6

Leveraging private finance

Introduction

According to the World Bank's 1994 World Development Report, a 1 per cent increase in the stock of a country's infrastructure is associated with a 1 per cent increase in the country's GDP. This suggests that investment in municipal infrastructure is critical for promoting and sustaining economic growth, as well as for eradicating service delivery backlogs, responding to demographic changes such as urbanisation, and rehabilitating ageing infrastructure.

The economic recovery is putting more pressure on municipalities to provide infrastructure to support growth

The economic recovery in South Africa in 2010 has resulted in a resumption of pressure on municipalities to provide infrastructure to support growth. Following a 1.7 per cent contraction in GDP in 2009, South Africa's economy grew by 2.7 per cent in 2010 and is projected to grow at 4.1 per cent by 2012.

Municipalities urgently need to find innovative ways of financing this new infrastructure. Existing sources of capital finance, namely municipalities' internally generated funds, intergovernmental grants and borrowing, are insufficient. Other sources of capital finance, such as development charges, land leases and public private partnerships (PPPs), can play important complementary roles.

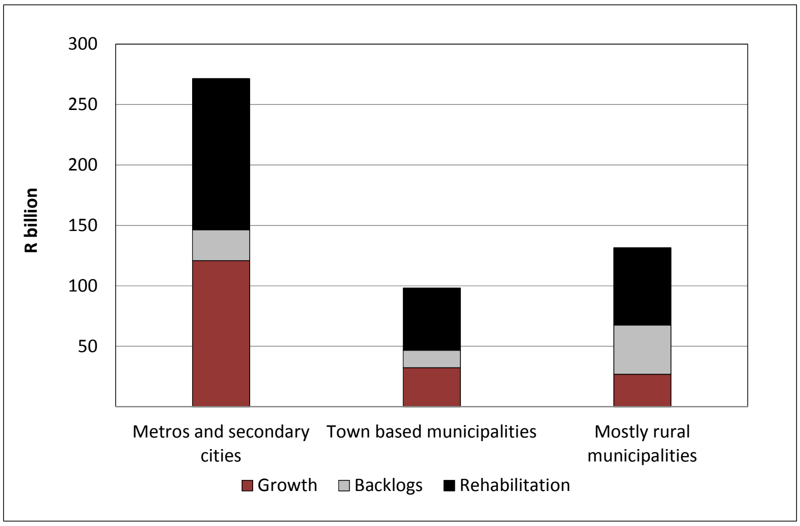
This chapter gives an overview of:

- municipal infrastructure investment requirements
- sources of infrastructure finance
- developing the municipal borrowing market.

Municipal infrastructure investment requirements

In 2009, the World Bank produced the Municipal Infrastructure Finance Synthesis Report that explored the demand and cost of South Africa's municipal infrastructure needs over the next 10 years. In this report, it is estimated that total municipal infrastructure investment requirements for all municipalities to be approximately R500 billion over the next 10 years. Of this amount, R421 billion is required to finance new infrastructure to support economic and population growth and the rehabilitation of ageing infrastructure, while the remaining R79 billion is required for the eradication of backlogs.

Figure 6.1 Municipal infrastructure investment requirement, 2009



Source: World Bank (2009 Municipal Infrastructure Finance Synthesis Report)

The burden of this investment requirement, however, differs markedly across municipalities:

Investment needs of metros and secondary cities are estimated to amount to R271 billion over the next 10 years

According to figure 6.1, the investment needs of metros and secondary cities are estimated to amount to R271 billion over the next 10 years, of which R26 billion is for the eradication of backlogs, and the remaining R245 billion is needed to fund new infrastructure to support growth and to rehabilitate ageing infrastructure.

The investment needs in these municipalities is estimated at about R98 billion

The investment needs of the 140 municipalities that are anchored by smaller cities and large towns (so-called B2 and B3 municipalities) amount to about R98 billion, of which R52 billion is needed for rehabilitation, R14 billion for addressing backlogs and the remaining R32 billion for supporting growth. These municipalities often find it difficult to access capital markets, either because the scale at which they wish to borrow makes lending expensive, or because weaknesses in their financial management make them a poor credit risk to lending institutions.

The investment requirement of the 70 mostly rural municipalities (so-called B4 municipalities) is estimated to be R131 billion over the next 10 years, of which R40 billion is for the eradication of backlogs, and the remaining R91 billion is for infrastructure to support growth and the rehabilitation of existing assets. The borrowing capacity of these municipalities is very limited. As average household incomes in these municipalities are very low, the scope for them to collect revenues from property rates and service charges is limited. Consequently, these municipalities will continue to rely mainly on government transfers to fund their capital budgets. Generally, borrowing to finance their infrastructure needs is not an option, unless provided on special terms by development finance institutions.

Sources of infrastructure finance

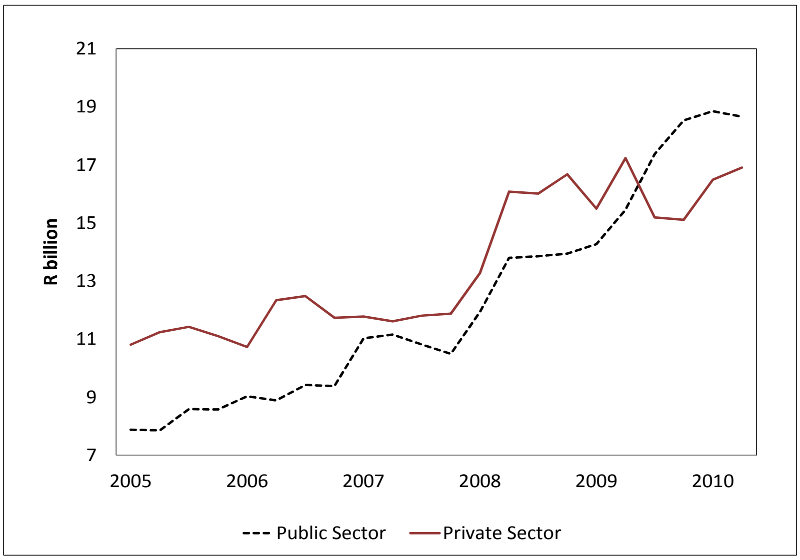
The primary sources of infrastructure finance available to municipalities are internally generated funds and national transfers from government. However, these are insufficient to meet the scale of infrastructure investment required by municipalities. There is thus a need for municipalities to explore ways of leveraging private finance to mobilise additional resources to fund infrastructure investments. Four broad options exist: borrowing, development charges, land leases and PPPs.

Municipalities need to explore ways of leveraging primary sources of finance to mobilise additional resources for funding infrastructure investments

Municipal borrowing

Figure 6.2 shows the trend in public and private sector lending to municipalities from 2005 to 2010. The total closing balances in outstanding municipal borrowings grew from R18.7 billion in 2005 to R38.1 billion in 2010, representing an average annual growth of 15 per cent.

Figure 6.2 Trends in the municipal borrowing market



Source: National Treasury local government database

The growth in borrowing from the public sector is of particular significance. Private lenders became more risk averse during the recession, with total debt from late 2008 to the end of the third quarter of 2010 remaining flat. In addition, INCA (which is the trading name of the Infrastructure Finance Corporation Limited), a major lender to municipalities, withdrew from the market in 2009 (citing declining margins due to competition from public sector lenders as the main

During the recession, total public sector lending exceeded private sector lending for the first time reason). By contrast, public sector lending – almost entirely from the Development Bank of Southern Africa (DBSA) – accelerated sharply during this period, resulting in total public sector lending exceeding private sector lending for the first time.

Most municipal borrowing from both private and public sector financial institutions takes the form of long-term loans. These account for R25.4 billion (64 per cent) of total borrowing. Securities, mainly in the form of municipal bonds, account for R11.8 billion (30 per cent) of total borrowing, while short term debt accounts for 6 per cent, of which R909 million are bank overdrafts and R2.4 billion is commercial paper.

The municipal bond market accounts for only 2 per cent of total government bonds listed on the Johannesburg Stock Exchange

Bonds have been issued by three of the six metros (Johannesburg, Cape Town and Ekurhuleni). Due to the limited activity in this area, at R11.8 billion, the municipal bond market remains small and underdeveloped, accounting for only 2 per cent of total government bonds listed on the Johannesburg Stock Exchange.

Municipal bond repayments are typically structured with a large, lump sum (or 'bullet') payment at the end of the repayment period. This creates a spike in municipal debt repayment profiles that requires careful management to minimise the risk of default. This risk is partly offset by the fact that by the time the bond needs to be repaid the municipality's revenues should have grown substantially.

Nevertheless, ideally, the debt service profiles of municipalities should be more or less uniform over time. Deferring higher levels of debt servicing to later years can indicate current fiscal pressure. If adequate reserves (a sinking fund) are not set aside over the period of the bond, the municipality will be forced to refinance the final 'bullet' payments with additional debt.

Although there has been a recent recovery in private lending to municipalities, there is a concern that both the historical and current level of private lending to municipalities is still very limited. This is despite the legislative and policy reforms that have been introduced to stimulate private sector participation. Recent research indicates that the development of the municipal debt market is being limited by the following six factors:

- *The lack of a developed secondary bond market.* A secondary market would enhance the liquidity of bond instruments as it enables municipal bondholders to trade the instrument. However, the limited size of the municipal bond issues to date is itself an obstacle to such a secondary market developing. The South African bond market is dominated by pension funds and insurers which invest funds with the intention to hold until maturity. The lack of a developed secondary municipal bond market means investors with shorter time horizons are reluctant to buy long-term instruments whose term matches the economic life of infrastructure investments.
- *Short maturities on loans.* The short maturities offered by banks means that municipalities cannot obtain loan tenures that are in

line with the life span of assets. Municipalities are compelled to finance long life assets with medium term funds. This means that rates and tariffs have to be higher in the medium term, and funds have to be used to fund higher debt service costs rather than services over the period of the loans.

- *Creditworthiness.* Borrowing should be used to finance infrastructure that will generate income for the municipality, either directly through tariff income or indirectly through higher property rates income. Currently, many municipalities are using borrowing to fund social infrastructure, which costs money to operate, but does not expand their revenue base. This impacts negatively on municipalities' creditworthiness and, together with many municipalities' overall poor financial performance, has reduced their capacity to incur further debt.
- *Lack of treasury management capacity.* Treasury management skills and capacity vary significantly across municipalities. Most municipalities do not have clear borrowing strategies that support their infrastructure investment programmes. Improving treasury management capacity within municipalities will help to optimise their borrowing activities, including their debt profile.
- *The role of the DBSA.* While the DBSA's increased lending to municipalities is a welcome development; going forward, it needs to explore strategies for partnering with the private sector so as to crowd-in lending to local government in line with its mandate. Also, the DBSA's loan book should reflect an appetite for risk that is somewhat different to that of private sector institutions and more commensurate with lending to municipalities at the lower end of the market.

Sustainability of metros' borrowing

The sustainability of a municipality's borrowing depends on a wide range of factors, including the strength of its management team, the type of infrastructure funded and the municipalities' revenue management record. Using the traditional gearing ratio within the municipal context does not provide a useful indicator of the sustainability of municipal debt, because in terms of section 48(3) of the MFMA a council may determine that certain assets are necessary to provide the minimum level of basic municipal services and so cannot be used as security for borrowing. Further, many assets now being brought onto municipalities' books in terms of GRAP 17 are not tradable (e.g. roads and pavements). GRAP 17 also allows municipalities to use different methodologies to value their assets; consequently the values reflected in the asset registers may not be comparable.

The following table compares measures of the six metros borrowing. This table should be read together with the information on the following two pages.

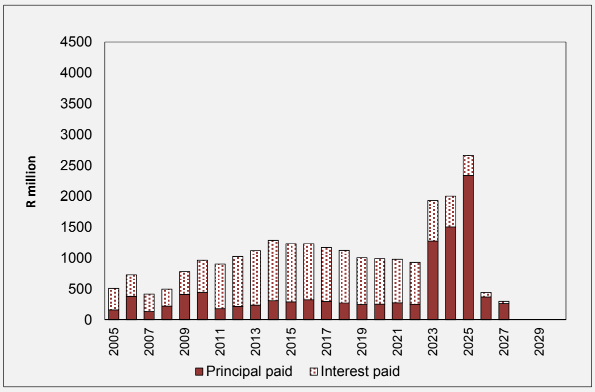
Measures of metro borrowing, 2011/12 adopted budgets

Rand thousands	Johannesburg	Cape Town	eThekwini	Ekurhuleni	Tshwane	Nelson Mandela Bay
Total borrowing liability	11 456 835	6 679 271	11 270 509	4 333 358	6 487 030	1 729 021
Proposed borrowing for the financial year	1 000 000	1 357 386	2 000 000	867 935	1 500 000	–
Cost of borrowing for the financial year	1 844 483	966 040	1 819 044	663 579	1 217 198	312 128
Total cost of debt as a % of total borrowing liability	16.1%	14.5%	16.1%	15.3%	18.8%	18.1%
Total cost of debt as a % of own revenue	7.5%	4.8%	9.4%	7.8%	7.7%	6.2%
Total cost of debt as a % of operating expenditure	6.5%	4.4%	8.6%	6.6%	6.7%	4.8%

Source: National Treasury local government database

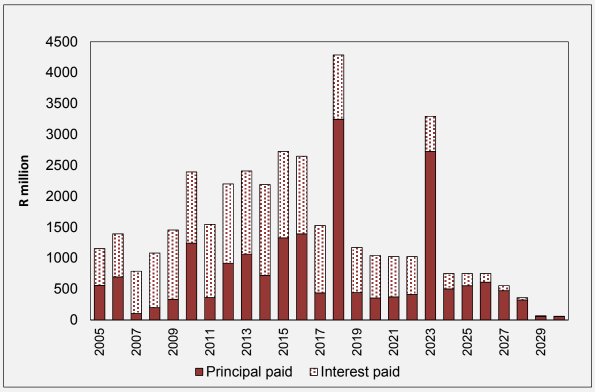
Debt service profiles of South Africa's metros

Cape Town



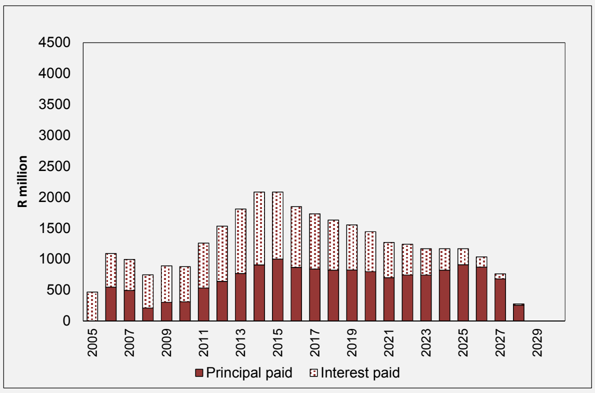
Cape Town's borrowing liability at the end of June 2011 was R6.7 billion. The debt profile shows that debt service costs average R900 million per annum and are expected to increase steeply between 2023 and 2025 as the principals on its three bond issues fall due. At 14.5 per cent, Cape Town's total cost of debt as a percentage of its total borrowing is the lowest of all the metros.

Johannesburg



Johannesburg's borrowing liability at the end of June 2011 was R11.5 billion. The peaks in the debt profile in 2018 and 2023 point to the need for the City to smooth the maturity profile of its debt. The use of municipal bonds has enabled the City to keep its total cost of debt as a percentage of its total borrowing to 16.1 per cent. Total cost of debt as a percentage of own revenue is at 7.5 per cent.

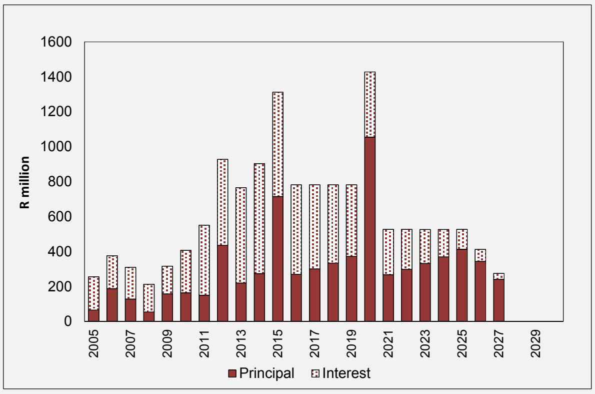
eThekwini



eThekwini's borrowing liability at the end of June 2011 was R11.3 billion. Cost of borrowing for 2011/12 is budgeted to be R1.8 billion. Debt costs increase steadily to 2015, where after they decline. The total cost of debt as a percentage of own revenue is at 9.4 per cent, which is the highest among the metros.

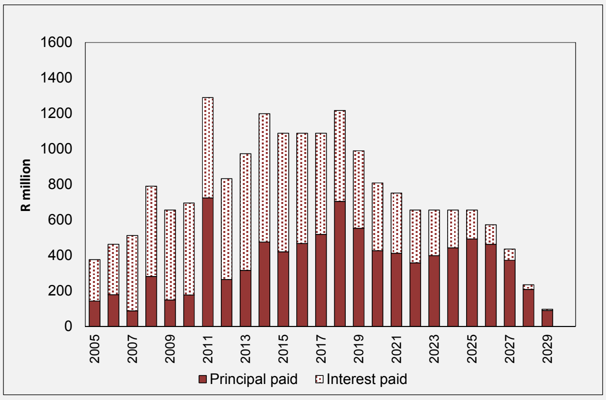
Debt service profiles of South Africa's metros (continued)

Ekurhuleni



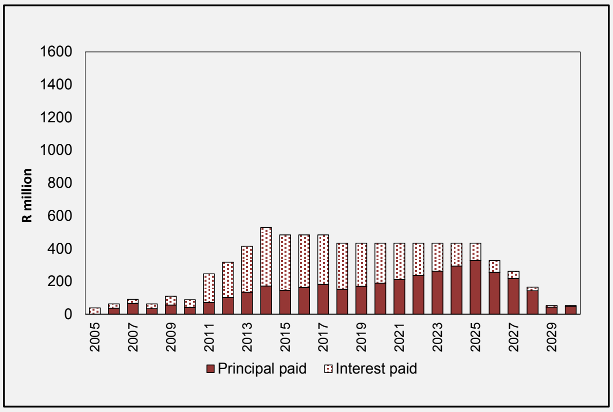
Ekurhuleni's borrowing liability at the end of June 2011 was R4.3 billion. In the medium term, debt service costs peak between 2011 and 2015. There is also a high payment due in 2020. At 15.3 per cent, the City's total cost of debt as a percentage of its total borrowing is the second lowest among the metros. However, its total cost of debt as a percentage of own revenue is at 7.8 per cent, which is the second highest of the metros.

Tshwane



Tshwane's borrowing liability at the end of June 2011 was R6.5 billion. The City's debt portfolio is dominated by amortising loans, which have a smooth repayment profile. This partly explains why the City's total cost of debt as a percentage of its total borrowing is the highest among the metros. Total cost of debt as a percentage of own revenue is at 7.7 per cent.

Nelson Mandela Bay



Nelson Mandela Bay's borrowing liability at the end of June 2011 was R1.7 billion. Cost of borrowing for 2011/12 is budgeted to be R312 million. Debt service costs increase steeply over the medium term as repayments on two large new loans take effect. At 18.1 per cent, the City's total cost of debt as a percentage of its total borrowing is the second highest among the metros.

Development charges

The municipal infrastructure required to support new property developments is typically very costly. There are essentially two approaches to financing it:

- The municipality borrows the required funds on the strength of its balance sheet and then repays the debt with income derived from all ratepayers and customers of the municipality, including those that benefit from the new development.
- The property developer is required to pay a development charge equivalent to the up-front cost of the new municipal infrastructure (and the cost of using the capacity of existing infrastructure) and passes these costs on to whoever buys into the development. Essentially, the new landowners finance the cost of the infrastructure, which may be through commercial debt, such as home loans in the case of residential property developments.

A development charge is designed to pass the up-front costs on to the responsible developers, who will then pass it on to their customers

Applying the 'benefit' principle of public finance means that those who benefit more from a product or service should pay for it in proportion to the value they derive from it. A development charge is designed to pass the upfront costs of the new municipal infrastructure associated with specific developments on to the responsible developers, who in turn will pass it on to their customers – the users of the new infrastructure. These users derive a direct benefit from the provision of infrastructure, since its value is reflected in their property valuations.

Development charges are thus an important component of a sustainable system of municipal infrastructure finance and, if used judiciously, can play an important role in accelerating the overall development of municipal infrastructure. This is because, without these charges, the infrastructure required for new developments would have to be financed within the confines of the municipality's capital budget. This means that the new infrastructure would need to be prioritised relative to other municipal projects, which may result in it being delayed for many years, particularly where municipalities' scope to borrow is limited due to weak balance sheets and poor credit ratings.

When the municipality decides to invest in the new infrastructure it would mean delaying other capital projects. It would also mean that the costs related to specific developments are unfairly borne by all residents in general, as the municipality would raise the required funds from its entire rates and tariff base.

It is generally accepted that using development charges is economically efficient in that the user pays. Their absence creates distortions in the economy, particularly through underpricing the cost of development in some municipalities and contributing to the under-provision of municipal infrastructure more generally. This, in turn, acts as a significant constraint to growth and job creation.

Development charges are not a general revenue source for municipalities. Rather, they are a once-off fee that must be used to cover the cost of municipal infrastructure associated with a new development. They do not cover the ongoing operating costs of the services that the infrastructure is used to provide, nor the future cost of the rehabilitation or replacement of the infrastructure. These costs ought to be funded through property taxes and user fees. Development charges are also not intended to cover the cost of infrastructure that is internal to a development, such as sewerage or water connections to private stands or infrastructure within the boundaries of a new development. These costs are always borne fully by the land owner.

Development charges are a once-off fee that must be used to cover the cost of municipal infrastructure associated with a new development

Development charges are imposed to meet the costs of bulk and connector infrastructure, such as water mains that bring services to the boundary of the development, as well as infrastructure costs associated with the utilisation of existing capacity or the need to expand the capacity of water storage and treatment facilities, substations and sewerage treatment works.

The use of development charges has declined over recent years. Among the metros, development charges were 2 per cent of the value of buildings completed in 2004/05. This has declined to 1.7 per cent in 2009/10. Implementation is also very uneven across municipalities. Both the decline and uneven implementation can be ascribed to weaknesses in the regulatory framework that make them administratively complex.

The use of development charges has declined over recent years, due to weaknesses in the regulatory framework

National Treasury has done extensive work in relation to municipal development charges, and is in the process of developing a framework that will set norms and standards to ensure that these charges facilitate (and do not stifle) new property developments. Certain municipalities have already begun revising their policies related to development charges in line with National Treasury's research findings. All municipalities are encouraged to do the same.

Land based financing strategies

Due to the recent rapid growth in land prices, municipal land sales have become an attractive way of mobilising finance for municipal infrastructure (and sometimes also to finance operating deficits). However, this use of municipal owned land undermines the long-term financial health and wealth of the municipality. Even where a municipality invests the funds in municipal infrastructure it is exchanging an appreciating asset (land) with a depreciating asset (infrastructure). As a principle of good stewardship, municipalities should always use the proceeds of municipal land sales to purchase other land for the municipality – so as to maintain and grow the value of the municipality's land portfolio, and to facilitate the realisation of its spatial development strategy.

Apart from selling land, there are a range of other land based strategies to raise finance for infrastructure investments that municipalities can explore. First, municipalities can use municipal land as security for raising loans to fund infrastructure related to the

Apart from selling land, there are a range of other land based strategies to raise finance for infrastructure investments that municipalities can explore development of that land or other infrastructure. This is fairly common practice among municipalities.

Second, municipalities can use leaseholds on municipal land. The experience of other developing countries is that this strategy has the greatest potential where there is rapid urban growth, such as in the metros and cities. The municipality will sell the development rights to the municipal land to a developer subject to the proposed development being in line with the municipalities spatial development framework. The parties may agree that part of the proceeds of the sale should be used to provide infrastructure to the approved development. The developer's rights to the property are spelt out in a leasehold agreement. Typically this agreement should require the lessor to pay a rental at least commensurate to the rates that would be raised on the developed property. The leasehold agreement will have a specific term (20, 40 or 99 years) depending on the type of development. Usually the developer is allowed to sell the leasehold to a third party under certain circumstances. Once the term expires, all rights in the property revert to the municipality. The leasehold system enables a municipality to partner with private developers to accelerate the development of inner city land, while retaining ownership of the land.

Third, municipalities can use land-use exchanges. The basic idea is that certain municipal offices or functions (such as stores, workshops or vehicle depots) are located on land that can and should be used for alternative, higher value purposes. Where this is the case, the municipality should explore relocating these offices or functions to suitable alternative locations (often on the city outskirts), and so release the high-value land for development.

In many instances, inner-city land is owned either by other spheres of government or by state owned enterprises. Municipalities need to engage with these property owners to explore ways in which they too can facilitate development through similar land-use exchanges.

Land-use exchanges may involve land swaps, lease swaps or simply buying land with the funds generated from either selling or leasing the vacated land. The net result should be a more appropriate use of land that fosters development. The best known example of this kind of development is the Victoria and Alfred Waterfront in Cape Town, where a harbour was turned into a shopping mall and tourist destination.

Public private partnerships

PPPs are important service delivery mechanisms that facilitate rapid infrastructure development. There are different types of PPPs that involve models for risk sharing between the municipality and its partners. In many cases the private party is in a better position to raise debt and equity to finance the project.

PPPs allow municipalities to take advantage of private sector expertise and experience

Municipalities can take advantage of private sector expertise and experience in the construction of the infrastructure. Furthermore, the development of PPPs for economically justifiable projects eases the pressure on the municipality's budget and allows for better allocation of funds towards addressing social needs of the community.

Developing the municipal borrowing market

Through the Regulatory Framework for Municipal Borrowing (1999) and the MFMA, the government has already put in place a range of measures to facilitate municipal borrowing. These are:

Government has already put in place a range of measures to facilitate municipal borrowing

- *Sovereign risk.* National government does not stand surety for municipal debt through sovereign guarantees or in any other way, except where such surety or guarantee has been explicitly approved in terms of chapter 8 of the Public Finance Management Act (1999) (PFMA). If a municipality defaults on its debt, lenders may follow the normal legal route to attach certain of the municipality's assets and revenue streams.

- *Credit enhancements.* Section 48 of the MFMA provides that a municipality may provide any appropriate security for its debt obligations, and sets out a range of options in this regard, including pledging specific revenue streams, ceding rights to future revenues and so on. These provisions are supported by a provision in the annual Division of Revenue Act that allows municipalities to pledge future conditional grants as reflected in the medium-term expenditure framework (MTEF). It is important that these credit enhancements are carefully designed and implemented to reduce moral hazard, and that they do not impede the delivery of basic services.

- *Maturities.* The MFMA provides that short-term borrowing for bridging finance purposes must be repaid within the financial year, and may not be refinanced under any circumstances. As regards long term borrowing, the term of the borrowing may not extend beyond the useful life of the property, plant or equipment that is being financed by the borrowed funds.

- *Avoidance of direct government assistance.* There is no legal provision that allows national government or provincial government to lend funds directly to municipalities. The national development finance institutions (such as the DBSA) are responsible for lending to municipalities in line with their mandates, and may provide interest rate subsidies in accordance with their developmental role.

- *Liquidity through the development of secondary markets.* Government is committed to facilitate the development of secondary markets for municipal debt to enhance the liquidity of the municipal credit market.

Generally, municipalities are encouraged to access private finance on the strength of their balance sheets and their credit ratings. The development of secondary markets for municipal debt could lower the risk of lenders and therefore lower the cost of borrowing for these municipalities.

Generally, municipalities are encouraged to access private finance on the strength of their balance sheets and their credit ratings

However, government is exploring various ways of enabling municipalities with no or only limited access to financial markets to access private finance.

Ways in which municipalities can access private finance

Pool finance for secondary cities

The basic idea of pool finance is to create an instrument for secondary cities with similar credit qualities that will allow them to pool their financing needs and approach the financial markets as a collective.

Secondary cities have large funding requirements (current borrowing was R4.1 billion at the end of 2010), they have adequate own revenues and good institutional capacity. However, they lack the finance expertise to issue bonds independently, and the scale of their financing needs makes it uneconomical to approach the bond market separately. It is envisaged that this bond pooling instrument would give the necessary scale, would justify contracting in specialised capacity to manage issuing the bonds and would reduce transaction costs in the underwriting process due to increased economies of scale.

Bond pooling would be cost effective for secondary cities

Such bond pooling would be cost-effective for secondary cities as they would benefit from the longer maturities and lower debt costs generally associated with bonds. In addition, bond pools can be structured to achieve higher credit ratings in the primary market which will further reduce the cost of the debt.

DBSA fulfilling its developmental role

Development finance institutions in other developing countries (such as India) have been instrumental in lending to municipalities with good potential but whose balance sheets are comparatively weak, and so developing the lower end of the capital market.

The DBSA needs to step up its support for municipalities in line with its developmental mandate

Government and the DBSA have agreed that the bank should step up its support for municipalities in line with its developmental mandate. This will entail increasing lending to particularly those municipalities that currently do not have access to credit markets. It is also envisaged that the DBSA will increasingly play the role of market facilitator and thereby crowd in private finance, instead of acting as a primary lender and effectively crowding out private finance. Steps the bank is being encouraged to take in this regard include:

- championing a model that involves private sector co-financing of the projects it invests in
- providing technical support to municipalities to build their capacity to participate in credit markets generally, and not simply to facilitate the DBSA's own lending activities
- facilitating municipalities' entry and participation into private capital markets by under-writing municipal borrowing, or offering limited guarantees to municipalities
- managing the development of a bond pooling instrument for secondary cities (using the DBSA's extensive treasury expertise)

- encouraging the development of the secondary market in municipal bonds by selling its current holdings of metro bonds to secondary investors that are more likely to trade them.

To support these initiatives, government has raised the DBSA's callable capital by R15.2 billion to R20 billion, thus increasing its lending capacity to R140 billion. Government is also exploring ways to reduce the DBSA's exposure when lending to municipalities that are a credit risk.

Government has raised the DBSA's callable capital to R20 billion

Developing the treasury function capacity in municipalities

Generally, municipalities' treasury function capacity is very poorly developed, even among certain of the metros. The result is that municipalities are not managing their borrowing optimally. This results in municipalities either under-utilising their borrowing capacity or borrowing excessively and getting into financial difficulties. It is also reflected in the unevenness of many municipalities' debt profiles.

National Treasury will be exploring ways of strengthening municipalities' treasury functions, which may include providing specific training, developing appropriate guidelines and providing technical advice to municipalities on how to optimise their borrowing strategies.

National Treasury will be exploring ways of strengthening municipalities' treasury functions

Conclusion

The demand for municipal infrastructure is spread across all municipalities, but is greatest in the metros and secondary cities. The primary sources of infrastructure funding are internally generated funds, transfers and borrowing. Government is exploring ways of deepening and broadening the municipal capital markets through developing a bond pooling instrument for secondary cities and building treasury function capacity. It is encouraging the DBSA to fulfill its developmental role and become a market facilitator and thereby crowd in private finance, instead of acting as a primary lender and effectively crowding out private finance. Government is also exploring ways of facilitating the use of development charges to finance municipal infrastructure required for private sector property developments.

In addition, municipalities need to explore land based financing strategies such as leaseholds and land use exchanges. Selling municipal land to fund operating deficits is discouraged. As a principle of good stewardship, municipalities should always use the proceeds of municipal land sales to purchase other land for the municipality in line with its spatial development plan – so as to maintain and grow the value of the municipality's land portfolio, thereby strengthening the municipality's balance sheet – which can then be leveraged to raise the finance required to fund infrastructure.