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Trade and Uneven Development: Opportunities and Challenges



The Role Of Local Government In Promoting Trade

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## **The Role Of Local Government In Promoting Trade**

Trade and industrial policies are generally viewed from the vantage point of national government. Hence the emphasis on the type of trade regime that should be pursued (tariffs, subsidies, etc), the state of the current account, the exchange rate and geo-political factors (globalisation, power blocs and regional associations). While the overwhelming importance of these factors should not be underestimated there is some questioning about shifting the emphasis slightly to include the role that local governments can (and do) play in promoting trade.

This paper will look at how local governments either promote or retard trade through the policies they adopt, especially with regard to tariffs for water and electricity consumption but also the provision of infrastructure such as roads and serviced sites. Using the case study of Drakenstein Municipality in the Western Cape and a large textile company, the paper will examine the possible factors that have contributed to the decline of an industry and resulting job losses. While acknowledging the devastating impact that imports from China has had on textiles in general, the paper will probe the policy options that were available to the municipality to counteract the fierce competition from the Far East. Was the appreciation of the Rand the only possible explanation for the drop in demand for locally manufactured garments or were there other contributing factors?

The first part of the paper deals with a brief review of the literature on tariff reduction as a way of assisting businesses. The second covers the legislative and regulatory context of tariff adjustments for municipalities. Section three is an historical review of the operations of the textile company in question as well as of the tariff structure of the municipality for water and electricity consumption, and rates. This will be followed by an analysis of the periods that were characterised by growth in sales and employment and how this correlated with wages, salaries, the exchange rate and general overhead costs. The fifth section deals with the more recent period in which increased global competitiveness has made its effects felt on the various operations of the local firm that have led to a serious loss of market share in both domestic and international trade. In the final section of the paper we place the problems posed by global competition in the context of local economic development with a view to illuminating the challenges that local governments in South Africa need to confront if the goals of growth and development are to be achieved.

NOTE: The name of the company has been changed to protect its identity and to respect the confidentiality of the information provided during the course of the research.

# 1 Introduction

## 1.1 Background to the study

In 2003 Gama Textiles (GTEX) requested a reduction in tariffs for water, electricity and sewerage to 2002 levels from the Drakenstein Municipality. The request is the culmination of a series of discussions that have taken place between senior personnel from the Drakenstein Municipality and worker's representatives on ways to prevent the further loss of jobs at the company. The financial circumstances in which GTEX found itself can be attributed to a complex set of factors but is largely the result of the economy being opened up to international competition, illegal imports and the fluctuations of the exchange rate. The main objective of this paper is to assess the request of GTEX against possible consequences namely, further retrenchment of workers and a reduction in revenue for the Municipality. Among the factors that the assessment considers is the effect such retrenchments would have on the local economy.

This study is comprised of five parts. The first part deals with the position of GTEX in the local economy and the second looks at the data on consumption and tariffs for water, electricity and sewerage. Part three analyses the financial statements of GTEX and the Municipality in which a financial ratio and trend analysis of key performance areas is undertaken for the Municipality and GTEX to determine their respective financial positions. The financial analysis also enabled the researchers to ascertain if a rebate to GTEX was warranted and affordable to the Municipality. Part four considers the request of GTEX in the context of the "public interest" and part five outlines a range of options that should be considered on the basis of the information at hand.

The research methodology used for this study was both desktop as well as interview based. Relevant documentation was obtained from various stakeholders including GTEX and Drakenstein Municipality.

Interviews were conducted with key individuals including the CEO of GTEX and the Financial Manager. In the interviews we sought to obtain information on what had motivated GTEX to seek assistance from Drakenstein Municipality and the extent to which this assistance is expected to provide a lifeline to the efforts of the managers to save the company from further decline in performance. The questions put to the two representatives thus covered a broad range of issues relating to the financial status of the company, its strategic objectives and its position in the industry and how national and international economic currents are affecting the company.

## 2 TARIFFS AND INDUSTRIES: A REVIEW OF THE LITERATURE

The role of municipalities in promoting growth and reducing poverty has received considerable attention over the past two decades. Much of the literature concentrates on the role that local governments should play in creating an enabling environment and practicing good governance. Hence, infrastructure provision, service delivery, an efficient and fair administrative apparatus, and cost control, among other things, generally receive wide berth. USAID, for example, in its series “Making Cities Work”, advocates that “the reliability, quality and cost efficiency of equitable services to all areas of the city — wealthy and poor — is the primary responsibility of local government, and is the most tangible result for which the community will hold their elected officials accountable” ([www.makingcitieswork.com](http://www.makingcitieswork.com)). It goes on to argue that “Decentralization should enable cities to better manage service delivery by having the autonomy to set tariffs and user fees and access other finance mechanisms.”

There is little in the literature that deals with local governments offering preferential tariff rates for businesses. The City of Maine seems to be the notable exception. It offers a 95% reduction in sales tax for all fuel and electricity purchased for manufacturing. There is, however, a considerable amount of information on other incentives that local governments offer to attract and retain business. The Pennsylvania Department of Community and Economic Development, for example, offers, among others things:

- Loans, grants, and guarantees
- Programs to leverage funds to generate private investment in economic and community development projects
- Investments in rural, urban, and suburban sites
- New capital resources for small cities and communities
- Incentives and services to attract high-growth firms
- Resources that allow traditional industries, especially manufacturing, to access new technology to enhance their productivity

Many of the incentives offered take the form of tax rebates or credits. The City of Maine offers a range of incentives, the aim of which is to boost employment, encourage the formation and upgrading of skills, promote manufacturing capacity and conduct research and development.<sup>1</sup> Where a reduction of tariffs for electricity and water are concerned some authorities have chosen instead to introduce competition among suppliers and leave it to businesses to choose a utility that offers them the best terms and conditions. This is the case in some New England states in the U. S., according to Heidi Kroll (2003). In 1996, she notes, the New Hampshire Legislature’s finding “that the most compelling reason

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<sup>1</sup> For a brief description of these incentives see [info@mesda.com](mailto:info@mesda.com)

to restructure the New Hampshire electric utility industry is to reduce [electricity] costs ... by harnessing the power of competitive markets” continues to be sound.

The New Hampshire Business and Industry Association’s Issue Survey conducted in March 2003, however, found that sixty-one percent of the survey respondents indicated that a “lower [electricity] price is more important than pure competition” in electricity supply markets. Kroll points out that in Granite State Electric Company’s service area, for example, less than 1 percent of businesses are taking service from competitive suppliers, but given that these businesses are very large consumers, they represent about 20 percent of electricity demand in the service area. In other New England states, she observes that the level of competitive activity has grown considerably in the last year or so.

*“In Massachusetts, about 28,650 commercial and industrial customers (around 10 percent of the state’s C&I customers) have switched to competitive suppliers. Approximately 21 percent of businesses’ demand for electricity and about 10 percent of the whole state’s demand for electricity is served competitively. These figures reflect a successful initiative that Massachusetts utilities have undertaken to help put interested business customers in touch with the six competitive suppliers and nine brokers that are currently active in the Massachusetts market. In Rhode Island, approximately 2,100 business customers are taking competitive supply, representing about 12 percent of the total electricity consumed in the state. And in Maine, more than 2,700 medium and large businesses have switched to competitive suppliers, along with almost 6,000 homes and small businesses, bringing the amount of the state’s electricity demand served by competitive providers up to approximately 32 percent. Customers of Maine Public Service Company have seen the greatest competition, with 100 percent of its large business customers now taking competitive supply.”*

While there has been some movement in the recent past towards a more decentralized system of distribution for electricity in South Africa, it is safe to say that the country is a long way off from introducing competitive supply options for consumers. Municipalities and Regional Electricity Distributors (REDS) will likely be the main decision makers in any application for reduced tariffs.

### **3 THE LEGISLATIVE CONTEXT**

The extent to which municipalities may or may not exercise discretion over the granting of concessions to one or more consumers of services is largely determined by the panoply of legislation and the regulatory regime which they are bound to observe. In South Africa the procedures that have to be followed for granting a company a reduced tariff for electricity and water are not particularly complex but time consuming. A municipality must first place the issue on the

agenda of the Mayoral Committee before it can be tabled at a full Council meeting. If approved, the decision must then be referred to the regional electricity regulator and the ???? in the case of water. If all conditions are satisfied approval is formalized and a municipality may then into an agreement with the select client/s.

Despite these control mechanisms municipalities have some scope within which to structure and set the tariff regime for services in the areas under their jurisdiction. The provisions for this flow from Section 74 of the Local Government: Municipal Systems Act 2000. The Act states that a “A tariff policy must be compiled, adopted and implemented in terms of Section 74 . . . such policy to cover, among other things, the levying of fees for municipal services provided by the municipality itself or by way of service delivery agreements.” The Act further articulates the municipality’s powers, rights, responsibilities and obligations in the following terms:

*In setting its annual tariffs the council shall at all times take due cognisance of the tariffs applicable elsewhere in the economic region, and of the impact which its own tariffs may have on local economic development.*

*The municipality shall ensure that its tariffs are uniformly and fairly applied throughout the municipal region.*

*Tariffs for the four major services rendered by the municipality, namely:*

- \* *electricity*
- \* *water*
- \* *sewerage (waste water)*
- \* *refuse removal (solid waste),*

*shall as far as possible recover the expenses associated with the rendering of each service concerned. The tariff which a particular consumer or user pays shall therefore be directly related to the standard of service received and the quantity of the particular service used or consumed.*

*The municipality shall, as far as circumstances reasonably permit, ensure that the tariffs levied in respect of the foregoing services further generate an operating surplus each financial year of 10% or such lesser percentage as the council of the municipality may determine at the time that the annual operating budget is approved.*

*In line with the principles embodied in the Constitution and in other legislation pertaining to local government, the municipality may differentiate between different categories of users and consumers in*

*regard to the tariffs which it levies. Such differentiation shall, however, at all times be reasonable, and shall be fully disclosed in each annual budget.*

*In adopting what is fundamentally a two-part tariff structure, namely a fixed availability charge coupled with a charge based on consumption, the municipality believes that it is properly attending to the demands which both future expansion and variable demand cycles and other fluctuations will make on service delivery.*

*It is therefore accepted that part of the municipality's tariff policy for electricity services will be to ensure that those consumers who are mainly responsible for peak demand, and therefore for the incurring by the municipality of the associated demand charges from Eskom, will have to bear the costs associated with these charges. To this end the municipality shall therefore install demand meters to measure the maximum demand of such consumers during certain periods. Such consumers shall therefore pay the relevant demand charge as well as a service charge directly related to their actual consumption of electricity during the relevant metering period.*

Parts 4 and 5 of the Act spell out the specific legislative competencies of municipalities with regard to electricity and water respectively. Section 75 of the Act (BY-LAWS TO GIVE EFFECT TO POLICY) comes close to giving municipalities a degree of autonomy:

*The council of the municipality must adopt by-laws to give effect to the implementation and enforcement of its tariff policy.*

*Such by-laws may differentiate in respect of services, service standards, service providers and other matters between different categories of users, debtors or geographical areas, but in a manner which does not amount to unfair discrimination.*

## **4 Profile of GTEX**

GTEX occupies a prominent position in the economy of Drakenstein and the country. Since its inception it has been one of South Africa's leading firms in the spinning, weaving, and fabric production operations of the textile industry. As a consumer of municipal services in Paarl, it is evident from the data below that GTEX makes a substantial contribution to the revenue of Drakenstein. In current prices this amounts to approximately R12 million per annum. It currently employs 470 people with a wage and salary bill amounting to approximately R33 million per annum.

In August 2003 a decision was taken to close the entire weaving operation in Paarl. This would have resulted in 234 retrenchments and the impact on the community would have been significant. GTEX and SACTWU, the representative Trade Union, entered into a consultation process from which a revised business model emerged. The revised model retained some weaving activity in Paarl and "mothballed" the balance of the machines. The effect of this was that 87 jobs were saved. However the revised model was based on a number of prerequisites namely:

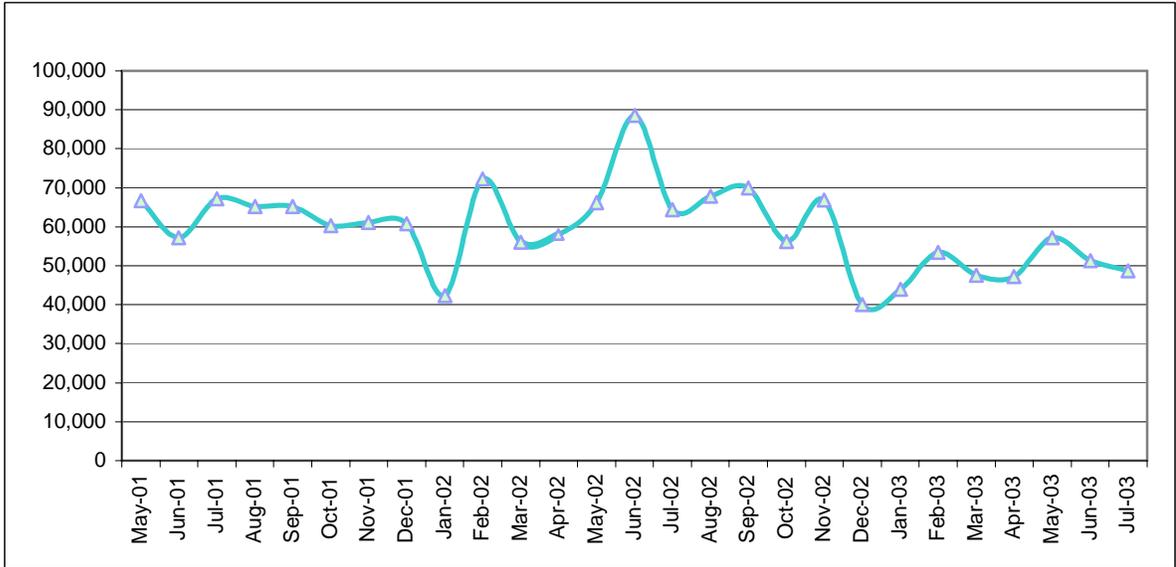
- A reduction in employment costs;
- Joint initiatives between GTEX and SACTWU to address productivity; waste, skills development; absenteeism etc.
- A real reduction of utility costs by 15% (GTEX has prepared a comparison of utility costs with a Textile company in Worcester and this shows a significant difference in utility rates.

GTEX saw itself as being in a crisis situation and requested that the matter be dealt with urgently in order to save the company. The Union and GTEX had already begun preparing for joint initiatives in the areas identified.

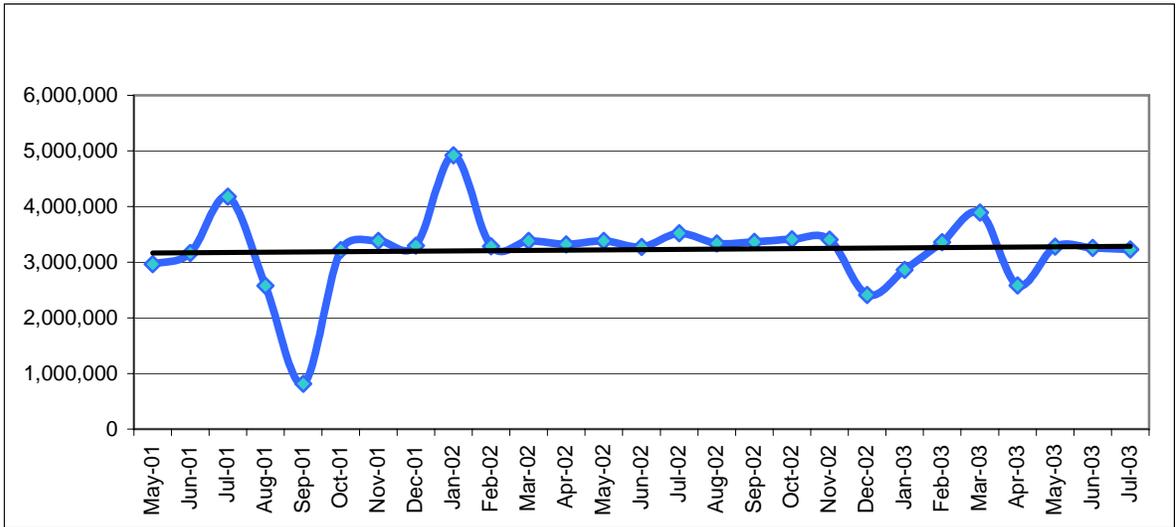
## **5 GTEX's Current Consumption and Tariffs**

On the basis of these and other data supplied by the Municipality and GTEX the following profile of GTEX's consumption and tariffs can be drawn. GTEX consumes roughly 3 000 000 units of electricity and water consumption has decreased to roughly 50 000 kl per month. See Figure 1 and Figure 2 below:

**Figure 1: Water Consumption (May 2001 - Jul 2003)**



**Figure 2: GTEX Electricity Consumption (May 2001 – June 2003)**



GTEX has invested many resources in trying to control the usage of utilities and minimize wastage. To this end GTEX has received two awards for environmental awareness and waste reduction. In the same period, usage has been reduced by the following:

- Electricity KVA decreased by 8%
- Electricity units decreased by 7.5%
- Water decreased by 22%
- Effluent decreased by 6%

The following tariffs were prescribed between 2000 and 2003 for water, electricity and sewerage by Drakenstein Municipality for industries like GTEX.

**Table 1: Municipal Tariff Charges for Water, Electricity and Sewerage**

	<b>Water cons</b>	<b>Electricity</b>	<b>Electricity KVA</b>	<b>Sewerage</b>	<b>Sewerage</b>
<b>2000</b>	2.5	0.1041	47.59	1.95	4.20
<b>2001</b>	2.85	0.1098	50.202	2.37	4.01
<b>2002</b>	3.24	0.1186	51.2	3.02	6.75
<b>2003</b>	3.569	0.1293	55.302	3.31	6.22

Tariff prices have risen quite substantially since 2000. In the past three years

- Electricity KVA increased by 16.2%
  - Electricity units increased by 24.2%
  - Water increased by 42.8%
  - Effluent Increased by 70% for the dye house 48% for the main factory
- (These statistics have been compiled from data supplied by GTEX and our own calculations, which are based on data supplied by the Municipality.)

The tariffs show a steep increase when compared against an inflation rate (CPIX) of roughly 8.1% for the period under consideration. Unit prices for electricity and water and effluent have increased greater than the rate of CPIX. How much of these increases can be attributed to higher cost prices for utilities is a question that should be examined further because of the impact that it could possibly be having on other manufacturing enterprises in the area.

Utilities represent 14% of total costs and without the reduction GTEX is at risk of closure.

## **4 Financial Analysis**

### **4.1 Ratio Analysis: Gama Textiles**

#### **4.1.1 Performance and Profitability Ratios**

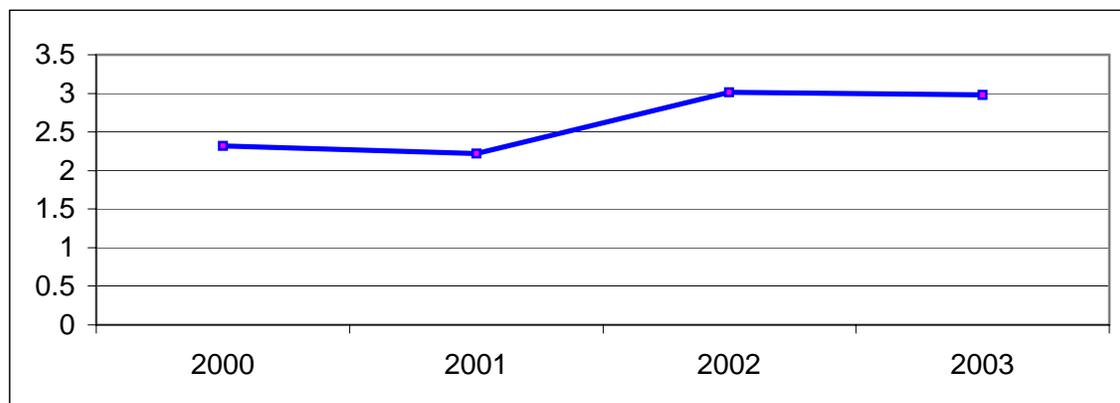
The following financial analysis gives an overview of the company's performance over the past two years. Performance is being measured against a host of accounting ratios that seek to establish whether liquidity and profitability has been maintained. The ratios are given in the table below and are examined in greater depth in the sections that follow.

**Table 2: Financial Ratios (2000-2003)**

Indicator	2000	2001	2002	2003
Current Ratio	2,32	2,22	3,01	2,98
Quick Ratio	1,36	1,31	1,94	1,98
Inventory Turnover Ratio	4,36	5,10	5,46	6,03
Average collection period of accounts receivable	69,13	71,10	69,51	58,40
Total Asset Turnover	1,33	1,31	1,35	1,81
Debt Ratio	111,47%	117,37%	121,43%	117,04%
Gross Profit Percentage on Sales	13,62%	5,31%	7,45%	6,11%

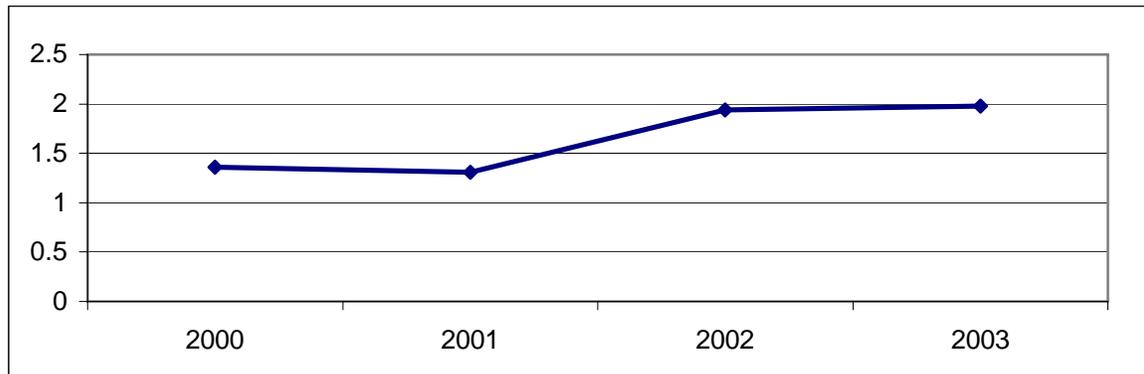
**The Current Ratio** measures the client's ability to meet its short-term obligations. A ratio of two and greater is generally acceptable. Even if GTEX's current assets shrunk by 50% the company would still be able to meet its short-term obligations. Figure 3 shows that the current ratio of GTEX has steadily improved since 2003.

**Figure 3: Current ratio (2000 – 2003)**



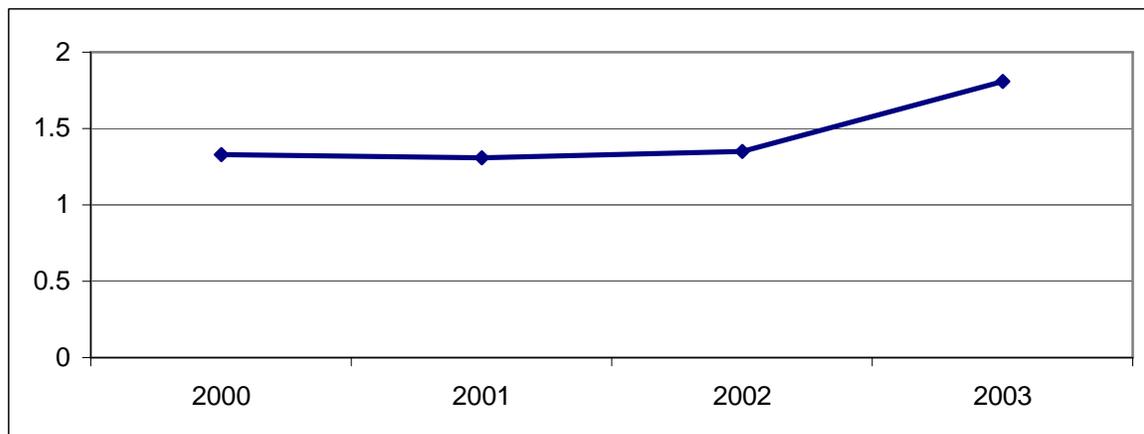
**The Quick / Acid Test Ratio** is similar to the current ratio but it excludes inventory from current assets, which is generally the least liquid current asset. A ratio of 1 and greater is generally acceptable. Based on the information from Table 2, GTEX is able to meet all its short-term obligations even if inventory is not sold. The ratio has improved since 2000.

**Figure 4: Acid Test Ratio (2000 – 2003)**



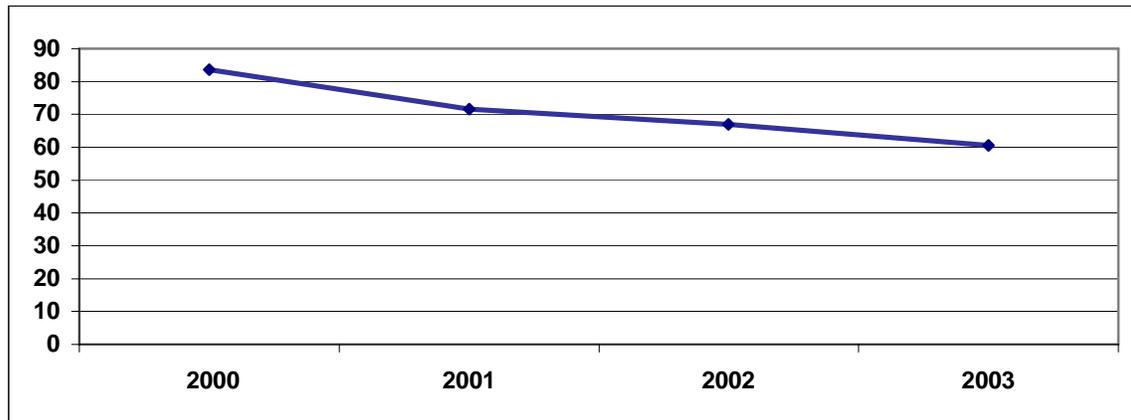
**The Total Asset Turnover Ratio** indicates the efficiency with which the firm uses its assets to generate sales. The higher the ratio, the more efficiently its assets have been used. This ratio is probably the most important to management because it indicates whether the company's operations have been financially efficient. There has been an improvement since 2000 where, for every R1 invested in assets R1, 33 was generated in sales to a situation where every R1 currently generates R1, 81 in sales.

**Figure 5: Total Asset Turnover ratio (2002 – 2003)**



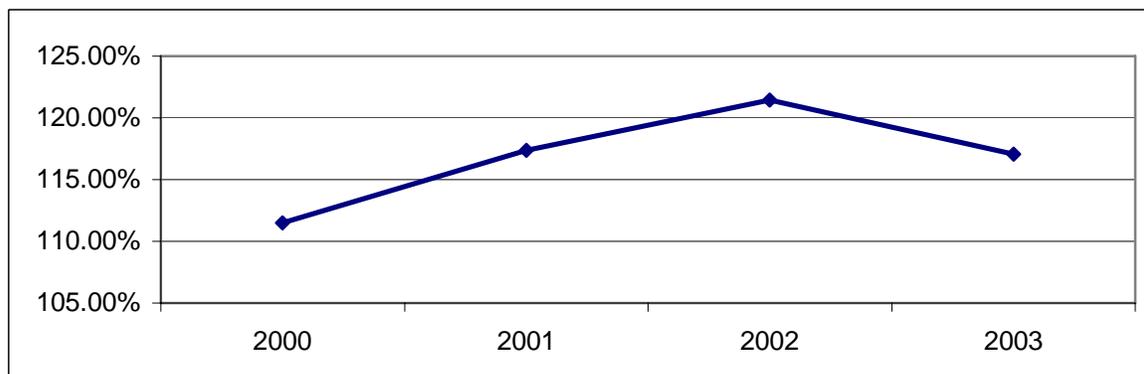
**The Inventory Turnover Ratio** measures the liquidity of the company's inventory – that is the average time it took for inventory to be sold. This ratio also shows a decline from 2000. In 2000 it took 84 days for inventory to be sold but in 2003 it only took 60 days.

**Figure 6: Inventory Turnaround Time**



**The Debt Ratio** measures the proportion of total assets being financed by the firms' creditors. Figure 7 shows that there has been an increase in this ratio since 2000.

**Figure 7: Debt ratio**



In 2000 the debt ratio was 111%. This increased to roughly 121% in 2002 before declining to 117% in 2003. The increase in the debt ratio does not bode well for the company, as the trend is that more of the company's assets are financed by debt. The main reason for this can be attributed to a host of factors including an increase in the price of raw materials particularly the world price of cotton.

The reason for the increase in the Debt ratio from 111% in 2000 to 121% in 2002 relates to funds being supplied by GTEX's holding company in order for GTEX to cope with the increase in cotton prices during the same period which explains why the interest expense increased from R3, 2 million in 2000 to R5, 8 million in 2002.

The reason for the decrease in the Debt ratio in 2003 relates to a book entry being passed by GTEX for the writing back of losses of about R25 million against the loan account of the holding company. The interest expense in 2003

increased from 2002 because the book entry was passed in December 2002 and not backdated to the beginning of the year. The writing back of the losses would decrease the interest burden in the future, which reflects that GTEX is trying to adopt new ways and means to alleviate the current cash flow crisis.

The Gross profit on sales percentage is calculated by deducting Cost of Sales from Sales to arrive at the Gross profit, which is then divided by Sales.

The Gross profit reflects the profit made on the sale of goods that will be used to meet all other incidental costs of running the business. The Gross profit on sales percentage declined from 14% in 2000 to 6% (less than half of the 2000 figure) in 2003. The main cause for this drastic decline since 2001 can be attributed to external purchases, which increased from R36, 2 million to **R87, 8** million. For the period 2001 to 2003, external purchases increased by **142%** whereas sales only increased by **40%** during the same period.

An increase in the external purchases has not only had an impact on the debt ratio of the company but also on the interest that is paid on that debt. Thus it is not surprising to see that the **Interest Cover ratio**, which measures GTEX's ability to meet interest payments, has also deteriorated since 2000. In both the 2002 and 2003 financial year there were insufficient cash profits available to meet the interest expense. The extent of the interest burden and the effect that it is having on the company is illustrated in the table below:

**Table 3: Impact of Interest Payments on GTEX's Finances**

<b>Description Of Item</b>	<b>2002</b>	<b>2003</b>
	<b>R'000</b>	<b>R'000</b>
<b>Net loss before interest and tax</b>	-2 300	-4 340
Add back depreciation	5 654	5 082
<b>Cash loss before interest expense</b>	3 354	742
Interest Expense	-5 838	-6 682
<b>Cash loss after interest expense</b>	<b>-2 484</b>	<b>-5 940</b>

What the data above illustrates is that one of the main causes for GTEX's financial difficulties is its huge interest burden. At 28 February 2003, GTEX's interest bearing non-current liabilities was roughly R42, 7 million of which R3, 8 million was owed to a financial services company and the balance of R38, 9 million is due to the holding company, a division of a larger group.

## 4.2 Trend Analysis of Key Performance Areas – GTEX

The trend analysis examines movements in the categories of sales. Below is an analysis of the different categories of sales as well as local and export sales.

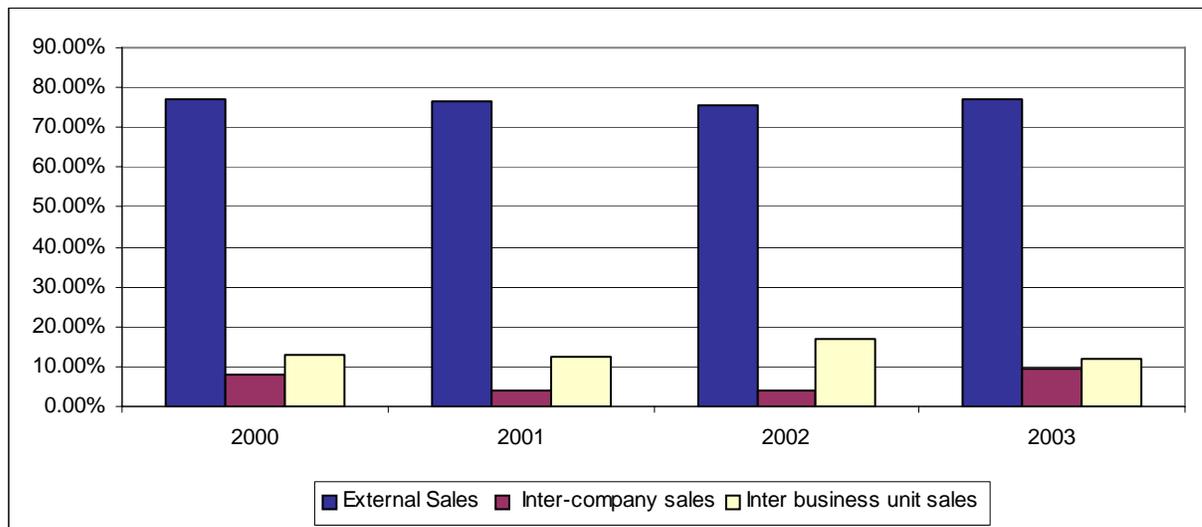
**Table 4: Categories of Sales**

	2000	2001	2002	2003
	R'000	R'000	R'000	R'000
External sales	115,879	120,256	139,193	158,635
Inter-company sales	12,156	6,057	7,396	19,043
Inter business unit sales	19,490	19,665	31,348	24,170

**Table 5: Local and International Sales**

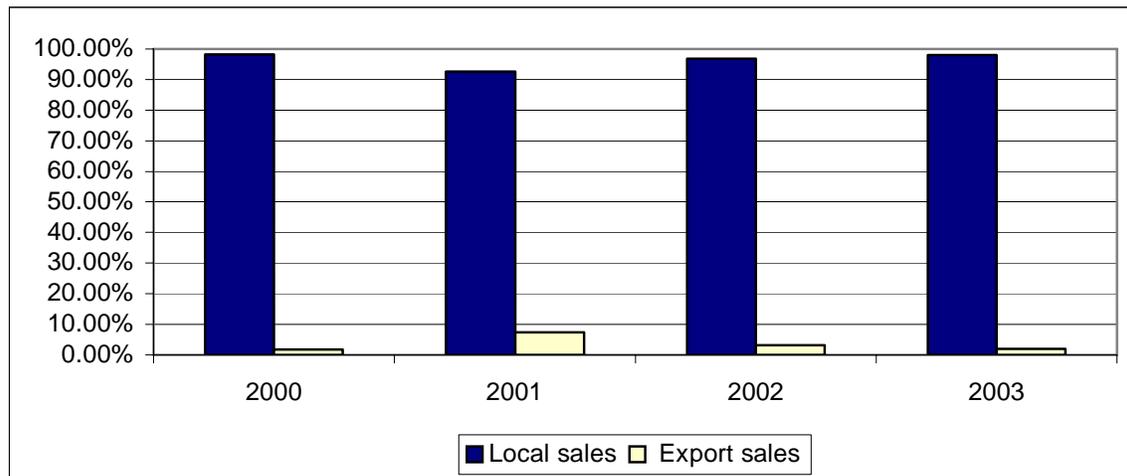
	2000	2001	2002	2003
	R'000	R'000	R'000	R'000
Local sales	147,525	145,978	177,937	201,848
Export sales	2,767	11,529	5,846	4,006
Total sales	<b>150,292</b>	<b>157,507</b>	<b>183,783</b>	<b>205,854</b>

**Figure 8: Division According to Category of Sales**



The great majority of sales that is generated annually are external sales, followed by inter- business unit sales and lastly inter-company sales. Inter-company sales represent all sales made to Frame. Inter-business unit sales represent all sales made to Romatex (which is also part of the Seardel Group of companies). External sales represent all other sales made on the local market.

**Figure 9: Division According to Local and International Sales**



#### 4.2.3.1 Loss Incurred for the year

Despite the favourable accounting ratios, GTEX incurred a loss in both the 2002 and 2003 financial years. The loss in nominal terms was greater in 2003 than what it was in 2002. In 2002, the loss amounted to R2 484 000 and in 2003 had deteriorated to R6 740 000. The significant loss was attributed to the steep decrease in net profit experienced by GTEX.

**Table 6: Net Cash Loss Net Loss before Depreciation (excluding all non-cash items)**

Description	2002	2003
	R'000	R'000
Net profit / (loss) before tax	(8,138)	(11,822)
Add: depreciation (non cash item)	5,654	5,082
<b>Net loss before depreciation</b>	<b>(2,484)</b>	<b>(6,740)</b>

#### 4.2.3.2 Summary of Purchases

While most expenditure items remained constant the external purchases increased by more than 100% in nominal terms between 2000 and 2003. Apart from that the only other purchase that stands out is the exchange loss that was experienced by GTEX in 2001.<sup>2</sup>

<sup>2</sup> Note: In accounting norms the R6, 7 million is in fact a gain and not a loss and the R1 million is in fact a loss. This is because purchases represents an expense item and therefore all exchange gains are recorded in brackets because they reduce the total expense and increase profits)

**Table 7: Summary of Purchases**

<b>Description</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>
	<b>R'000</b>	<b>R'000</b>	<b>R'000</b>	<b>R'000</b>
Exchange loss / (gain)	0	1,018	-6,735	0
External purchases	36,200	53,768	75,128	87,864
Internal business unit purchases	138	0	0	0
Inter-company purchases	806	0	0	0
Packaging, dyes & chemicals	18,148	16,075	18,396	18,302
Overheads in stock exchange	2,494	0	0	0
<b>Total Purchases</b>	<b>57,786</b>	<b>70,861</b>	<b>86,789</b>	<b>106,166</b>

**Table 8: Categories of Purchases Reflected as a Percentage of Total Purchases**

<b>Description</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>
	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>
Exchange loss / (gain)	0,00%	1,44%	(7,76%)	0,00%
External purchases	62,64%	75,88%	86,56%	82,76%
Internal business unit purchases	0,24%	0,00%	0,00%	0,00%
Inter-company purchases	1,39%	0,00%	0,00%	0,00%
Packaging, dyes & chemicals	31,41%	22,69%	21,20%	17,24%
Overheads in stock exchange	4,32%	0,00%	0,00%	0,00%
<b>Total Purchases</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

From the above we can see that external purchases as a percentage of total purchases increased from about 65% in 2000 to about 83% in 2003 which as stated above was one of the main causes for the decline in the Gross Profit on sales percentage and the increase in the Debt ratio during the same period.

#### **4.2.3.3 Summary of Operating Costs**

An analysis of the Operating Costs shows the main categories of operating costs. While labour costs, administration and selling expenses remained relatively steady, variable and fixed manufacturing overheads increased quite significantly since 2000.

**Table 9: Operating Costs**

<b>Description</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>
	<b>R'000</b>	<b>R'000</b>	<b>R'000</b>	<b>R'000</b>
Direct labour	20,784	21,271	22,292	21,982
Variable manufacturing overheads	22,350	25,072	30,643	32,394
Fixed manufacturing overheads	28,904	31,939	30,368	32,738
Admin expenses	7,604	7,498	8,534	8,513
Selling expenses	7,530	8,616	8,787	8,572
<b>Total Operating Costs</b>	<b>87,172</b>	<b>94,396</b>	<b>100,624</b>	<b>104,199</b>

#### 4.2.3.4 Operating costs as a percentage of Total Sales

Despite the GTEX experience of greater costs, efficiency has improved since 2000. From the table below it is clear that GTEX became much more efficient as the Sales to Operating Costs ratio increased from 1.72 in 2000 to 1.98 in 2003.

**Table 10: Operating Cost as a Percentage of Sales**

	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>
	<b>R'000</b>	<b>R'000</b>	<b>R'000</b>	<b>R'000</b>
Sales for the year	150,292	157,507	183,783	205,854
Operating costs incurred	87,172	94,396	100,624	104,199
<b>Percentage</b>	<b>58.00%</b>	<b>59.93%</b>	<b>54.75%</b>	<b>50.62%</b>
Sales to operating costs ratio	1.72	1.67	1.83	1.98

#### 4.2.3.5 Categories of Purchases and Expenses as a Percentage of Total Sales

**Table 11: Purchases and Expenses as a Percentage of Total Sales**

	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>
Exchange loss / (profit)	0,00%	0,65%	-3,66%	0,00%
External purchases	24,09%	34,14%	40,88%	42,68%
Inter business unit purchases	0,09%	0,00%	0,00%	0,00%
Inter-company purchases	0,54%	0,00%	0,00%	0,00%
Packaging, dyes & chemicals	12,08%	10,21%	10,01%	8,89%
Overheads in stock exchange	1,66%			
Comm proc charges	0,00%	0,00%	0,00%	0,00%
Direct labour – wages	13,83%	13,50%	12,13%	10,68%
Variable manufacturing overheads	14,87%	15,92%	16,67%	15,74%
Fixed manufacturing overheads	19,23%	20,28%	16,52%	15,90%
Admin selling expenses	5,06%	4,76%	4,64%	4,14%
Selling expenses	5,01%	5,47%	4,78%	4,16%
<b>Purchases and expenses as a % of sales</b>	<b>96,45%</b>	<b>104,92%</b>	<b>101,98%</b>	<b>102,19%</b>

Therefore, from 2001 to 2003 GTEX incurred losses as total Purchases and Expenses were in excess of total Sales

The main cause for the drastic increase in External purchases from 24,19% in 2000 to 42,68% in 2003 was the increase in Cotton prices. Standard Bank's commodity monitor indicates that Cotton prices increased by 43.75% for the period between December 2001 and December 2002 and increased by a further 32.95% for the period between December 2002 November 2003.

#### 4.2.3.6 Summary of GTEX's Salaries and Wages Expense

The main reason for the analysis on GTEX's salary and wage expenses is to ascertain if wages and salaries have been a contributing factor to the company's losses.

**Table 12: Direct Labour and Salary Expenses**

<b>Description</b>	<b>2002</b>	<b>2003</b>
	<b>R '000</b>	<b>R '000</b>
Direct labour	22,292	21,982
Salaries	21,305	22,363
Total	<b>43,597</b>	<b>44,345</b>

During the 2002 and 2003 period, total benefits increased from R1 286 000 to R1 441 000 respectively in nominal terms. But as a percentage of total operating costs, the employment bill and turnover there has been no substantial increase. The following table looks at benefits and direct labour cost as a percentage of the operating costs, total employment bill, operating costs and turnover.

**Table 13: Benefits and Direct Labour Costs as a Percentage of Costs and Benefits**

<b>Description</b>	<b>2002</b>	<b>2003</b>
Direct labour as a percentage of operating costs	22,15%	21,10%
Benefits as a percentage of total employment cost bill	2,95%	3,25%
Benefits as a percentage of operating costs	1,28%	1,38%
Benefits as a percentage of turnover	0,70%	0,70%
Benefits as a percentage of total employment cost bill	2,95%	3,25%

It can therefore be concluded that GTEX's salaries, wages and benefits are not the cause of its financial difficulties as the expenses are in line with market trends and are not excessive.

### 4.3 Drakenstein Municipality

A similar financial analysis was undertaken for Drakenstein Municipality to ascertain what impact a reduction in tariffs for GTEX will have on the financial position of the municipality.

#### 4.3.1 Ratio analysis

A ratio analysis was undertaken for Drakenstein to ascertain the municipality's profitability and liquidity.

**Table 14: Financial Ratios (2001-2003)**

<b>Indicator</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>
Current ratio	2,54	3,08	2,66
Quick ratio	2,37	2,92	2,50
Average collection period of accounts receivable	89,82	81,98	58,22
Total asset turnover	1,03	1,00	1,06
Debt ratio	33,14%	39,24%	40,30%
Interest coverage ratio	1,09	4,33	0,19
Net profit / (loss) before tax	986,520	32,714,111	-7,446,778
Accumulated funds at year end	9,640,117	42,354,228	34,907,450

**The Current Ratio** of the municipality is greater than the acceptable level of 2 which implies that the municipality is able to meet its short-term obligations quite comfortably. The current ratio steadily improved from 2,54 in 2001 to 2,66 in 2003.

**The Quick / Acid Test Ratio** - Based on the information from Table 14 the municipality is able to meet all its short-term obligations even if inventory is not sold. The municipality's quick ratio is well above the acceptable level of 1.

**The Total Asset Turnover Ratio** – For the period 2001 to 2003, the municipality just managed to generate R1 in Revenue for every R1 invested in Total Assets.

**The Debt Ratio** increased from 33% in 2001 to 40% in 2003 which means that the municipality's reliance on debt is increasing. Coupled with the increase in the debt ratio there has been a decrease in the **Interest Cover ratio** from 1.09 in 2001 to 0.19 in 2003 which means that as the municipality became more and more reliant on debt there were fewer profits to meet the increasing interest burden.

**Table 15: Net Profit for the Year Summary (2001 – 2003)**

	<b>2001</b>	<b>2002</b>	<b>2003</b>
	<b>R'000</b>	<b>R'000</b>	<b>R'000</b>
Net profit before adjustments	2 069	39	7 783
Prior year adjustments (Income/expenses)	(1 082 )	32 674	(15 230)
<b>Net Profit</b>	<b>987</b>	<b>32 714</b>	<b>7 447</b>

The audited financial statements of the municipality gives no detail of the prior year adjustments but only mentions that it relates to operating transactions. It is clear from the above that the prior year adjustments are the cause for the erratic increase and decrease in the Net Profit figure year on year.

### 4.3.2 Trend analysis of Key Performance Areas for DLM

#### 4.3.2.1 Summary of Income Categories

The main sources of the municipality's income and their respective contribution to revenue is given in the table below:

**Table 16: Sources of Municipal Income (2001-2003)**

Description	2001	2002	2003
	R'000	R'000	R'000
Community services - includes rates	67,194	72,813	90,774
Electricity	164,340	172,125	192,515
Water	31,069	37,620	42,766
Housing services	10,971	8,880	8,262
Sewerage	16,280	19,907	21,801
Cleansing	17,531	22,385	26,454
Saron Boerdery	8	0	0
Subsidiary services	8,429	9,719	8,606
<b>Total</b>	<b>315,823</b>	<b>343,450</b>	<b>391,178</b>

**Table 17: Sources of Municipal Income**

Description	2001	2002	2003
Community services - includes rates	21,28%	21,20%	23,21%
Electricity	52,04%	50,12%	49,21%
Water	9,84%	10,95%	10,93%
Housing services	3,47%	2,59%	2,11%
Sewerage	5,15%	5,80%	5,57%
Cleansing	5,55%	6,52%	6,76%
Saron Boerdery	0,00%	0,00%	0,00%
Subsidiary services	2,67%	2,83%	2,20%
	<b>100,00%</b>	<b>100,00%</b>	<b>100,00%</b>

It is clear from the above table that the main income sources for the Drakenstein Municipality is electricity together with community services which includes rates. Together, water and sewerage accounts for about 16% of the Drakenstein Municipality's income.

#### 4.3.3 GTEX utilities consumption as a percentage of total Municipal consumption

GTEX's total electricity, water and sewerage bill for 2001, 2002 and 2003 is given in the table below:

**Table 18: GTEX's Electricity, Water and Sewerage Expenditure**

	2001	2002	2003
	R'000	R'000	R'000
Electricity	7,227,259	7,623,408	8,029,715
Water	1,496,713	1,706,253	1,939,740
Sewerage	731,359	728,434	953,469
<b>Total</b>	<b>9,455,331</b>	<b>10,058,095</b>	<b>10,922,924</b>

**Table 19: GTEX's Consumption of Utilities as a % of Municipal Income**

	2001	2002	2003
GTEX's electricity consumption as a % of municipal electricity income	4.40%	4.43%	4.17%
GTEX's water consumption as a % of municipality water income	4.82%	4.54%	4.54%
GTEX's sewerage as a % of municipal sewerage income	4.49%	3.66%	4.37%

On average GTEX contributes roughly 4% of the municipality's electricity revenue, 5% of total water revenue and 4% of sewerage revenue. GTEX is therefore a very important consumer of municipal services in the area.

## 5 Interest and Criteria

It is one thing to assess the GTEX request purely on technical criteria based on the above analysis. It is quite another when the assessment has to take into consideration the impact that a reduction in tariffs is likely to have on wider society. The obvious danger in granting such a request is that it could set a precedent for other companies to follow suit whenever financial or other circumstances are believed to warrant it. One way of dealing with such a fall in revenue to the municipality that such a request entails is to balance the interest of a company like GTEX with the Public Interest. Since the decisions that a municipality takes should ultimately be in the public interest, it is useful to clarify the distinction between the two.

### 5.1 GTEX Interest

As a company engaged in production for profit, GTEX has to maximise the returns to its shareholders. In a highly competitive environment like the textile industry, the managers of GTEX are under constant pressure to reduce costs as far as possible. Its operating costs become a critical factor in its efforts to remain competitive, as does the cost of its inputs. Global forces of demand and supply determine the latter while the former is based on the domestic regulatory regime. As in most cases when firms become less competitive due to rising costs the labour force is usually the first casualty. For GTEX, then, the choice is one of shedding labour in order to remain in business or reducing other operating costs.

While preservation of jobs may not be a primary objective of GTEX, the employment it provides nevertheless benefits numerous households. This, in turn, is important to the local economy as this income flows into sectors of consumption goods and services and stimulates growth through the multiplier effect. The retrenchments that may follow from a cost cutting strategy may thus have a particularly severe impact on the local economy, especially at a time when the manufacturing sector is recording a decline in Paarl.

The productive capacity of GTEX in several processes of fabric production also means that the Company plays a vital role as a supplier of intermediary products to other manufacturers. In the clothing, upholstery and bed linen industries, where the linkages with GTEX are strongest, manufacturers would have to find alternative suppliers. Should these inputs be imported there is a possibility that it could fuel inflation (when the Rand depreciates) and add to a deficit of the current account.

## **5.2 Public Interest**

The Public Interest derives from concerns about protecting and promoting benefits that accrue to a defined community from either commercial or social activities. Governments at various levels, by virtue of being representatives of the electorate, are generally the chief custodians of the public interest. As such, one of their objectives is to seek to maximise the interests of the community by selectively intervening in policies and decisions that are deemed to have a social, political, economic or moral effect.

The criteria for public interest can be sourced from national policy frameworks and provincial, district or local governance practice. Broadly speaking these include the fiscal impact, direct and indirect employment impact and the social impact.

In the case of Drakenstein, the Public Interest can be more specifically articulated in terms of sustainable development such that the reduction in income inequality and poverty in the future becomes an overriding objective. Maximising revenue and generating or maintaining high levels of employment would thus form the cornerstones of the municipality's poverty alleviation strategy. Striking the balance between the two, however, is a much more difficult exercise. Since the loss of jobs is likely to lead to increased levels of poverty while a reduction in tariffs will result in lower revenue the municipality is faced with the dilemma of choosing an option that is least harmful to the public interest.

The main thrust of the public interest argument is that public sector fiscal decisions should enhance local economic development and reduce inequality. In this instance the technical analysis reveals that the loss of jobs will have a far greater negative impact on the local economy than the loss of revenue through reduced tariffs.

There is little to indicate that jobs lost now would be restored at some point in the future and so the loss to the local economy could be permanent. For this reason there is a compelling case to be made for the preservation of the manufacturing sector. It allows for the creation of a more diverse structure which, through backward and forward linkages, makes further employment a greater possibility than reliance on the primary sector.

### **5.3 The Financial Viability of the Municipality**

Any request for reduced tariffs has to be considered in terms of the effect it will have on the finances of the municipality. Our analysis therefore sketches several scenarios from which the municipality could choose and calculates the impact each will have on its finances.

In so far as the long-term strategy of the municipality is concerned a point to bear in mind is that while revenue may decline with the reduction of tariffs, this could be compensated for through a growth in manufacturing. The employment created thereby translates into less resources being required for welfare and poverty alleviation programmes. This underscores the need for policies that favour the expansion of the manufacturing base.

## **6 Evaluation of options**

### **6.1 Option 1: Maintain the Status Quo**

This option considers what would happen if the municipality was not to assist GTEX at this time. GTEX has argued that the situation it finds itself in is severe enough to threaten closure of the plant. This would even further reduce revenue for the municipality and add significantly to its burden of alleviating poverty and unemployment.

The following analysis shows the effect of these losses on major areas of the municipality's income and expenses. The economic costs to Drakenstein are divided into direct and indirect and total costs.

**Direct economic costs:** GTEX currently employs 470 people. If GTEX closes down this would mean that 470 high skilled, skilled and semi skilled jobs would be lost to the Municipality. The staff at GTEX currently earn salaries of approximately R44 000 000 per annum.

When procurement costs are added to this, the total costs to Drakenstein would be much more.

#### **Indirect economic costs**

If we assume that on average these 470 individuals save 25% of their income and that the turn around rate of the income that is spent on goods and services is

3 times<sup>3</sup>, then indirect costs are estimated to be around R99 million per annum<sup>4</sup>. The region will also lose additional jobs because many professionals and semi-skilled workers will no longer require the help of middle to low skilled occupations such as domestic workers, gardeners, shop attendants etc. If we assume a multiplier as high as 4, the indirect loss could be in the area of R132 million per annum.

### ***Total economic costs to Drakenstein***

The total amount of jobs lost in Drakenstein will be 470 to which must be added the indirect jobs that will be affected once the expenditure on goods and services begins to shrink. Not only will other jobs be shed but the closure of the plant also has the following implications:

- (i) It will impact on the GGP of the Municipality
- (ii) The Provincial savings rate.
- (iii) The decline in economic activity in the area, and exacerbate the current downward trend in the local economy.
- (iv) The demand for goods and services and hence an
- (v) Impact on SMME development

## **6.2 Option 2: Reduce Tariffs Unconditionally**

In this option the tariffs for each year from 2000 to 2003 are compared and the effects of a reduction are calculated on the profits of GTEX. The calculations cover two scenarios - one in current prices and one in constant prices. (Current prices reflect the prices that obtain in the year in question without being discounted by inflation. Constant prices use a base year and reflect the prices of the following years according to the annual rate of inflation.)

The following scenario considers the impact on GTEX and the Municipality if tariffs for water, effluent and electricity are reduced to 2000, 2001, 2002 and 2003 prices in nominal terms, assuming that current consumption patterns for services hold:

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<sup>3</sup> Turn around rates measures the amount of times every R1 circulates in the economy.

<sup>4</sup> Mehl. M. Using Connectivity to create wealth in poor communities. 2000.

In his paper Prof. Mehl states that different population groups have different turnover rates. The average turnover rate for the white population is 8 times and for the black communities it is 1 times. We have used a fairly conservative figure of 3 times.

**Table 20: Effect On GTEX If The Municipality Were To Charge GTEX 2000, 2001, 2002 And 2003 Tariffs In Current Prices**

	R'000	R'000	R'000	R'000
	2000 rates	2001 rates	2002 rates	2003 rates
Actual current prices incurred	11,883	11,883	11,883	11,883
Less: 2000 rates at current prices	-9,455			
Less: 2001 rates at current prices		-10,058		
Less: 2002 rates at current prices			-10,923	
Less: 2003 rates at current prices				-11,883
<b>Cash saving to GTEX</b>	<b>2427</b>	<b>1825</b>	<b>960</b>	<b>0</b>
GTEX's actual cash loss in 2003	-6740	-6740	-6740	-6740
<b>Adjusted loss after cash saving to GTEX is added</b>	<b>-4313</b>	<b>-4915</b>	<b>-5780</b>	<b>-6740</b>

If the Municipality chooses to use this method and reduces the tariffs to 2000 levels, it will bear a loss of R2, 427 million. GTEX, on the other hand, will reduce its cash loss from R6, 740 million to R4, 313 million.

**Table 21: Effect On GTEX If The Municipality Were To Charge GTEX 2000, 2001, 2002 And 2003 Tariffs In Constant Prices**

	R'000	R'000	R'000	R'000
	2000 rates	2001 rates	2002 rates	2003 rates
Actual current prices incurred	11,883	11,883	11,883	11,883
Less: 2000 rates at constant prices	-11,157			
Less: 2001 rates at constant prices		-11,366		
Less: 2002 rates at constant prices			-11,360	
Less: 2003 rates at constant prices				-11,883
<b>Cash saving</b>	<b>726</b>	<b>517</b>	<b>523</b>	<b>0</b>
Actual cash loss incurred	-6,740	-6,740	-6,740	-6,740
<b>Adjusted loss</b>	<b>-6,014</b>	<b>-6,223</b>	<b>-6,217</b>	<b>-6,740</b>

In contrast to the current prices method, this calculation shows that if tariffs were to be reduced to 2000 levels adjusting it to 2003 prices, then the cash saving to GTEX would be R726, 000 and will result in an adjusted loss of R6, 014 million.

The Municipality may also be guided by a comparison of GTEX's tariffs with those of its competitors that are located in other areas. The following shows similar consumption levels with actual tariff differentials between GTEX and HEXTEX, which operate out of Worcester. The differences in their bills are quite striking: for the same consumption of water GTEX pays R831 573 more than HEXTEX. For electricity it pays R1 786 358 more in unit costs and R1 075 784 more for KVA (electricity).

**Table 22: Comparison Of Hextex Tariffs To GTEX's Tariffs**

<b>HEXTEX</b>	<b>Water</b>	<b>Electricity</b>	<b>Electricity</b>
Rate	2.18	0.0829	39.4
Consumption	598 685	38 499 086	67 651
Bill	R1 305 134	R3 191 574	R2 665 444
<b>GTEX</b>			
Rate	2.569	0.1293	55.302
Consumption	598 685	38 499 086	67 651
Bill	R2 136 707	R4 977 932	R3 741 228
<b>Difference in bills</b>	<b>R831 573</b>	<b>R1 786 358</b>	<b>R1 075 784</b>

If GTEX were to be located in Worcester, it would be paying R3, 7 million less for water and electricity than it is currently paying. Such large differences in tariffs in adjoining municipalities suggest that a review of the tariff pricing policy of Drakenstein may be necessary for large-scale industrial users and should be part of a broader industrial promotion programme.

### **6.3 Option 3: Reduce Tariffs with Conditions**

The Municipality may have an obligation to assist a company like GTEX as and when it is in the public interest to do so. But it has an equal, if not greater, obligation to ensure that the revenue it earns is not jeopardised because it is so crucial to achieving the many social and economic objectives that have been identified in the IDP and LED strategies. Moreover, the Municipality cannot be seen to offer a subsidy to the private sector while ignoring the plight of the poor, especially if this were to set a precedent for other companies. One way of dealing with these opposing interests is to set conditions for reducing tariffs and in so doing, the Municipality might be able to fulfill both obligations.

The conditions can take several forms and will depend on the consensus that is reached by Council or other decision-making bodies. One option that can be explored is to treat the reduction in tariffs as an interest free loan payable over a 2 - 3 year period. This would allow GTEX some relief in so far as their operating

costs are concerned but still impose the obligation to pay, albeit on terms acceptable to them.

Another option would be to link the reduction in tariffs to an incentive scheme that could encourage GTEX to improve its performance. The DM would still recover the costs associated with supplying GTEX with services. Based on performance indicators agreed upon by both parties, portions of the loan can be discounted or even written off after a period of time as agreed upon by the two parties.

The loan can also be turned into an instrument of social development by converting part of the repayment into a bursary scheme for students seeking a career in textiles or a related field. Local economic development (LED) projects such as a community-sewing scheme and skills training could also be undertaken. These LED projects will form part of the broader LED objectives of the DM.

Other conditions that can be attached include the ceding of property as security against the amount of the tariff reduction. This would allow the Municipality to use the property either as a facility for training and skills development or the promotion of small business.

Another variant of this option is to offer to keep the reduced tariffs in place for a longer period in return for a clearly articulated business strategy that seeks to turn GTEX into a profit-making business again and addresses the present weaknesses in the company. A reduction in tariffs can also be linked to getting GTEX to reduce its interest burden, which is currently payable to Investec and Frame (its holding company), the holders of the debt. A prudent course to pursue with respect to these options is to request that targets be established, the achievement of which would lead to a continuous review of tariffs.

NOTE: The reduction in tariffs has to be approved by the National Electricity Regulator (NER). The approval can be facilitated by GTEX if it were to shift its production times to coincide with the cheaper tariff periods set by the NER. The DM should explore this option with GTEX in the discussions it holds prior to the submission to the NER as this could mean a more sympathetic response from the NER.

#### **6.4 Option 4: Negotiate a Moratorium on Payments**

This option would grant GTEX temporary relief by deferring payments to some date in the future. The Municipality would have to negotiate the amount to be deferred; the period involved and whether re-payments would be interest bearing. A major problem with this option is that it forces GTEX to accumulate additional debt, which could impose greater hardship on the company if its performance is not improved in the short term. The analysis above shows the extent of the debt that the company already has to service and this would add a

substantial amount to that burden. This would also mean that the Municipality exposes itself to higher risk than may be defensible and the loss that it suffers could seriously impair its work in other critical areas, especially relief to the poor.

## **7 Conclusion**

The problems facing local industries have an effect on the broader economic situation in Southern Africa. It is imperative that an integrated approach to dealing with issues of local industries in an environment of global competitiveness be developed. A presentation of the problems surrounding GTEX to the Provincial Government is essential, as this will inform the Provincial Government as well as National Government of the problems that confront industries like GTEX in South Africa. Imported and substitute textile products place great strain on many South African companies and threaten thousands of jobs. In circumstances of high unemployment, robust policies are required to address issues of interest rates, the exchange rate and trade policy on textiles. Until such time as these policies are addressed local industries will be unable to compete with foreign imports. The result can often have devastating consequences for small and medium sized municipalities like Drakenstein

In outlining the options above we have attempted to provide officials of Drakenstein Municipality with a basis for making a decision that would serve their long-term interests as well as that of GTEX. The revenues flowing to municipalities are crucial for implementing their local economic development programmes, especially the creation of employment opportunities. Any reduction in its financial resources is sure to threaten the municipality's capacity to effectively provide essential services to those who are unable to afford it. In the case of GTEX's request, however, these priorities have to be balanced against an event that could have far more serious repercussions if a satisfactory solution is not found. We believe that the analysis carried out in this report demonstrates that the Municipality has at its disposal a set of options that makes such a solution possible without harming the public interest.

