

Project Preparation Challenges: Improving Project Financing for Local Government Infrastructure Development

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Development Dialogues

“ Municipal service delivery, or lack thereof, appears not to be constrained by the lack of financial resources but rather by insufficient institutional capacity, capability and skills to plan and implement these infrastructure programmes. ”

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“ ...a critical challenge for institutions is how to operate within a dysfunctional environment and what could be done to build a more functional environment? ”

*Mark Misselhorn,
KZN Project Preparation Trust*

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1. Introduction

The DBSA convened a Roundtable to discuss improving project financing outcomes for infrastructure development through improvements in the preparation phase of a project cycle. The purpose of this session was to identify and understand factors within the project preparation phase that influence project success, and to consider measures to improve the practice of lending to enhance effectiveness and efficiency in infrastructure project financing.

Presentations by Mark Lewis of the Development Bank of Southern Africa (DBSA) and Mark Misselhorn of the KZN Project Preparation Trust (PPT) provided the opportunity to analyse the experience gained by both organizations in this field. The discussion presented a valuable opportunity to tap into grounded experience. The purpose of this report is to provide a high level summary of the key issues that emerged from the engagement.

2. Key issues

2.1. The Core issue

Democratic South Africa continues to tackle a significant range of infrastructure concerns. There are concurrent demands for major economic infrastructure development such as roads, railways, ports and power, as well as for social infrastructure including water, sanitation, housing and tertiary roads. In relation to the demand, South African local authorities have been undertaking this work with limited financial resources while simultaneously transforming policy and attempting to build the capacity of the public sector resulting in mixed success.

The DBSA's fundamental role is to finance infrastructure. Over time, through accumulating technical know-how, the Bank's operating procedures have evolved to enable the development of a substantial facility to support the preparation of projects. In similar circumstances, the KZN PPT emerged in response to public recognition of sub-optimal conditions in municipal project preparation that need to be addressed.

Against this background, the core question framed for the roundtable was: What conditions, resources and skills are required at project preparation to improve success in financing and implementation of public infrastructure projects?



2.2 Municipalities: central to basic infrastructure provision

While considerable progress has been made in the provision of infrastructure to support socio-economic development and provide services to communities, the development needs of South Africa remain wide-ranging. The level of poverty is high and structural weaknesses in key areas of the economy persist. These problems are characterized by extensive backlogs in infrastructure and the provision of associated services such as water, electricity, sanitation, housing and health. Municipalities and other public sector utilities are expected to drive public infrastructure delivery.

Municipalities face a range of challenges, including increasing demand for economic infrastructure, ageing assets requiring upgrading or rehabilitation or replacement. In addition the spatial locations of poverty and infrastructure are not static, requiring constant adaptation and assessment. Moreover, the economic and fiscal context has resulted in slower growth of many municipalities' revenue, making it all the more important to ensure that spending is prioritized appropriately and implementation is effective and efficient. Under these conditions, good governance is critical.

In terms of the DBSA's mandate and its organizational framework, the South African Operations (SAOps) division of the DBSA emphasises project origination with municipalities that constitute a large part of its client base. Likewise, the KZN PPT also focuses much of its work on municipalities.

National government has a very comprehensive Conditional Grant Programme for municipal service delivery. The following Conditional Grant Programme is being supported by the DBSA:

- The Municipal Infrastructure Grant (MIG)
- The Integrated National Electrification Programme (INEP)
- The Strategic Infrastructure Programme (SIP 6)

DBSA support is focused on exploring products to improve the institutional capacity of municipalities to implement these programmes and on front-loading MTEF funding to accelerate programmes.

2.3. Municipal capacity constraints

A key issue for agencies such as the KZN PPT and the DBSA, interfacing with municipalities to finance infrastructure, is municipal capacity. This relates to their ability to:

- prepare projects. This is aggravated by:
 - o Lack of funding
 - o Absence of specifications
 - o Lack of project management skills
 - o Failure to link infrastructure projects to MTEF planning.
 - o Lack of adequate integration prior to capital approvals.
- manage consultants
- plan effectively
- secure revenue streams
- borrow funds

Consequently, local authorities employ consultants to conceptualize and prepare projects. This has an effect on the ongoing management of projects, and the need to support finalization of business plans before any decision can be made on financing.

2.4. DBSA's current project development process

To assist clients with project preparation, the DBSA has introduced a social accounting matrix model, as well as cost-benefit and cost management tools, all of which have proved helpful. In addition, there has been a shift away from quantitative to more qualitative measures of assessing a municipality's financial status.

2.5. Financing climate

Since 2008, there have been a number of significant developments in the socio-economic context of local government, such as the economic recession, rising unemployment and the 2010 FIFA World Cup. There is strong evidence of ongoing rural-urban migration, although the extent of this movement is unknown.

Under-resourced municipalities are predictably reliant on agriculture, fishing and forestry activities, while the secondary and tertiary sectors are more dominant in metropolitan areas. These differences underscore the need for individual municipalities to pursue vastly different infrastructure investment and service delivery strategies. All levels of municipalities, especially those with high numbers of poorer and unemployed communities, are increasingly finding their income streams under pressure.



Further, any decline in the dominant sectors of a local economy can have a knock-on effect for household spending, which ultimately impacts on municipal revenues. The magnitude of electricity increases has impacted on the ability of municipalities to recoup costs from consumers. Municipalities with low income communities specifically find it difficult to recover all costs and to retain their surpluses on this service. Electricity has always been the one traded service which allows municipalities to cross-subsidise other services, but this opportunity is increasingly under pressure.

The total demand for funding has increased, but the absorptive capacity to raise and manage funding and to comply with credit criteria is under pressure. As a result, the volume of funding mobilised from the market, although higher, is concentrated in a few metros and the top end of secondary municipalities. The mobilization of funding for smaller secondary and under-resourced municipalities is at a relatively small scale due to their poor absorptive capacity.

The appetite from the private sector and asset managers for municipal debt has increased, probably in response to legislative and policy changes introduced to stimulate private sector participation in public infrastructure funding. Considerations such as risk, transaction costs and increases in liquidity in the banking sector, have also led the private sector to seek alternative but profitable investment opportunities in infrastructure and housing. These conditions have contributed to intensified price based competition between banks to secure the few available low risk and high volume based municipalities as clients.

2.6. Supporting project preparation

KZN PPT was established in 1993 to support efforts to secure a pipeline of viable development projects. Currently it focused on pro-poor projects, usually basic services. The organisation's core business is to help clients manage the project preparation process and to address non-loan financing of projects – in other words to pursue grant funding. KZN PPT's interventions are focused on assisting government, community and donor clients to ensure that effective and systematic project preparation occurs through management of project preparation funding and contracted professional project teams. This approach ensures the identification and elimination of key risks at the earliest possible time and maximization of development opportunities, by ensuring that projects are well conceptualised. The approach of revolving project preparation funds is used; PPT takes the risk upfront and recovers the cost once the project gets approved.

For infrastructure projects the KZN PPT has identified the following as central:

- Project preparation must entail analysis of feasibility and appropriateness
- The risks involved at different levels of the project need to be identified
- Synchronisation with the budgeting process - early stages of projects usually are not aligned to the medium term expenditure framework (MTEF)
- A participative approach that develops capacity in all parties
- Economic, political and social returns must all be adequately assessed
- Poor project management at early stages of project preparation stalls progress, and hinders achieving the desired outcomes
- Scaling up of institutional capability is a strategic priority
- Clarity on land reform and finalization of claims is needed to to promote sustainability and reduce uncertainty.
- Poor project planning results in greater costs down the line, therefore adequate planning needs to take place (see diagram below on the Project Cycle)

2.7. Institutional issues

A range of institutional challenges have been encountered and need to be addressed. These include:

- Changing political agendas – Risks increase with changes in political administration as continuity of projects can be jeopardized. Turnover in government can result in the loss of key skills. It is necessary to examine whether the resources expended in skills support, generate sufficient benefits in the light of turnover rates.
- Capacity building – With respect to building capacity in government, investment should also be channeled towards institutional development as opposed to only individual capacity building.
- Decision making – Conversion rates from approved to built projects are relatively high for KZN PPT (70 – 80%), and they are usually higher in cases where there is a predictable capital funder. However, a key factor affecting conversion rates is government prioritisation and reprioritization. Consequently, socio-political issues impacting on government decision-making can be considered as key risks.
- Impact monitoring - In planning, projects are monitored until capital approval is confirmed. Thereafter impact evaluation is costly, but necessary. Government-driven reviews would be more effective if they were conducted at project level, took account of the project impact at societal and economic levels and included the leveraged effect.
- Rehabilitating dysfunctional environments – a critical challenge for institutions is how to operate

within a dysfunctional environment and to establish what could be done to build a more functional environment. In terms of addressing a dysfunctional financial environment, it was observed that National Treasury could play a pivotal role.

2.8. Greater synergy for effectiveness

Providing support for project preparation is essential to enable financing, use of grants and implementation of infrastructure. The role played by the KZN PPT is complementary to that played by the DBSA, both play a role in assisting municipalities, which have inadequate human and knowledge capacity, with their project planning.

The provision of support includes: getting closer to client service providers, ensuring that project plans cater for potential dysfunctionality, using the multiple stakeholder engagement approach, utilizing additional capacity support, such as the Municipal Infrastructure Support Agency (MISA).

From a policy perspective, it was suggested that the regulatory environment requires tweaking to facilitate greater input from multiple stakeholders. Higher levels of collaboration are also needed in policy planning and implementation.

3. Conclusion

Over time both the DBSA and the KZN PPT have developed various tools, tool kits and knowledge resources to assist municipalities and other public bodies with project preparation. These have proved their value. However, in view of the shortage of essential skills, support for project preparation will be required for some time. Beyond improved project preparation to improve implementation of infrastructure projects and supply of the resultant services, stability needs to be strived for, skilled capacity built and institutions supported.