



**THE SUPREME COURT OF**

**AFRICA  
JUDGMENT**

**APPEAL OF SOUTH**

**Reportable**

Case no: 358/2018

In the matter between:

**UMGENI WATER**

**APPELLANT**

and

**SEMBCORP SIZA WATER (PTY) LTD**

**FIRST RESPONDENT**

**MINISTER OF WATER & SANITATION**

**SECOND RESPONDENT**

**ILEMBE DISTRICT MUNICIPALITY**

**THIRD RESPONDENT**

and

Case no: 497/2018

In the matter between:

**MINISTER OF WATER & SANITATION**

**APPELLANT**

and

**SEMBCORP SIZA WATER (PTY) LTD**

**FIRST RESPONDENT**

**UMGENI WATER**

**SECOND RESPONDENT**

**ILEMBE DISTRICT MUNICIPALITY**

**THIRD RESPONDENT**

**Neutral citation:** *Umgeni Water and Minister of Water & Sanitation and another v Sembcorp Siza Water (Pty) Ltd* (358/2018 & 497/2018) [2019] ZASCA 133 (30 September 2019)

**Coram:** Ponnann, Wallis, Dambuza and Mokgohloa JJA and Weiner AJA

**Heard:** 21 August 2019

**Delivered:** 30 September 2019

**Summary:** Setting of Water Tariffs in terms of the Water Services Act 108 of 1997 – differentiation between respondent and other purchasers of bulk water – tariff of 37,9% set for respondent as opposed to 7,8% for municipal customers – rationality of decision.

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## ORDER

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**On appeal from:** Kwazulu-Natal Division of the High Court, Pietermaritzburg (Mnguni J sitting as a court of first instance):

(a) The order of the high court is amended to read:

‘1 The decision of Umgeni Water on 12 November 2014 proposing to impose a tariff increase of 41,4 per cent on the cost of supply of bulk water to the Applicant for the financial year commencing on 1 July 2015 and the subsequent approval of a tariff increase of 37,9 per cent by the Minister is hereby reviewed and set aside.

2 Pending any further determination of tariffs for the supply of bulk water Siza is ordered to pay for bulk water supplied to it by Umgeni Water at the same tariff as that at which Umgeni Water supplies bulk water to all other water services providers.

3 Umgeni Water and the Minister are directed to pay the costs of this application jointly and severally, the one paying the other to be absolved, such costs to include the costs occasioned by the employment of two counsel.’

(b) The appeal is dismissed with costs, such costs to be paid jointly and severally by the appellants, the one paying, the other to be absolved and to include the costs consequent upon the employment of two counsel.

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## JUDGMENT

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### **Wallis JA and Weiner AJA (Ponnan, Dambuza and Mokgohloa JJA concurring)**

[1] The right of access to sufficient water is provided for in s 27(1)(b) of the Constitution. Section 27(2) of the Constitution requires '[t]he state to take reasonable legislative and other measures, within its available resources, to achieve the progressive realisation of each of these rights.' Umgeni Water, the first appellant, is a water board,<sup>1</sup> established in terms of s 28 of the Water Services Act 108 of 1997 (the Act). In terms of s 29 of the Act, its primary duty, as a bulk water provider, is 'to provide water services to other water services institutions within its service area.'<sup>2</sup> The municipalities receiving water from Umgeni Water are water services authorities,<sup>3</sup> which, in terms of s 19 of the Act, may perform the functions of a water services provider, or enter into a contract with another water services provider to provide such services.<sup>4</sup> The service area that Umgeni Water serves extends along the coast from the southern boundary of KwaZulu-Natal to the Tugela (or uThukela) River and inland to the boundaries of the uMgungundlovu District Municipality west of the city of Pietermaritzburg. It is the largest supplier of bulk water in the province.

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<sup>1</sup> A 'water board' is defined in s 1 of the Act as 'an organ of state established or regarded as having been established in terms of [the Act] to perform, as its primary activity, a public function'.

<sup>2</sup> 'Water services institutions' are defined in s 1 and include, inter alia, 'a water services authority', a 'water services provider' and a 'water board'.

<sup>3</sup> A 'water services authority' is defined in s 1 as any municipality, including a district or rural council as defined in the Local Government Transition Act 2009 of 1993, responsible for ensuring access to water services.

<sup>4</sup> A 'water services provider' is defined in s 1 of the Act as 'any person who provides water services to consumers'.

[2] The respondent, in these consolidated appeals, Sembcorp Siza Water (Pty) Ltd (Siza) is a water services provider within an area under the jurisdiction of the third respondent, the Ilembe District Municipality (Ilembe). It purchases bulk water from Umgeni Water. In the 2015/6 financial year, Umgeni Water, after obtaining approval from the second appellant, the Minister of Water and Sanitation (the Minister), imposed a tariff increase on bulk water supply of 37,9% for Siza, a private entity, as opposed to an increase of 7,8% for its other customers, all of which were municipalities.<sup>5</sup> This decision led to the review application in the high court. It held that there was no lawful basis for differentiating Siza from Umgeni Water's municipal customers and accordingly upheld the review and set aside the tariff increase applicable to Siza. The court *a quo* refused leave to appeal. This appeal is with the leave of this court.

### **The agreements**

[3] In terms of s 19 (1)(b)(1) of the Act, on 29 January 1999, the Dolphin Coast Transitional Local Municipality (DCLM), the predecessor to Ilembe, concluded a Water and Sanitation Concession agreement (the concession agreement) with Siza. The DCLM, as a water services authority, appointed Siza, a private entity, as a water services provider with the obligation to supply potable water and sanitation services to a portion of the DCLM's region (the concession area) for a period of 30 years. The concession area lies between the Tongaat River and the Umvoti River and incorporates the urban areas of Zimbali, Ballito, Umhlali, Shakas Kraal, Chakasrock, Salt Rock, Sheffield Beach and Tinley Manor. It also incorporates certain inland areas and informal settlement areas. Pursuant to the concession agreement DCLM assigned to Siza its rights under an existing Bulk Water Supply Agreement it had concluded with Umgeni Water.

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<sup>5</sup> The municipalities are eThekweni Municipality, Msunduzi Local Municipality, Ilembe District Municipality, the Ugu District Municipality, Harry Gwala District Municipality and uMgungundlovu District Municipality.

[4] The concession agreement contemplated that a new Bulk Water Supply Agreement (the BWSA) would be concluded between Umgeni Water, Siza and DCLM. On 7 August 2000, the BWSA was concluded. It provided for the manner in which Umgeni Water would supply Siza with bulk water to enable it to discharge its obligations under the concession agreement. After the restructuring of local government and the dissolution of DCLM, Ilembe succeeded to the rights and obligations of the DCLM in relation to both agreements. In terms of the BWSA, read with the Act and the Municipal Finance Management Act 56 of 2003 (the MFMA), Siza purchases its water from Umgeni Water at tariffs determined by Umgeni Water and approved by the Minister, and distributes this water to end users within the concession area. It does so in terms of a tariff determined initially by the DCLM and currently by Ilembe, under a provision in the concession agreement providing that: 'The determination, amendment and approval of all tariffs shall be undertaken exclusively by the COUNCIL in accordance to all prevailing Regulatory Provisions and the provisions of this Contract.'

[5] The concession agreement could only have been concluded after DCLM had, in terms of s 19(2) of the Act considered all known public sector water services providers which were willing and able to provide the services in the concession area. Thereafter, in terms of s 19(5) of the Act, the Minister was obliged to ensure, prior to the conclusion of the concession agreement, that water services were provided in an efficient, cost effective and sustainable manner and that the terms were fair and equitable to the water services authority, the water services provider and the consumer. Accordingly, it must be accepted that the terms of the concession agreement were approved by the Minister and that Siza was appointed as the most suitable water services provider in the concession area, notwithstanding the fact that it was a private entity.

[6] Ilembe has a duty to all consumers, or potential consumers, in its area of jurisdiction to ensure efficient, affordable, economical and suitable access to water services. Outside the concession area, Ilembe itself performs the function of a water services provider. It receives its bulk water supply from Umgeni Water at R5.41 per kilolitre, as opposed to the price of R6.98 per kilolitre that Umgeni Water has determined for Siza.

[7] There was some debate in the papers about the precise nature of Siza's role in terms of the concession agreement. Siza described it as a mandate. The high court described Siza's position as an 'in-line function'. Umgeni Water described it as a 'sui generis' relationship between Siza and Ilembe and the Minister described it as a statutory assignment. On appeal Siza contended that the court a quo correctly characterised its role, in that in terms of the concession agreement Siza performs statutory functions that would otherwise have to be performed by Ilembe. It referred to *Allpay Consolidated Investment Holdings (Pty) Ltd & others v Chief Executive Officer of the South African Social Security Agency & others (No 2)*<sup>6</sup> where the Constitutional Court held that when a private entity performs a public function, it steps into the shoes of the relevant organ of state.

[8] Umgeni Water accepted that when Siza distributes water, it acts as a 'municipality'. It stated that 'municipality', as read in s 42(1)(a) of the MFMA, included Siza or any person to whom the provision of a 'municipal service has been

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<sup>6</sup> *Allpay Consolidated Investment Holdings (Pty) Ltd & others v Chief Executive Officer of the South African Social Security Agency & others (No 2)* [2014] ZACC 12; 2014 (4) SA 179 (CC) paras 53-60.

outsourced'. Umgeni Water also admitted that the nature of the Concession Agreement 'is to assign all of [Ilembe's] rights and obligations to Siza'.

[9] This municipal function to distribute water within the Ilembe concession area would, but for Siza's involvement, be performed by Ilembe. The closeness of the link between Ilembe's constitutional and statutory obligations and those undertaken by Siza in terms of the concession agreement is demonstrated by the fact that in terms of clause 14.1 of the BWSA, read with clause 1.8 thereof, the DCLM (and now Ilembe) guaranteed Siza's obligations in terms of the BWSA. In terms of s 81(1) of the Local Government: Municipal Systems Act 32 of 2000, Ilembe remains responsible for ensuring that the service is provided to the community. Clause 14.2 of the BWSA provided that, in the event of the concession agreement terminating, the DCLM could be substituted in Siza's stead. All the rights and obligations of Siza would, in such event, be ceded and assigned to DCLM (and now to Ilembe).

[10] In our view, it is unnecessary definitively to characterise Siza's legal status. Ilembe elected to appoint Siza as the water services provider to discharge the duties, which it was obliged to perform. Siza is thus performing the identical functions to those that Ilembe would otherwise have to perform. If Siza stops supplying those water services, or the concession agreement is terminated, Ilembe (which is also the guarantor) must supply the end users with water it has obtained from Umgeni Water. In the result Siza is discharging a constitutional obligation resting upon Ilembe in the same manner and in terms of the same constitutional and statutory obligations as those resting on Ilembe. Its obligations are no different from those of the municipalities to which Umgeni Water supplies bulk water. It is

against this background that the lawfulness of the differential tariff imposed on Siza must be considered.

### **Determination of the tariffs**

[11] Clause 10.1 of the BWSA provides that 'Siza shall pay Umgeni Water for bulk water supplied in terms of this agreement, in accordance with the tariff determined by the board of Umgeni Water in terms of the Act as amended from time to time'. It also provides that Umgeni shall consult with Siza annually in regard to any adjustments to the tariff.

[12] The appellants relied for the determination of the tariffs upon the Act, the MFMA, the norms and standards prescribed by the Minister in terms of s 10(1) and 10(2)<sup>7</sup> of the Act and Umgeni Water's pricing policy. Section 34 of the Act<sup>8</sup>

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<sup>7</sup> Section 10 provides that—

'(1) The Minister may, with the concurrence of the Minister of Finance, from time to time prescribe norms and standards in respect of tariffs for water services.

(2) These norms and standards may—

(a) Differentiate on an equitable basis between—  
 (i) different users of water services;  
 (ii) different types of water services; and  
 (iii) different geographic areas, taking into account, among other factors, the socioeconomic and physical attributes of each area;  
 (b) place limitations on surplus profit;  
 (c) place limitations on the use of income generated by the recovery of charges; and  
 provide for tariffs to be used to promote or achieve water conservation'.

<sup>8</sup> Section 34(1) provides—

'In performing its activities, exercising its powers and carrying out its duties a water board must achieve a balance between—

(a) striving to provide efficient, reliable and sustainable water services;  
 (b) optimally using available resources;  
 (c) strive to be financially viable;  
 (d) promoting the efficiency of water services authorities;  
 (e) taking cognisance of the needs of water services institutions, consumers and users;  
 (f) taking into account national and provincial policies, objects and developments;  
 (g) acting in an equitable, transparent and fair manner;  
 (h) complying with health and environmental policies; and  
 (i) taking reasonable measures to promote water conservation and water demand

provides that, in exercising its powers and duties a water board must, in a fair and transparent manner, achieve a balance between, inter alia, striving to provide efficient, reliable and sustainable water services, financial viability, and the needs of water services institutions, consumers and users. Financial viability is defined in s 34(2) of the Act.<sup>9</sup>

[13] The Minister prescribed the norms and standards, in respect of the tariffs for the provision of bulk water services by promulgation in the Government Gazette No 39411 of 13 November 2015.<sup>10</sup> In terms of s 10(2) of the Act and Regulation 7(4), the norms and standards may differentiate ‘on an equitable basis’ between different users and different types of water services, and different ‘geographic areas, taking into account, inter alia, the socioeconomic and physical attributes of each area’.

[14] In 2014, in terms of s 34(1)(c) and s 34(2) of the Act, Umgeni Water adopted a Pricing Policy (the pricing policy) to ensure its financial viability, which provided for:

- (a) the pricing of section 29 bulk water supply services;<sup>11</sup>
- (b) the determination of the capital and operational costs of supply;<sup>12</sup>

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management, including promoting public awareness of these matters’.

<sup>9</sup> S 34(2) reads:

‘For the purpose of subsection 34(1)(c) a water board is financially viable if it is able to-

- (a) repay and service its debts;
- (b) recover its capital, operational and maintenance costs;
- (c) make reasonable provision for depreciation of assets;
- (d) recover the costs associated with the repayment of capital from revenues (including subsidies) over time; and
- (e) make reasonable provision for future capital requirements and expansion’.

<sup>10</sup> Norms and standards for setting water services tariffs, GN 1153 GG 39411 13 November 2015.

<sup>11</sup> Section 4 of the Pricing Policy

<sup>12</sup> Clause 26

- (c) the benchmark tariffs for each category of scheme;<sup>13</sup>
- (d) the extent of cross-subsidy per annum between schemes, or group of schemes, for any given set of tariff proposals.<sup>14</sup>
- (d) the smoothing over time of tariffs where the cash flows showed that there would need to be a significant increase in the tariff to meet Umgeni Water's financial targets.<sup>15</sup>

[15] Umgeni Water conducted the Annual Bulk Water Review (the annual review) for the years 2015/2016 in order to determine the bulk water supply tariffs for such period. In the "Document for Discussion" presented in the annual review, it was recommended that its municipal customers would be subject to an increase across the board of 8.2%, while the increase proposed for Siza was 41,4%. After engaging with Siza, which understandably objected to the proposed increase, Umgeni Water, recommended the same increase for the same reasons, in the final annual review submitted to the Minister for her approval. She reduced the increase for Siza to 37.9% and the increase for the other customers to 7,8%.

[16] The rationale for imposing a different tariff on Siza was described in the annual review document as follows:

'Siza Water draws its sales volumes from the North Coast Pipeline only. However based on a 8,3% tariff increase for 2016, the cross subsidy to Siza Water (who is not a municipal customer to UW), will be R1.534/kl. To reduce the cross subsidy to nil, the required tariff to Siza Water will be R6.552/kl. Therefore, the tariff increase will have to be 41,4% in 2016. Alternatively, the increase can be smoothed in (over the next five years).'

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<sup>13</sup> Clause 33

<sup>14</sup> Clause 40.

<sup>15</sup> Clause 42.

[17] In its letter to the Minister seeking approval for the increases, Umgeni Water said that, in order to break even,

*“Umgeni Water cannot continuously cross subsidize losses incurred in the water supply to Siza Water which is a private entity that continuously makes a profit on its water supply operation.”*

It went on to say in regard to Siza that:

*‘... as far as supply of water to Siza is concerned UW has to at least break even, since Siza Water [is a] private entity all the profits it makes from supplying water does not necessarily get ploughed back into service delivery in a similar manner as other municipal entities.’*

In the answering affidavit, the Chief Executive of Umgeni Water said that its ‘municipal public sector clients’ operate various water schemes, which make it possible for Umgeni Water to explore other avenues through which it can enable municipal customers to break even. This was not the case with Siza. In order to break even, Umgeni Water would no longer allow the ‘cross-subsidy’ which applied to Siza.

[18] In her affidavit, the Minister referred to the categorisation of entities into economic and social schemes. She stated that ‘cross-subsidisation’ is an on-going feature of water service provisions between economic and social schemes. She referred to the Hazelmere scheme (which supplies water to Siza, through the North Coast pipeline), as an economic scheme as opposed to a social scheme. Economic schemes are expected to achieve full cost recovery as opposed to social schemes, which are not. Only four out of the eight schemes operated by Umgeni Water are profitable. According to the appellants all the others, including Siza and Ilembe, require ‘cross-subsidisation’ as they ‘contribute to a major portion of the shortfall’.

[19] In summary, two reasons emerge from the above passages in the record.

The primary reason was that it was aimed at reducing to nil what was described as 'the cross-subsidy to Siza'. The secondary reason was that Siza was not a municipal customer. The review was properly directed at these two reasons. It is unnecessary therefore to differentiate between Umgeni Water and the Minister. At the hearing, counsel for the Minister informed us that the Minister had accepted the validity of Umgeni Water's reasoning without investigating its correctness. Accordingly she accepted that if Umgeni Water's decision on the tariff payable by Siza fell to be set aside, so did the Minister's decision.

[20] The appellants contended that the reason and the methodology used by it to determine the tariff increases and the outcome were lawful and rational and that the Minister, who is empowered to exercise oversight in respect of and approve the tariff increases, also interrogated the increase in respect of Siza and executed her functions properly in this regard. They submitted further that, in terms of the Act and the norms and standards, Umgeni Water was entitled to impose the water tariffs in a manner that differentiated between its customers. Siza did not take issue with this, but it argued that the proposed differentiation was irrational and unlawful, whereas the appellants contended that it was rational and lawful.

### **The law**

[21] Although Umgeni Water initially argued that this was purely a contractual matter, it accepted that because the tariffs had to be determined in accordance with the Act, the process was essentially statutory and subject to review as administrative action. Siza's review was based on the Promotion of Administrative Justice Act 3 of 2000 (PAJA). The appellants did not address this directly and approached it as a rationality review based on the principle of legality, where, generally speaking, the threshold for a successful review is high, and the decision

is protected from review as long as the means selected are rationally related to the objective sought to be achieved.<sup>16</sup> Siza's approach was correct. The decision was one of an administrative nature under an empowering provision taken by an organ of State, when exercising a public power in terms of legislation. It had a direct external legal effect and adversely affected the rights of Siza and Siza's customers. As such it was administrative action and it must be reviewed under PAJA.<sup>17</sup>

[22] In *National Energy Regulator of South Africa & another v PG Group (Pty) Limited & others*<sup>18</sup> Khampepe J in dealing with the test for rationality under PAJA said:

'The relevant question for rationality is whether the means (including the process of making a decision) are linked to the purpose or ends. . . .

It is a natural and inescapable denouement that the process leading to a decision 'must also be rational in that it must be rationally related to the achievement of the purpose for which the power is conferred'. As stated in *Democratic Alliance*:

"The means for achieving the purpose for which the power was conferred must include everything that is done to achieve the purpose. Not only the decision employed to achieve the purpose, but also everything done in the process of taking that decision, constitutes means towards the attainment of the purpose for which the power was conferred."

Additionally, in *Zuma* Navsa ADP stated that a rationality review also covers the process by which the decision is made. There is no reason why rationality under PAJA should be given a different (more restrictive) meaning. It follows that rationality under PAJA includes an assessment of whether the means (including everything done in the process of taking the decision) links to the end. Problems found in the process used to reach a decision can be very useful evidence or illustration of a faulty rational link. How far that evaluation of

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<sup>16</sup> *Albutt v Centre for the Study of Violence and Reconciliation & others* [2010] ZACC 4; 2010 (3) SA 293 (CC)(*Albutt*).

<sup>17</sup> *Minister of Defence v Xulu* [2018] ZASCA 65; 2018 (6) SA 460 (SCA) paras 47-50.

<sup>18</sup> *National Energy Regulator of South Africa & another v PG Group (Pty) Limited & others* [2019] ZACC 28 paras 48-50 (footnotes omitted).

process goes depends on the facts of a particular case.’

### **Were Umgeni Water’s reasons rational?**

[23] The reasoning of the appellants for differentiating between Siza and its other customers, was rejected by the high court as irrational and unlawful and in violation of s 6(2)(d), s 6(2)(e)(i), s 6(2)(f)(i), s 6(2)(f)(ii) and s 6(2)(h) and (i) of PAJA.<sup>19</sup> The High Court held—

‘As I see it, the hurdle besetting Umgeni Water and the Minister is that the water services contract between the applicant and Ilembe came about as a result of the decision of Ilembe in considering how best to serve its residents in the concession area and this arrangement is allowed by s 19 of the Act. It follows from this that once it is accepted (as I do) that the applicant performs an in line function in the delivery of bulk water from Umgeni Water to the Ilembe and to the water consumers of the concession area, the fact that the applicant is interposed in that chain of delivery is an irrelevant consideration in deciding on such increase and that cannot serve to justify the imposition of a different tariff by Umgeni Water. In my view, the fundamental tenet which lies at the heart of this application is that Ilembe as the guarantor of all debts owed by the applicant to Umgeni Water which is a committal of public funds and is only valid because the applicant has stepped into the shoes of the

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<sup>19</sup> Section 6(2), in relevant parts, reads—

‘ . . .

(d) the action was materially influenced by an error of law;

(e) the action was taken—

(i) for a reason not authorised by the empowering provision;

. . .

(f) the action itself—

(i) contravenes a law or is not authorised by the empowering provision; or

(ii) is not rationally connected to—

(aa) the purpose for which it was taken;

(bb) the purpose of the empowering provision;

(cc) the information before the administrator; or

(dd) the reasons given for it by the administrator;

. . .

(h) the exercise of the power or the performance of the function authorised by the empowering provision, in pursuance of which the administrative action was purportedly taken, is so unreasonable that no reasonable person could have so exercised the power or performed the function; or

(i) the action is otherwise unconstitutional or unlawful’.

Ilembe and acts as a public service provider instead of Ilembe to fulfil Ilembe's constitutional and statutory role as a water services provider within the concession areas which form part of its jurisdiction. In the circumstances it seems opportunistic on the part of the respondents to consider the applicant's identity as a commercial entity warranting an imposition of a different tariff from the municipal entities.<sup>20</sup>

[24] As set out above, the two reasons identified by Umgeni Water in its pricing review were to put an end to cross-subsidisation and the fact that Siza was not a municipality. Each will be dealt with in turn.

***Eliminating cross-subsidisation***

[25] It is apparent from the annual review that eThekweni (75%) and Msunduzi (15%) together account for 90 percent of the bulk water that Umgeni Water supplies. The reasons for this as set out in the review were twofold. Firstly, the cost of the infrastructure required to supply eThekweni and Msunduzi is lower than the cost of the infrastructure required to supply the more remote areas within Umgeni Water's jurisdiction. Secondly, the volume of water supplied is much greater in these areas, thereby greatly reducing both the average and the marginal cost of the supply. Only these two municipalities generate more revenue for Umgeni Water than they cost to operate and supply. The result is that the supplies of bulk water to eThekweni and Msunduzi generate profits for Umgeni Water, which offset the losses incurred in providing bulk water supplies to the rest of its supply area.

[26] This offsetting is what Umgeni Water describes as cross-subsidisation, which it explains in the answering affidavit as follows:

'In order to keep schemes with higher costs and low revenue afloat, Umgeni Water has

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<sup>20</sup> Judgment paras 43 to 44.

over the years had to rely on the fact that other municipalities make profits in their schemes in order to sustain Umgeni Water's sustainability'.

On its face this is a curious explanation. Whether a municipality makes a profit on its water supply schemes will depend on the tariffs it charges its customers. This is only indirectly relevant to Umgeni at the level of the likelihood of that municipality being able to pay Umgeni Water for bulk water supplied. Whether Umgeni Water's operations are sustainable will depend on whether the tariff it charges its customers generates sufficient revenue in total to cover its total cost of operations. The record demonstrates that this is the position. It appears that what Umgeni Water is trying to convey is that the two customers from which it generates the bulk of its revenues and profits, namely eThekweni and Msunduzi, could be charged a lower tariff for bulk water without such supplies being unprofitable for Umgeni Water, but that by generating profits on these supplies it is able to cover the losses it makes on supplying its remaining customers in more remote areas.

[27] The term 'cross-subsidisation' as explained by Umgeni Water is a misnomer as is apparent from dictionary definitions of the term. The Business Dictionary defines it as:

'A strategy where support for a product comes from the profits generated by another product.'

The Collins Dictionary of Business defines it as:

'the practice by firms of offering internal subsidies to certain products or departments within the firm financed from the profits generated by other products or departments.'

This is not the case here because Umgeni Water has only the one product – bulk water – that, until now, it has sold at a single standard price. It does not suggest that its wastewater activities subsidise bulk water prices, so there is no question of internal subsidies. The Cambridge Dictionary defines it as:

'a situation in which profits from one activity are used to pay for another activity that is losing money or making less money.'

Once again that is not the situation here because Umgeni Water has only the one activity. Lastly, the Shorter Oxford English Dictionary<sup>21</sup> gives the following definition of a cross-subsidy:

'the financing of losses arising from one business or activity out of profits from another, which may be deliberately increased for the purpose.'

When Umgeni Water speaks of cross-subsidisation therefore, it does not intend it to be understood in any conventional way, but merely as an indication that some supplies of bulk water generate profits and others losses, and the latter are offset by the former. It is in that special sense that we use it in what follows.

[28] Umgeni Water faces a dilemma. In the highly concentrated urban areas containing the cities of Durban and Pietermaritzburg it supplies water at a profit. This is so across the board, even though, within those areas of supply, there are social schemes where there is not a full recovery of costs. However, Umgeni Water is obliged to make provision for bulk water supply in the far larger areas outside those cities but within its service area. Because of their far greater area and far smaller populations, the average and marginal cost per customer in these areas is necessarily higher. Imposing tariffs to cover the full costs of supply in those areas would not necessarily be feasible, as they cover rural and poorer parts of the service area. The elimination of what it describes as cross-subsidisation would require it to increase tariffs to all these areas and reduce tariffs to eTehkweni and Msunduzi, but there is not the slightest indication that this is feasible or that Umgeni Water has any intention of doing it. Hitherto Umgeni Water has applied a uniform tariff across all areas of supply, which overall enables it to remain profitable and financially viable. The tariff increase imposed on Siza involved a departure from this policy.

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<sup>21</sup> Shorter Oxford English Dictionary 6ed, 2007.

[29] Umgeni Water sought to justify this departure in terms of its pricing policy. It said that Siza had not been singled out, but that it had adopted a transparent policy to remove cross-subsidisation and require every water services provider to break even with it, that is, to pay for its water operations costs across the board. The passage in the pricing policy relied on in support of this contention read:

**'21 Financial viability and sustainability**

Umgeni Water will "strive to be financially viable" which means it will seek as far as is practical to recover its costs from tariffs and fees (Water Services Act Section 34).

Umgeni Water will be financially sustainable by ensuring that its costs are fully recovered through tariffs and fees with defined fiscal support where services cannot be provided on a cost recovery basis. (*Note: This is consistent with DWA's Water Policy Position, August 2013.*)'

[30] The difficulty with this passage is that it does not support Umgeni Water's contentions. It does not deal with cross-subsidisation at all. It provides a model in terms of which, on an overall basis, from tariffs charged on all its supplies of bulk water, Umgeni Water will recover its costs, which is a statutory requirement. The second sentence shows that this is to be done with 'defined fiscal support', that is, financial subsidies from outside sources, where services cannot be provided on a cost recovery basis. Other provisions of the pricing policy are far more relevant to the issue of cross-subsidisation as understood by Umgeni Water.

[31] The passage from the policy quoted above in para 29 appears under the heading 'The calculation of scheme costs and benchmark tariffs – policies and guidelines'. Reading on demonstrates that this is not the process whereby actual tariffs are to be determined under the pricing policy. The following section is headed 'The calculation of revenue requirement and *an average bulk water tariff* – policies

and guidelines.’ (Emphasis added.) This section requires all revenues and costs from all activities to be determined ‘for the calculation of an average bulk water tariff’. These figures are then used in a cash flow model which determines the ‘necessary average tariffs to achieve target financial ratios and performance indicators’.

[32] The final relevant section from the policy follows on from the determination of these average tariffs and is headed ‘Making bulk water tariffs proposals to the board’. Under this section the chief financial officer makes tariff proposals to the board. In doing so the chief financial officer will have available the benchmark tariff for each scheme or group of schemes, which is a cost recovery tariff; the benchmark tariff for each category of schemes, namely, economic and social schemes; the average tariff required for Umgeni Water to achieve its financial targets and ‘the extent of cross-subsidy ... between schemes (or groups of schemes) for any given set of proposals.’ Nothing in this allows for differentiation between customers in this fixing of tariffs. The only distinction that is drawn is between economic schemes, where the aim is full recovery of costs, and social schemes, where full recovery is not possible. There will be cross-subsidisation (as Umgeni Water used that term) between these two classes of schemes.

[33] Finally, the policy deals with the determination of tariffs. It reads as follows: ‘The approved tariff (or tariffs for different categories or individual schemes) will therefore determine the extent of cross-subsidisation between schemes. While it is the responsibility of the board to make the final tariff decision, it is the responsibility of the CFO to propose the tariffs.

***41 Cross-subsidy parameters for utility-wide, category-based and/or scheme-based tariffs***

*The existing schemes will be at the uniformed bulk water tariff approved on an annual basis.*

For new schemes, where the affordable tariff is less than a *uniformed tariff*, the board must approve the level of cross-subsidy (expressed as a percentage of the tariff) that is an allowable cross-subsidy from existing schemes to the new economic and social schemes.'(Emphasis added)

[34] The contemplation therefore was that the process would lead to there being a uniform bulk water tariff and that this might be fixed at a level that would involve cross-subsidisation. This would be a general tariff. In addition there might also be scheme category-based tariffs or scheme tariffs relating to the only two types of scheme identified in the policy namely economic and social schemes. These had to be identified so that proper account could be taken of any grant funding or cross-subsidisation. Nowhere in the document is there any suggestion that one out of the seven bulk water customers who were water services providers would be singled out for separate treatment. There is a single reference to 'customer specific tariffs', but that appears to relate to supplies to commercial customers rather than water services providers. A single example of the supply of water to a large industrial concern, Sappi, is mentioned in the papers.

[35] Umgeni Water's contention that its differential treatment of Siza was in accordance with and justified by the pricing policy is not borne out by reference to the policy. In fact the contrary emerges, namely, that a uniform bulk tariff would be formulated applicable to all bulk water customers similarly situated. This would allow for cross-subsidisation of social schemes and maintain Umgeni Water's financial viability. The elimination of a uniform tariff for the principal purchasers of bulk water was not mentioned. Nor was the elimination of cross-subsidisation as between eTehkweni and Msunduzi, on the one hand, and Ugu District Municipality,

uMgungundlovu District Municipality, Ilembe District Municipality, Siza and Harry Gwala Municipality, on the other.

[36] Leaving the pricing policy on one side nothing else suggested that Umgeni Water had a goal of eliminating what it called cross-subsidisation. It fixed a uniform tariff for all its other bulk water customers. The annual review demonstrated that Ugu District Municipality, uMgungundlovu District Municipality, Ilembe District Municipality and Harry Gwala Municipality would continue to be supplied with bulk water at a price less than it cost Umgeni Water to supply it. The fact that Siza also supplies water to indigent communities was not taken into account.<sup>22</sup> There appears to be no reason why the other municipalities who operate at a loss were not treated in the same way as Siza. The claim that other municipalities operate 'a mix of profitable and unprofitable water and waste water treatment plants' that Umgeni Water can exploit on a management fee basis of cost plus a margin does not mean that the bulk water supply to them is any the more profitable. It simply provides Umgeni Water with an additional source of revenue. The confusion is apparent from statements in the answering affidavit that these schemes would 'enable municipal customers to break even' and that operating these schemes 'allows UW to make profits that will even out the losses incurred by loss-making schemes within each municipal customer'. These display a confusion of thought between the profitability of municipal operations and that of Umgeni Water.

[37] Nor do the actual figures demonstrate that charging a differential tariff to Siza would have a material beneficial effect on Umgeni Water's financial situation and contribute to the elimination of cross-subsidisation. The gross revenue earned

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<sup>22</sup> According to Siza's managing director more than 50% of Siza's consumers were estimated to fall into the indigent community, a figure not challenged by Umgeni Water.

by Umgeni Water in the year under review was R2.5 billion. Siza's consumption is 1,2% of the total consumption. On a simple mathematical calculation, the increased tariff applicable to Siza would result in, at best, R10 million in additional revenue, for Umgeni Water. The additional revenue and removal of the subsidy applicable only to Siza would not make any material difference to Umgeni Water's financial viability. Nor would it assist Umgeni Water in funding the bulk water supply to its other loss-making customers. There is no suggestion in the annual review that by increasing the tariff payable by Siza, the other municipalities' financial situation was affected at all. The non-profitable municipalities are still not profitable for Umgeni Water and it would seem, are not required to be. It is only Siza that is singled out on this basis.

[38] No provision in the empowering legislation justifies this type of discrimination between municipal and non-municipal water services providers, more particularly when they are both performing a municipal function. Penalising Siza for its ability to generate a profit through its efficiency would be irrational. Siza pays the revenue it collects on behalf of Ilembe into Ilembe's coffers. These fees and the tariff Siza charges are controlled by Ilembe. The rationale behind entering into a contract with a private water services provider under s 19(2) is that it will undertake the function of supplying water services more efficiently than the water services authority is able to do. There is no question of excessive profits being earned because the Minister is entitled to impose conditions concerning the overall profitability of the private water services provider.

[39] Siza is discharging a public function of Ilembe in a manner approved by the Minister as a carefully balanced arrangement including calculations as to the returns that would be received. Although s 34 provides the powers of Umgeni Water to set tariffs, in terms of s 19(5) of the Act, the Minister must ensure that the contract

that Ilembe has with Siza is fair and equitable to all parties. A change of tariff of the nature proposed by Umgeni Water cannot be seen as being fair to all parties, in particular Siza and the consumers. Siza does not have a free hand to increase its tariffs based upon the tariff approved by the Minister. It charges in accordance with the tariff laid down by Ilembe. Umgeni Water's first reason that the differential tariff was necessary to eliminate cross-subsidisation does not stand up to scrutiny. It is neither reasonable nor rational and proceeds on an incorrect factual premise. Furthermore there is nothing on the evidence to suggest that Umgeni Water is indeed endeavouring to eliminate cross-subsidisation in relation to the beneficiaries other than Siza. This casts doubt on the veracity of this reason and leads to a consideration of the other reason proffered by Umgeni Water.

***Siza is a private entity not a municipality***

[40] The record suggests that this reason lay at the heart of Umgeni Water's determination of a differential tariff for Siza as opposed to its municipal customers. It was a theme struck in every presentation leading up to the tariff determination. In considering the 8.3% tariff increase for 2016 the discussion document said:

'... the cross-subsidy to Siza Water (who is not a municipal customer to UW) will be R1.534/kl. Therefore the tariff increase will have to be 41.4% in 2016.'

The document did not discuss the cross-subsidy in relation to any other customer even though four others were, like Siza, supplied with bulk water at a loss. The ground for distinction lay in the fact that Siza was not a municipal customer. Why else did that statement appear in this quoted passage?

[41] This theme was sounded again in the customer consultation presentation dated 12 November 2014. In describing the pricing policy it read:

'The new pricing policy allows for a uniformed tariff increase to be applied to UW *current public sector customers* and a cost recovery tariff for the *private sector customers*.'

As demonstrated earlier the policy does not allow for that, but it is again significant

that the line of demarcation is drawn between public sector and private sector customers, which in reality meant differentiating between Siza and the rest.

[42] The purported justification carefully avoided dealing with the reason for this differentiation. It read:

- 'The Base Case Tariff will no longer allow a cross subsidy on price of Bulk Water granted to SemCorp Siza Water.
- Given the financial distress as a result of higher cost drivers and negative financial outlook which leads to the cost of capital being higher, UW will have to eliminate the cross subsidy previously enjoyed by Siza Water.
- In this manner UW will have the ability to increase the cross subsidy to the more indigent areas, as a service delivery vehicle of government of the day.
- Therefore the cost incurred in providing water to Siza will have to be recovered in full going forward, such that UW breaks even on the segment of supply to Siza.'

The first and last of these are mere assertions of a fixed position. The analysis in para 37 above demonstrates that the proposed 41.4% tariff increase for Siza would have no significant impact on Umgeni Water's financial viability, contrary to the statement in the second bullet point. As to the third, Umgeni Water had no intention of using the additional revenue from Siza to subsidise 'more indigent areas', conveniently overlooking the indigent areas served by Siza. The additional revenue generated thereby would, from Umgeni Water's perspective, be the figurative drop in the ocean. One is left with the bare fact that Siza was a private sector customer.

[43] When Siza engaged in correspondence with Umgeni Water over the proposed increase, the fact that it was from the private sector was highlighted. In a letter dated 8 January 2016 the Chief Financial Officer, who was responsible for preparing the proposed tariffs and presenting them to the board, explained that: Furthermore, the municipal customers are related parties to UW as part of the intergovernmental structure who operate to break even and not for profit, whereby any

margins made are ploughed back into the service delivery system. On that premise therefore, Umgeni Water strives to break even with Siza Water supply by achieving a break even tariff in the area of supply of Siza Water ...'

[44] Lastly in dealing with the correspondence there was the letter to the Minister seeking her approval of the increased tariffs the relevant portions of which are quoted in para 17 above. The theme of the letter is that Siza is a private company that makes profits, which are not ploughed back into the community 'in a similar manner as in other municipal entities'.

[45] The conclusion is inevitable that Umgeni Water drew a distinction between Siza and its other customers on the basis that Siza was a private sector company with a profit motive, while the municipalities were public entities that ploughed any surplus from the provision of water to consumers back into service delivery. Was this distinction valid? In our view, not.

[46] We have dealt in some detail, in paragraphs 3 to 10 above, with the precise role that Siza plays in the delivery of water services to customers within the concession area. In summary it performs exactly the same function as every other municipal customer purchasing bulk water from Umgeni Water. It is like them a water services provider subject to the same constitutional and statutory obligations as the municipalities. The fact that it is a private entity is irrelevant. It does not alter in any way its obligations in respect of the supply of water in fulfilment of the constitutional guarantee referred to at the outset of this judgment.

[47] The elephant in the room, that Umgeni Water sought studiously to avoid,

was the difference between its treatment of Ilembe and its treatment of Siza. Ilembe was treated in the same way as the other municipalities in respect of its own purchases of bulk water. Siza was discharging Ilembe's functions, constitutional and statutory, in the concession area, yet Umgeni Water was requiring it to do so on the basis that it should pay considerably more than Ilembe for its bulk water. Counsel conceded that if the concession agreement was terminated Umgeni Water would be obliged to supply bulk water to Ilembe in accordance with the tariff applicable to the municipal customers, at the tariff applied to Siza. We do not know how practically feasible it would be to extend or restrict the concession area by adding an additional area or excising part of it. However, if it were expanded, the included area would immediately pay for water at tariffs based on the special Siza tariff, while if it contracted the excised portion would pay for water at tariffs based on the lower municipal tariff. Imposing a higher tariff on Siza was potentially detrimental to Ilembe, which guaranteed Siza's obligations to Umgeni Water.

[48] One would have expected in these circumstances that Umgeni Water would provide a clear explanation for the difference in treatment between Ilembe and Siza. It did nothing of the sort. In the founding affidavit, after referring to some of the material set out above, the deponent said:

'The staggering price increase thus turns on SSW not being a municipal customer. That is an artificial and contrived distinction.'

The response to this very direct statement was as follows:

'I deny the allegations in this paragraph and reiterate that the increase is based *inter alia* on the operating costs associated with supplying the water. The unfortunate consequence for Siza is that it became financially unsustainable for UW to not impose a large increase despite it considering every other alternative and avoiding such increases in previous financial years.'

[49] The problem with this explanation was that Ilembe itself was in precisely the same situation as Siza. Umgeni Water supplied bulk water to it at a price that did not cover the costs of supply. In fact the principal source of that water was Hazelmere Dam, which was also the source of supply to Siza. Ilembe required nearly three times as much bulk water as Siza, and its cross-subsidy, according to Umgeni Water's own figures, was R3.874 per kilolitre as opposed to Siza's R0.599 per kilolitre. The cross-subsidy of both the Ugu District Municipality, which required twice as much bulk water, and the Harry Gwala municipality was greater than that of Siza. As already discussed, the contention that the differential tariff increase for Siza was necessary because it was 'financially unsustainable' for Umgeni Water to continue supplying water on the same basis as its other customers does not bear scrutiny. The proposition that Umgeni Water considered other alternatives to imposing a large tariff increase on Siza was not borne out by any document in the review record. That reflects that from the outset the approach was to impose a larger tariff increase on Siza than on other customers.

[50] Umgeni Water was therefore caught on the horns of a dilemma. When it sought to rely on an explanation based on eliminating cross-subsidisation it was unable to furnish any coherent explanation for treating Siza differently from Ilembe or the other municipalities that purchase bulk water from Umgeni Water at less than the cost of supplying them. When this led to the conclusion by Siza, accepted by the judge in the high court, that the true explanation was simply that Siza is a private entity not a municipality, it had no answer to the proposition that this was 'an artificial and contrived conclusion'. On either basis the reasons given by Umgeni Water in the pricing review document for seeking an increase in the tariff payable by Siza by 41.4%, as opposed to 8,2% for its other customers lacked any rational basis. They were founded on clear errors of fact and have unreasonable results. In consequence the tariff increase fell to be set aside in terms of ss 6(2)(e)(iii),

6(2)(f)(ii) and 6(h) of PAJA.

### **The management scheme argument**

[51] In its heads of argument, Umgeni Water relied upon a different rationale for the differentiation in tariffs. Counsel sought to establish that there was a material difference between Siza and the other municipal customers. The paragraphs relied on from the answering affidavit referred to a 'management scheme' and read as follows:

'[72] Of the six UW's municipal customers, four are unprofitable or loss-making, principally due to high costs coupled with lower revenues. They are uMgungundlovu, Ugu, Ilembe and Harry Gwala. Unlike Siza, these municipal customers operate and run a mix of profitable and non-profitable water and waste water treatment plants.

[73] Unlike Siza, these municipal customers operate and run a mix of profitable and non-profitable water and waste water treatment plants.

[74] In order to reduce the impact and the burden of losses occurred by UW in relation to bulk water supplied to the mostly rural municipalities and to enable those municipalities to break even, UW has proposed and concluded agreements for the appointment of UW to take over the operation and management for all bulk schemes including their water waste treatment plants on a management fee basis of a cost plus margin. This allows UW to make profits that will even out the losses incurred by loss making schemes within each municipal customer. A similar proposal was tendered to Ilembe, which it has yet to accept.

[75] This then explains why UW:

75.1 Manages Siza differently from its municipal customers.

75.2 Imposed a lower tariff on those municipal customers that imposed on Siza.'

[52] The appellants are however bound by the original reasons given for their decision. They cannot now rely upon the management scheme as a further reason

and engage in 'ex post facto rationalisation of a bad decision'.<sup>23</sup> According to Umgeni Water these agreements between municipalities and Umgeni Water were in place at the time that the annual review took place, although they have not been placed before us, nor have their terms been explained. The problem in seeking to rely on the 'management scheme' as the rationale for the increased tariff is that there is no reference to this 'management scheme' in the annual review and it was not relied upon in such review. Nor was it referred to in the customer presentation to Siza. There it was said that the differential tariff was based upon the need to eliminate cross-subsidisation and because Siza was a private entity.

[53] There was no explanation why, if these schemes were relevant, this did not appear either in the annual review or in the letter to the Minister asking for her approval of the revised tariffs. The Minister based her decision on the information supplied to her in the annual review. She did not consider or rely upon the management scheme. It was never canvassed with Siza at the consultation or in any correspondence. This apparent change in Umgeni Water's functions is not reflected in any of the figures presented in the annual review, which records that the municipalities, which it contended it has taken over in the management scheme, are still making losses, in amounts similar to those in previous years. It is clear from the annual review and the Minister's letter of approval that the tariffs were based on the material in the review document. As such, the rationale contained in the explanation of the new management scheme cannot be relied upon. The management scheme played no part in the decision.

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<sup>23</sup> *National Lotteries Board v South African Education and Environment Project* [2011] ZASCA 154; 2012 (4) SA 504 (SCA).

## Result

[54] The primary issue in this case was whether there was a rational basis for the differentiation in tariffs between Siza on the one hand, and Ilembe and the other municipalities on the other, when they were performing the same function and obtaining their bulk water from the same source. In order for there to be differentiation, there needed to be a rational basis therefor. None was produced. It seems reasonably clear that Siza was targeted because it is a private entity. There was no rational connection between the purpose for which the power to fix a tariff was conferred and the exercise of that discretion. The decisions fixing the tariff were correctly set aside by the court a quo.

[55] Counsel for the Minister urged us, if we concluded that the appeal fell to be dismissed, to remedy a *lacuna* in the high court's order. The problem was that the tariff increase payable by Siza was set aside, but no tariff increase was substituted for it. Counsel informed us that in practice Siza has been paying the same enhanced tariff as Umgeni Water's other customers. That was a sensible arrangement and all parties agreed that we should vary the high court's order to provide for it to continue until a fresh tariff determination is made.

[56] Accordingly the following order is made:

(a) The order of the high court is amended to read:

'1 The decision of Umgeni Water proposing to impose a tariff increase of 41,4 per cent on the cost of supply of bulk water to the Applicant on 12 November 2014 for the financial year commencing on 1 July 2015 and the subsequent approval of a tariff increase of 37,9 per cent by the Minister is hereby reviewed and set aside.

2 Pending any further determination of tariffs for the supply of bulk water Siza is ordered to pay for bulk water supplied to it by Umgeni Water at the same tariff

as that at which Umgeni Water supplies bulk water to all other water services providers.

3 Umgeni Water and the Minister are directed to pay the costs of this application jointly and severally, the one paying the other to be absolved, such costs to include the costs occasioned by the employment of two counsel.'

(b) The appeal is dismissed with costs, such costs to be paid jointly and severally by the appellants, the one paying, the other to be absolved and to include the costs consequent upon the employment of two counsel.

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M J D Wallis  
Judge of Appeal

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S E Weiner  
Acting Judge of Appeal

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