape Town in the range of between R500 million and R1 billion over a maximum maturity of 10 years would be well received by the capital market. "Cape Town's access to this well-developed market would greatly expand its borrowing options, reduce its average cost of borrowings and enhance its profile in financial markets," he says.

The once-off costs in issuing a bond of R1 billion are estimated at between R2.5 million and R3 million. These costs can be paid for out of savings achieved through a reduction in the rate of interest payable. Cape Town's average cost of borrowing was 11.4 percent in 2007, so a bond issue was clearly the best approach to reducing these costs. The city calculated that a 0.4 percent reduction in interest rates applicable to a R500 million loan would result in savings of R2 million per year.

Is it worth getting a credit rating?

Lenders look at both internal and external factors in evaluating a potential borrower. But if a municipality is well run and stable, investors will want to come to the party. While a decision to opt for a credit rating will be based on a municipality's specific conditions, it's not the credit rating itself that is crucial, but the work on the fundamentals that this represents. Any municipality that wishes to consider issuing a bond requires a credit rating.

The experiences of Buffalo City, South Africa and Ezulwini, Swaziland in opting to obtain credit ratings are reviewed below.

Buffalo City: the importance of timing and planning

A well-timed credit rating can have financial, management, and investment and marketing benefits. Buffalo City is now going through its third round of credit rating. It obtained its last investment grade rating of A1 in 2006/07. The city is planning to issue a bond after 2010, partly to assist in developing waste management infrastructure.

The municipality has been able to leverage the strength of this rating to obtain loans from the International Finance Corporation, the DBSA and commercial banks. In

addition, the European Union has accepted the credit rating as a strong basis for further engagement. The credit rating also demonstrates to national and provincial government that the municipal finances are on a sound footing. Buffalo City has loans to the value of about R450 million.

The municipality's decision to opt for a credit rating was informed by its strategic approach. The city's vision is to be "a people-centred place of opportunity where the basic needs of all are met in a safe, healthy and sustainable environment".

The Buffalo City experience demonstrates that timing is crucial. A municipality should only apply to obtain a rating when it is ready to do so, which presumes a good understanding of the fiscal position. Key questions to be addressed include cost drivers such as remuneration and debt servicing to reduce these expenditure items in future years, the need to reconsider indigence and credit control policies, and formulating revenue management strategies to ensure generation of income that is affordable and recoverable. It is essential to identify cost drivers at an early stage.

Long-term financial challenges include:

- Determining whether services such as sanitation and roads are appropriate and sustainable, and the exploration of alternatives
- Developing a sustainable approach to service delivery in rural areas
- Making delivery of services more cost effective
- Assessing the cost structure of service provision and making improvements to lower costs and improve output
- Working out a strategic approach to cash flow management to contain costs appropriately
- Improving revenue collection rates.

Buffalo City also grappled with various expenditure challenges:

- Salaries – Labour flexibility, downsizing, redeploying and retraining
- Operations and maintenance – Efficiency measures, decentralising, austerity budgeting, asset stripping, deferring expenditure, vertical subsidies and service contracts
- Interest and depreciation – Outsourcing capital works, cheaper borrowing, capital grants, gearing and privatising.

In the end, the municipality had to use strategies and programmes for revenue raising, asset management, financial management, capital financing, operational financing and cost effectiveness.

In Buffalo City's experience, credit ratings have a number of financial, management, and investment and marketing benefits.

- The financial benefits include obtaining a reliable gauge of credit risk, diversifying funding sources, negotiating better loan terms, enabling providers of capital to match risk and return, and making it easier for lenders to make lending decisions.
- The management benefits include benchmarking against peers, building on the city's strong points, making progress in problem areas, support and a guide for strategic planning and, ultimately, a financially stronger municipality that can provide better services.
- The investment and marketing benefits include the use of ratings in investment decisions, the ability of the municipality to provide sustainable services, attracting development and PPPs, low-cost advertising, communicating the municipality's strengths and actively using the rating to obtain maximum benefits.

Moody's approach to Buffalo City

Moody's rating criteria is based primarily on two factors: the intrinsic credit quality of a municipality, which forms its baseline credit assessment, and the extraordinary support from (and dependence on) higher-tiered government to prevent a default by a municipality, which forms the joint default analysis.

The baselines credit assessment focuses on the operating environment, institutional framework, financial condition and performance, debt and liquidity profile, governance and management practices, and economic fundamentals.

The joint default analysis focuses on extraordinary support from the province and national government to prevent default by the municipality. Extraordinary support may take different forms, including formal guarantees, direct cash infusions or negotiations with lenders to restructure loans.

The capacity of higher-tiered government to provide extraordinary support and prevent default by a municipality is conditional on the solvency of both entities. If the municipality pulls the higher-tiered entity down then no benefits are to be gained from joint support.

The rating process proceeds through the following steps:

- **Rating application/mandate**
- **Information flow**
- **Desktop analysis**
- **Meetings with management**
- **Finalise analysis**
- **Rating committee**
- **Rating announcement and report**
- **Monitor and review.**

Ezulwini, Swaziland: using a credit rating to unlock finance

Credit ratings are not just for big cities. The town of Ezulwini, Swaziland has applied for a credit rating to unlock finance. Ezulwini, located along the Mbabane-Manzini corridor, has a night-time population of 2 000 (4 000 during the day). The economy is based on the tourist trade and the town can be considered Swaziland's tourism hub. It houses a large number of hotels, guesthouses and cultural sites, and is close by various nature conservation areas.

The town council provides services ranging from environmental health to refuse collection and disposal, road and stormwater construction, and public parks and markets. However, the town lacks a well-developed road network, street lights, sewerage system and water supply. Existing infrastructure needs refurbishment, and for a variety of reasons this means approaching the private sector. An additional challenge facing the town is the prevailing system of land ownership, in which land is owned by a few individuals who parcel it out on a piecemeal basis.

The town presents a number of opportunities. The local economy is growing rapidly and has potential for additional growth. Most of the population is classified in Swaziland's high-income group and the majority of households are formal. Highly populated informal settlements surround the town. The municipality is home to most of Swaziland's leisure lodges, with 1 567 tourist beds on offer. The area enjoys a good climate, is drained by four perennial rivers and is next to a major highway.

The town board is currently very liquid in terms of finances. Operating expenditure is funded through property taxes, service charges and operating grants. Capital projects are funded through capital grants, private loans and operating revenues. Central government funding support for capital projects is calculated using the night-time population of the various towns in Swaziland. Funding for any additional projects is through the local banks.

A credit rating will help the local authority access local markets for funds to finance capital projects at negotiated and justifiable rates. The infrastructure will be paid for by spreading the costs to taxpayers more evenly over a reasonable period. Over time, there will be less financial reliance on the central government.

Since spending on large infrastructure items tends to be "lumpy", borrowing will provide large capital sums for immediate use. The resulting longer-term debt can be serviced from a regular stream of municipal income, whether directly from revenue resulting from the investment or indirectly through increased tax revenues.

A credit rating will also assist the central Swazi government in its drive to decentralise service delivery. Furthermore, the recent introduction of the new Retirement Funds Act (2005), which states that insurance companies need to invest at least 30 percent of their funds in the country, ensures that the local market can be tapped for funds.

The central government Ministries of Housing and Urban Development, and Economic Planning and Development are supporting local authorities' approach to markets for financing.

Understanding how lenders work

From a lender's perspective, everything boils down to one question: will I get my money back on time?

The key features of bonds and loans are presented in Figure 17. All of these features have an impact on the price of borrowing.

Figure 17: Key features of bonds and loans

Feature	Bond	Loan
Tradability/liquidity	High	Low
Sources of finance	CSI [2]	Banks
Interest rate risk	Market	Borrower
Regularity	Important	Not important
Maturity	Long	Shorter
Documentation	Prospectus	Agreement
Rating	Required	Not required

Source: *Johan Kruger workshop presentation*

Key lender considerations are credit risk (probability, frequency, severity and concentration) and liquidity (market movement, exit potential and alternative opportunities)

The lender's *internal* considerations will typically include:

- The state of the market
- Internal liquidity
- Mismatches
- Inflation expectations
- Sector view
- Return potential of sector
- Cost of capital and statutory requirements
- Alternative investment opportunities
- Concentrations/diversity
- Scale
- Regularity

[2] *CSIs or contractual savings institutions are typically large long-term investors, such as pension funds.*

In addition the lender has a range of *external* considerations in relation to the borrower:

- The municipality's economic base, its expected diversification and vulnerability
- Possible government support
- Tariffs versus income of customers
- Environment (for example, the quality of postal services)
- Challenges (level of backlog)
- Risk of political interference
- Vulnerability to political/legal/ demographic changes

These considerations boil down to two primary concerns: political risk and commercial risk. Political risk arises from the possibility that unanticipated events may change prospects for profitability. Such risks can develop from a range of factors, including changes of laws, failures to obtain tariff increases or delays in government approvals. Commercial risks include construction delays and cost overruns, changes to input costs, availability and quality of supplies, contractor insolvency and so on. While commercial risks are generally within the control of the project managers and/ or sponsors, political risks are influenced primarily by governments.

Top 10 ways to improve or maintain a municipal credit rating

In 2002, Standard & Poor's published a document entitled *Top 10 ways to improve or maintain a municipal credit rating*. **While aimed at the vast US municipal bond market, where the challenges of municipal finance are significantly different to those in Southern Africa, the broad principles still apply to all municipal borrowers. We have abbreviated the document for presentation below:**

Best practice

In addition to quantitative factors, qualitative information factors heavily into credit analysis. Management can contribute significantly to many of the individual credit benchmarks and can positively impact ratings in a number of ways. Conversely, the lack of strong management is usually a significant factor in a weakened credit profile. The management or administrative structure of a government will move a rating up or down more significantly and swiftly than any other element of a credit review.

1. *Establish or enhance rainy day/budget stabilisation reserves*

As economic trends have weakened, the importance of reserves from credit standpoint is again highlighted. It clearly provides a measure of financial flexibility to react to budget shortfalls in a timely manner.

2. *Establish regular economic and revenue reviews to identify potential budget problems early*

Establishing a formal mechanism to monitor economic trends and revenue performance at regular intervals is a key feature of stable financial performance. This is particularly true if a government relies on income tax or consumption-based taxes that respond rather quickly to economic fluctuations.

3. *Prioritise spending plans and establish contingency plans for operating budgets*

What is done with surplus funds can be as important as how shortfalls are addressed. Contingency planning should be an ongoing exercise for governments.

4. *Have a formalised capital improvement plan to assess future infrastructure requirements*

Highly rated credits will have a long-term capital improvement programme that comprehensively assesses the infrastructure requirements of the government and a plan to fund these requirements over a five-year (or longer) time frame.

5. *Establish a debt affordability model to evaluate your future debt profile*

Such models enhance capital budgeting and related policy decisions regarding debt.

6. *Develop a pay-as-you-go financing strategy as part of your operating and capital budget*

Pay-as-you-go financing can be a sound financing policy. Not only does it lower debt service costs, but it provides a lot of operating budget flexibility when the economy or revenue growth slows.

7. *Consider the affordability of actions or plans before they become part of your budget by analysing revenue and spending as part of a multi-year financial plan*

It is important to do this on a comprehensive basis. A multi-year planning process is critical.

8. *Long-term planning for all liabilities, including pension obligations and contingent liabilities, would be optimal and would allow for comprehensive assessment of future budgetary risks*

9. *Establish and maintain effective management systems*

Investing in systems that improve the efficiency and effectiveness of a government unit and enhance overall service delivery is a positive financial management tool.

10. *Have a well-defined and coordinated economic development strategy.*

The lender will take a close look at the borrower's financial position, including cash flow, existing debt, budget surplus/deficit, ability to service debt, reserves, collateral and scale. It will assess management's commitment, experience, ability and qualifications, as well as key relationships (between the executive and political leadership, with trade unions and with customers).

Finally, performance factors will come under the microscope, though these may be considered secondary issues in an assessment. These may include indicators (e.g. non-revenue water), collection ratios, costs of services rendered, billing efficiency and vulnerability to change, such as rising energy costs.

All these factors are taken into account in pricing a bond or loan.

Using a credit rating to effect improvements in Windhoek

Windhoek, the capital of Namibia, currently has about R451 million in loans outstanding. Average annual debt service costs of R21 million amount to about 2 percent of operating expenditure (see Figure 9).

As described in Section 2 of this booklet, the municipality is responsible for providing a full range of services to residents, from bus and taxi ranks to pumping of water. And water security is an important issue given that Namibia is the most arid country in the region.

In November 2006, Windhoek obtained a credit rating from CA Ratings, which described the outlook as stable and assigned a long-term rating of zaBBB, which indicates a capacity to repay liabilities, and a short-term rating of zaA2, reflecting strong capacity to repay short-term debt (the "za" prefixes identify these ratings as being on the South African national scale). The municipality uses the rating report to effect improvements that will improve the rating once reviewed and as a marketing tool when engaging potential investors.

In reviewing the city's creditworthiness, the agency examined such elements as the economy (demography, economic structure, comparison with world GDP growth, growth prospects), system and administration (government structure and legal considerations, strategy, management and administration system) and financial position (revenue and expenditure, comparative analysis with other Southern African cities, debt management and liquidity management).

The report noted that "the scarcity of water … remains a limitation to development in the city. The effective management of water is a key factor for the municipality."

Average annual rainfall is 360 mm, and the city relies to a large degree on an aquifer to augment the supply from nearby dams. This borehole water "delivers a sustainable yield of 1.7 million m^3 per annum".

The report stated: "Windhoek has a moderate financial profile. Revenue is growing moderately and expenditures are controlled within budget parameters. Liquidity is considered satisfactory but this is dependent on the collection rate of amounts payable by the debtors.

> **"The debt burden of Windhoek has increased over the last few years and is expected to increase further due to relatively large capital expenditures. The incomplete collection of outstanding debtors result in a build-up of long overdue debtor balances and this has an adverse effect on the cash flow of the city.**
>
> **"Tight financial management will be required to steer the city through the next couple of years."**

Windhoek is currently planning a new rating review and is investigating whether a bond issue would help the city to meet its investments requirements.

Municipal borrowers need to keep the following considerations in mind:

- A lender's responsibility is to shareholders, not to the fulfilment of social concerns
- The market is unforgiving
- The market does not require perfection, but transparency
- Business plans need to address issues
- Municipalities have restricted sources
- Funders have many opportunities.

Technical support

From a municipality's perspective, negotiating with a lender or group of lenders requires a strong negotiating team with technical expertise. The capital markets are highly specialised areas, and municipalities with less capacity will require additional experience and professional advice. Municipalities may require assistance on restructuring their current loan books, preparing proposals for grant funding or putting together bond issues.

The SACN's project supporting sustainable municipal finance can provide country- or project-specific advisory assignments of the following type:

- **Country review of sub-national finance legal framework**
- **Credit assessment for one or more sub-national entities**
- **Creditworthiness enhancement programme for one or more sub-national entities**
- **Project appraisal or structuring**
- **Bond issue design and preparation.**

Maximising public accountability and setting prudent limits

To maximise accountability and healthy management of the public finances, municipalities should only consider issuing long-term debt when a clear written policy and a strategic investment plan setting out the priority capital requirements are in place. The policy should establish the overall limits of debt and set a general direction for municipal officials in issuing debt.

In South Africa, national government has published a *Policy Framework for Municipal Borrowing and Financial Emergencies*. The framework states that "the type of debt, or debt instrument, that municipalities may issue – and any regulation thereof – is best approached by examining the kinds of security that may be given to municipal borrowers". The document goes on to say that

Government's overall policy position on this matter is characterised by two broad principles:

- The contracting parties should be allowed broad leeway to craft security provisions that meet their needs. In addition to the conventional "full faith and credit" (general obligation) provisions, this should include special security arrangements including the pledging of assets, of local tax and tariff revenue streams, of intergovernmental grants or transfers, and tax and tariff level covenants
- Certain limits should, however, apply. Specifically, municipalities should not be permitted to pledge assets deemed essential to the maintenance of public health and safety, nor should they be allowed to pledge revenue streams to the extent that this may compromise their ability to deliver certain essential services …

Approaches to municipal finance should bear these principles in mind.

Limiting default risk

Once a city secures financing, it needs to limit the risk of default. There are five key strategies to reduce default risk:

1. Borrow as little as possible without compromising project outcomes

Project design and planning should be thorough and reasonable. A project with well-planned cash flows will inform a borrowing schedule that reduces the cost of finance because money is drawn down only as it is required. Cash-flow projections must take accumulated reserves into account. Municipalities that borrow too much, or borrow too quickly, have to pay interest on money that sits in the bank for months and months because of project delays.

In addition to good project planning, it is crucial that municipalities have adequate project and contract management capacity to implement the project according to plan. Contracts should contain penalties for missing interim delivery targets, and there should be assertive contract monitoring to ensure that municipalities know immediately when delivery delays will have an impact on cash-flow schedules. Contracts must also clearly assign the risk of construction inflation; wherever possible these risks should be passed on to the contractor.

2. Insure against external risks that cannot be controlled by the municipality

Risks such as cost increases due to exchange rate fluctuations, inflation and interest rate increases can all be insured against. In the current volatile global economy, this is a good idea.

3. Assemble funding partnerships

Innovative, structured financing deals that place infrastructure grants in first-loss position, or ring-fence certain revenues to partially secure repayments, can significantly reduce the cost of finance and diversify default risks.

4. Optimise municipal revenues

Global experience shows that delivering good quality services, introducing reliable financial management systems, reporting in a transparent and clear way, and encouraging citizen consultation are key factors in increasing municipal revenue collection.

Municipalities can use property taxes, bulk infrastructure contributions and other local taxes in an innovative way to increase revenue. Public awareness campaigns in Serbia, for example, helped to secure public acceptance of changes in the tax system.

Where a municipality does not have adequate capacity to strengthen local tax collection, it may be feasible for a number of municipalities to collaborate to introduce a single tax administration.

5. Increased transparency and good financial management

Credible revenue projections are important, as is credible financial reporting. In Ecuador, for example, financial management reforms were welcomed by lenders and gave public-sector institutions access to finance at a lower cost.

Adapted from a session on Financing Urban Infrastructure at the World Urban Forum 4, Nanjing, China, 3 November 2008, hosted by the German Federal Ministry of Economic Development.

5. Conclusion

To develop sustainable municipal finance programmes throughout Southern Africa, a supportive environment is required. This means having the right policies in place, learning to talk to the capital markets, building up capacity (in planning, finance, administration, management and project management), ensuring a healthy balance between social and commercial projects, and supporting projects that foster long-term economic development by attracting investment and developing employment opportunities.

Over the next year or so, the SACN intends to expand its review of municipal finance in Southern African cities and prepare to publish the results. The preliminary review, however, has already identified a number of common elements:

- The financial strength of local government correlates strongly with GDP density. Where there are weak local economies, high levels of poverty and affordability issues municipal finance is weaker.
- The functions and powers of local government – particularly the interface between spheres of government and borrowing powers – is a complicating factor.
- The relations between the political and administrative functions are often fraught with difficulty, and political and professional mandates are rarely given appropriate separation.
- Billing, credit control and politics –
  - Billing and collection systems are weak and partial
  - Credit control procedures are expensive and time-consuming
  - There is concern about the political implications of credit control action
  - People are genuinely poor.
- The skills crisis is widely described as "severe", characterised by especially poor skills in technical fields and a lack of systematic training.
- Accounting and controls are weak and assistance is needed to upgrade these functions.

By addressing these considerations and taking the steps suggested in this booklet, municipal officials can work towards financially stronger, creditworthy municipalities that can roll out investment strategies that benefit their citizens in the form of essential infrastructure.

6. Appendices

Appendix A: Workshop participants

Sustainable municipal finance in Southern Africa, 2-3 October 2008

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Appendix C: Acronyms

DBSA	Development Bank of Southern Africa
PPIAF	Public-Private Infrastructure Advisory Facility
PPP	Public-private partnership
SACN	South African Cities Network
SADC	Southern African Development Community

Appendix D: Municipal-sector contacts in Southern Africa

Cities Alliance: **www.citiesalliance.org**

Cities Alliance's Municipal Finance Task Force: **www.mftf.org**

Development Bank of Southern Africa: **www.dbsa.org**

Infrastructure Finance Corporation: **www.inca.co.za**

Public Partnership Infrastructure Advisory Facility: **www.ppiaf.org**

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