



INSTITUTE OF DIRECTORS
SOUTHERN AFRICA

Municipal entities:
Governance challenges
Public Sector Working Group: Discussion Paper 1



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1. Executive summary

Local government in South Africa includes the provision of municipal services through separate municipal utilities known as “municipal entities” (MEs). In furthering the governance discussion in local government, which started with the issue of the Public Sector Working Group’s Position Paper on Local Government and King III in October 2010 (Position Paper 2), this Discussion Paper aims to further unlock those governance challenges facing municipalities with municipal entities and seeks to provide some insight into their resolution.

In summary, the following challenges and suggested approaches are presented in this Paper:

Challenge	Suggested approach
a. MEs as an extension of their municipalities rather than as independent service providers	To avoid MEs operating at a disconnected level from the objective of service delivery and development of the parent municipality, more emphasis should be placed on the functioning of the ME in a manner that ensures that the mandate of the municipality is delivered. Hence it should be, and be seen to be, an extension of the municipality rather than an independent service provider.
b. The delivery of services and economic and social development in an efficient, effective and transparent manner	Focus should be placed on the business planning relating to the ME and the role of the Board as focal point of good governance supported by the CEO of the ME – a top-down approach, to ensure the ME operates in an effective and efficient manner within a service delivery and development mandate.
c. Monitoring of the performance of MEs by Council, Audit Committee and MPAC	The role of the Municipal Public Accounts Committee or MPAC should not be underestimated to support the independent oversight over MEs too, not only over municipalities.
d. Collaboration of MEs with their municipalities to achieve economies of scale	MEs and their parent municipalities should leverage their governance structures for achieving good governance across the group.



2. Introduction

In Position Paper 2 we discussed the following: The role of effective leadership in responsible and accountable local government; the advantages and awareness of the governance principles as they relate to local government; and a framework for the application of King III in local government. For purposes of that discussion, municipal entities were excluded, so as to be discussed separately in this Paper.

In South Africa, there are approximately 60 municipal entities which provide basic services (water, electricity, etc.), whilst others were established either to champion economic and social development in their municipal area or for commercial ventures.

The Auditor-General in his General Report on audit Outcomes for Local Government 2010/2011, reported that municipal entities showed improvement in their three-year progress to clean administration, with only 5% receiving an adverse/disclaimed audit report. This is down from 14% in the previous year. Worryingly though, more municipal entities had findings pertaining to compliance, which includes elements dealing with governance structures. This percentage was 88% compared to the 75% in the year prior. This was exacerbated by the report that 37% of municipal entities had sustainability issues, which is a key aspect of the King Code on Corporate Governance (King III)'s principles.

The General Report as referenced above was utilised for the 2011/12 version of this report and is yet to be issued by the Auditor-General. The statistics provided may thus differ.

Where does this leave municipal entities in terms of governance and what is the impact on the delivery of services and local economic development?

Our discussion focuses on the following matters:

- a. MEs as an extension of their municipalities rather than as independent service providers;
- b. The delivery of services and economic and social development in an efficient, effective and transparent manner;
- c. Monitoring of performance of MEs by Council, Audit Committee and MPAC; and
- d. Collaboration of MEs with their municipalities to achieve economies of scale.

Most, if not all, MEs are registered companies, or state-owned companies (SOCs), in terms of the Companies Act, 2008. However, our discussion will not focus on the detail governance matters contained in the Companies Act, 2008. For more information, reference can be made to Position Paper 1: State-owned companies: Companies Act, PFMA and King III in perspective, the first paper in this series, which focussed specifically on key laws, rules, codes and standards that concern the governance of a state-owned company. The objective of that paper was to highlight to boards of SOC's those areas in which governance and legislation intersect and to offer a position on how these varying and sometimes conflicting provisions could be reconciled. The paper did not deal with MEs, but it acknowledged that the same principles of financial management contained in the PFMA were also contained in Chapter 10 of the MFMA.



3. MEs as an extension of their municipalities rather than as independent service providers

We presented in Position Paper 2 that municipalities have a constitutional duty (Section 152) to (supported by King III principles of good governance, where appropriate):

- provide democratic and accountable government for local communities (King III, principle 1.2);
- ensure the provision of services to the communities in a sustainable manner (King III, principle 2.2);
- promote social and economic development;
- promote a safe and healthy environment; and
- encourage the involvement of communities and community organisations in the matters of local government (King III, principle 8.1).

To do this, many municipalities have established municipal entities to operate as ring-fenced business units which provide services or promote social and economic development. We note that the majority of “services MEs” are located in the Gauteng province where three metropolitan municipalities and a number of smaller local municipalities service a population exceeding 11 million people. In this context, there appears to be a logistical rationale to operate the various core functions of the municipalities using MEs, of which the City of Johannesburg is the biggest practitioner (approx. 13 MEs). However, by contrast, the Western Cape Province only has three MEs in total, with none of them providing basic services. This therefore indicates that the extent to which municipalities utilise the separate legal structures of MEs varies between municipalities. However, as the use of MEs by municipalities throughout the country is commonplace this should not limit the application of this Discussion Paper.

With the above in mind, we will discuss the governance of MEs by their parent municipalities, which is preceded by their establishment.

The establishment of a ME should be preceded by a public participation programme as required by the Municipal Finance Management Act (“MFMA”). This requires the parent municipality to determine the precise functions and services that the ME will provide as well as to assess the impact on the municipality’s assets, liabilities and staff.

This infers that there should be a sound rationale for establishing a ME to provide services or promote social and economic development rather than relying on the municipality itself. The ME needs to be functioning in a manner that ensures that the mandate of the municipality is delivered; hence it should be and should be seen to be an extension of the municipality rather than as an independent service provider.

It can therefore be argued that where the “business” rationale for establishing a ME moves beyond service delivery or for certain development objectives, the ME may start operating at a disconnected level i.e. it becomes too powerful so as not to consider the input and direction of the parent municipality, which should have the objective of service delivery and development at its core.



4. The delivery of services and economic and social development in an efficient, effective and transparent manner

An efficient and effective public service is desired throughout the world, especially in South Africa. This desire is further supported by the ethics of providing services in a transparent manner (King III, principle 1.1). Various legislated governance provisions help MEs to keep in-line with the mandate of the municipality that established them (King III, principle 6.1):

a. Business planning

Parent municipalities typically have a 20/30 year development strategy, which is broken down into five-year plans. Integrated Development Plans (IDPs) set the scene on an annual basis. The following focus areas should make a difference in achieving the IDPs through the use of MEs where they are established (we do not intend to promote or discourage the establishment of MEs, but rather promote the existence of a sound business rationale):

- Purpose – Business planning and performance management of MEs, and their key partnerships must have a well-defined purpose in order to meet the legislative reforms as contained in the Local Government: Municipal Systems Act, 32 of 2000 and the Municipal Finance Management Act, 56 of 2003. This purpose must be monitored and control exercised over the change in purpose through organisational reform, should this come about.
- Application - IDP applies to MEs in order to monitor business planning and performance and to ensure continuity and integration. In respect of identified strategic partners, binding contractual arrangements should be entered into as required by the Supply Chain Management regulations of National Treasury. Examples of where strategic partnerships are of benefit to the municipality are: OUTsurance Points People and Dial-Direct Pothole Brigade who partnered with the Johannesburg Metro Police and Johannesburg Roads Agency in the provision of services.

- Business plans - It is a requirement of Section 87 of the MFMA that any multi-year business plan:-
 - sets key financial and non-financial performance objectives and measurement criteria as agreed with the parent municipality,
 - is consistent with the budget and integrated development plan of the parent municipality,
 - is consistent with any service delivery agreement or other agreement with the parent municipality, and
 - reflects actual and potential liabilities and commitments, including particulars of any proposed borrowing of money during the period to which the plan relates.



An integrated development plan and process which integrates municipal and ME strategy and execution must therefore be established. In the end, the public and ratepayers believe they interact with their respective local municipalities on matters of services and development, even if this interaction is through an agent in the form of an ME. Therefore, this ultimately influences the public opinion of the town or city.

b. The Board of directors and the CEO responsible to the municipal Council

The Board

Some MEs were formed as companies, whilst others as trusts. However, the idea of a board of directors or board of trustees finds common place in the Municipal Systems Act which provides for the establishment of these boards.

The powers and responsibilities of the board of directors of an ME are captured in the MFMA. Some examples, which indicated that reduced autonomy (the increased shareholder authority) exists in these boards, include:

- Budgets of the municipal entity are approved by the Board but submitted to the Mayor (and indirectly the Council) and may only be amended with the approval of the Mayor and only in certain circumstances;
- Monthly financial reports must be submitted to the parent municipality; and
- Approval by the parent municipality of the upper salary limits of the ME's CEO and senior management.

The CEO as “accounting officer”

Contrary to the requirements of the PFMA, where the fiduciary responsibility of the public entity rests in the hands of the accounting authority, which is ordinarily the board, the MFMA puts these duties of utmost care in the accounting officer, who is the CEO. Therefore the Board as an expected focal point of governance plays a significantly less prevalent role surmised from the lack of fiduciary duties provided for in the MFMA. However, the Municipal Systems Act does put the following duties on the Board of the ME:

- Provide effective, transparent, accountable and coherent corporate governance and conduct effective oversight of the affairs of the ME;
- Ensure that it and the ME comply with all applicable legislation and agreements;
- Communicate openly and promptly with the parent municipality of the ME; and
- Deal with the parent municipality of the ME in good faith.

In summary then, MEs are accountable to the parent municipality council. However, this does not devolve the Board and CEO from their fiduciary duties. MEs are therefore aligned to the objectives of service delivery and the development of the municipality, one of which is to operate in an effective, efficient and transparent manner.

5. Monitoring of the performance of MEs by Council, Audit Committee and MPAC

Council is mandated with oversight over the actions of the administration and executive organs of the municipality, including the MEs. In Position Paper 2, the roles of Council (King III, Chapter 2) including the role of the Audit committee (King III, Chapter 3) had been expressly discussed. To further the discussion we focus on the role of the Municipal Public Accounts Committee (MPAC).

“Effective oversight and accountability is largely dependent on distinctive roles for different structures and sub components within Council.” To this end the MPAC was established.

The MPAC fulfils the oversight capacity of Council for enhanced financial management of the municipality and ME. However, the MPAC should not be confused with the audit committee (MFMA s. 166) or the finance portfolio committee. “The primary function of the Municipal SCOPA is to assist Council to hold the executive and the municipal administration to account and to ensure the effective and efficient use of municipal resources.”¹

The MPAC’s terms of reference should be clarified and formalised by Council in light of the requirement by the MFMA that the Audit Committee perform the functions as set out in s. 166(2).

It is recommended that the MPAC examines the following:

- Financial statements of all executive organs of Council;
- Any audit reports issued on those statements;
- Any reports issued by the Auditor-General on the affairs of any municipal entity;
- Any other financial statements referred to the committee by Council; and
- The annual report on behalf of Council and make recommendations to Council thereafter.

¹ Department of Local Government and Traditional Affairs – KwaZulu-Natal Provincial Government – Standing Committee on Public Accounts in Municipalities (Municipal SCOPA) Terms of Reference

It may be assumed that the key focus of the MPAC is on financial performance. But the MPAC should further consider that the Auditor-General’s audit report also make reference to the performance of the municipality and ME against the objectives which it has set out in its IDP.

The MPAC should be supported by an efficient and effective, independent internal audit function and should hold the Accounting Officer accountable. To this end it is appropriate to consider that National Treasury has prescribed minimum competency levels for municipal and ME officials, which amongst others describe the minimum competency levels for Accounting Officers as:

- Financial and supply chain management competencies;
- Core managerial and occupational competencies;
- Higher education qualification at NQF Level 6 or a Certificate in Municipal Financial Management; and
- Minimum of five years work experience at a senior management level.

These minimum requirements will aid the MPAC to call on the Accounting Officer to deliver what is legally expected.



6. Collaboration of MEs with their municipalities to achieve economies of scale

MEs were established to operate independently from their municipality, but not without the necessary alignment to municipal mandate and the oversight of its operations. However, in this economic climate of significant budget restrictions, strained industrial relations and ever increasing public pressure to improve services, MEs need to work closely with their respective municipalities to capitalise on economies of scale that may exist. Some examples are:

- An ME making use of the billing systems of its parent municipality (King III, Chapter 5);
- The opportunity to employ staff with more specific skills; and
- Communication channels with wider reach at the disposal of the ME.

What MEs and municipalities should not lose sight of is to also leverage their governance structures. This includes:

- The Audit Committee – This is a legally required element of the governance of municipalities and MEs, yet it is allowed that there may be a single audit committee for a municipality and municipal entities under its sole control. Other committees of Council may also be considered to fulfil these joint oversight roles;
- The Internal Audit function – It is not expressly disallowed under the MFMA for municipalities and MEs to also share this function as with the audit committee (King III, Chapter 7);
- The Municipal Public Accounts Committee (MPAC) – The AGSA reported “The establishment and functioning of a municipal public accounts committee (MPAC) at each municipality, or a shared committee for smaller municipalities, is a relatively new and evolving concept. If implemented and operating as intended, the MPAC will be one of the most critical role players and success factors in municipal oversight and governance to ensure a positive impact on audit outcomes.”²

² CONSOLIDATED GENERAL REPORT on the audit outcomes of LOCAL GOVERNMENT 2010-11, Auditor-General South Africa, 2011, RP216/2012, ISBN: 978-0-621-41079-2



7. Conclusion

MEs play an important role in assisting municipalities to fulfil their mandate. Challenges are experienced when the rationale for creating a ME is not sound, or even if the rationale is sound, the activities of the ME may extend beyond the purpose for which it was created.

In order for a ME to function effectively and efficiently there needs to be continuous and rigorous oversight of the ME by the oversight structures within the municipality.





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