

Information statement on proposed transfer of MyCiTi buses

Issued in terms of the Municipal Asset Transfer Regulations.

27 August 2010

Preface

The accompanying information statement is required in terms of section 14 of the Municipal Finance Management Act and the Municipal Asset Transfer Regulations in terms of processes that must be followed in cases where the City wishes to transfer high value assets to a third party.

The information statement is structured so as to meet the information requirements as set out in relevant legislation. However, a description of the overall transaction that the City wishes to implement and the basis for following this path rather than other alternatives is set out in Annex B of the information statement.

For ease of understanding it is recommended that Annex B be read prior to reading the main body of this information statement.

This transaction forms one element of the Business Plan of the MyCiTi project. The full Business Plan is available on this website.

This information statement is closely linked to the information statement also available on this website entitled “**Information statement on proposed transactions to establish desired title holding and use of MyCiTi buses**”. The two statements have been issued separately because they seek to address different elements of applicable legislation.

Table of contents

Valuation of the asset	2
Reasons for the proposal to transfer the capital asset	2
Expected benefits to the municipality that may result from the transfer of the asset	3
Expected proceeds to be received by the municipality from the transfer of the asset	3
Expected gain or loss that will be realised or incurred by the municipality arising from the transfer of the asset	4
Annex A: Indicative values of MyCiTi Phase 1A initial fleet	
Annex B: Assessment of the options regarding ownership of buses	6
1. Objectives	6
2. The exceptional nature of Phase 1A	6
3. Important considerations relating to financial and tax impacts	6
4. The four options	7
5. Conclusion	11

Valuation of the asset

The City took delivery of the initial 43 MyCiTi vehicles during May and June 2010. It is envisaged that these 43 vehicles will be transferred around February 2011 when the MyCiTi starter service is due to commence.

When valuing the assets, account must be taken of the fact that the vehicles already purchased, although very new, will be used during the process of public consultation and thus will depreciate in value, and the vehicles not yet purchased must still be acquired through a tender process. Thus, the following information is provided in material compliance with the provisions of the Regulations:

- At the time of writing this report, these vehicles are between 1 and 2.5 months old, and have between 1 000 and 15 000 kms on their clocks. Barring very minor body damage to some, all are in excellent condition, other than one that was in a relatively serious accident and two that were in minor accidents. The vehicles that are damaged will be repaired through the insurer. The value of all these vehicles is estimated on average to be at least 90% of their purchase price.
- The exact value of the vehicles will be set at a date closer to the actual transfer. This will be based on the original price of the vehicle as stated above minus an estimation of depreciation determined by an independent valuer appointed by the City.
- It is envisaged that a further 267 vehicles will be transferred over the following three years as Phase 1A of MyCiTi is implemented. These vehicles are not planned to be used prior to transfer and thus are planned to be transferred at the same price at which they are purchased by the City in terms of the normal supply chain management processes.

The indicative value of MyCiTi Phase 1A initial fleet to be transferred is as set out in Annex A, which is subject to review.

Reasons for the proposal to transfer the capital asset

The City has considered a number of mechanisms through which ownership of the vehicles could best be arranged. These options and the reasons for adopting the proposed approach are set out in detail in Annexure C to the MyCiTi Business Plan as tabled in Council – see Annex B to this document.

In summary, the options to Council include:

- Option A: Transferring the vehicles to the MyCiTi vehicle operators at no charge in order that the vehicle operators provide the service;
- Option B: Selling the vehicles to the vehicle operators through an instalment sale agreement with conditions attached to the use of the vehicles;
- Option C: Retaining the vehicles and leasing them to the vehicle operators;

- Option D: Selling the vehicles to a financial institution, which in turn leases the vehicles to the vehicle operators. The City invests the proceeds of its sale with the financial institution and pays the vehicle operators out of the proceeds of the investment to enable the vehicle operators to lease the vehicles and so provide the public transport service (ie the model described in the main report).

There are four key reasons for adopting Option D, namely the option of transferring the vehicles to a financial institution which leases them to the vehicle operators.

Firstly, if the City transfers at no cost or sells the vehicles to the operators, by whatever mechanism, and the vehicle operators get into financial difficulty and are liquidated, the vehicles may be possessed by the liquidator and lost to the system.

Secondly, by selling the vehicles to a financial institution tax benefits are available arising from the depreciation of the vehicles; these are not available if the City retains ownership since the City is not a tax paying entity. The proposed transaction is designed so that the tax benefits accrue, in effect, to the MyCiTi system.

Thirdly, there are legal restrictions on the City itself entering into any instalment sales agreements.

Fourthly, the City is not experienced in instalment sales or in leasing out of vehicles, while this is part of the core business of many financial institutions.

Option A, the option of transferring the vehicles at no charge to the vehicle operators, is financially the most beneficial for the system as a whole, but carries the risk of possible loss of vehicles in cases of operator liquidation. Financial modelling has shown that Option D is the second most financially beneficial of the options and a further analysis that this option carries only minimal risks.

Expected benefits to the municipality that may result from the transfer of the asset

The key benefits from transferring the vehicles to a financial institution as envisaged include:

- Risk management benefits: Assuming the financial institution is financially sound the risk of the loss of vehicles to the system arising from liquidation of the owner is much lower than if the vehicles are owned by the vehicle operators.
- Financial benefits: Through this mechanism the financial institution is able to access tax advantages which can be passed on to the system as a whole. This lowers the financial cost and risk for the City.
- Administrative benefits: Instalment sales or leasing of vehicles is not a core business of the City and the City does not possess the appropriate capabilities for this, while such activity is the core business of many financial institutions.

Expected proceeds to be received by the municipality from the transfer of the asset

The proceeds to be received from the sale of assets will be, as indicated above, approximate the cost of the assets minus a reasonable amount arising from depreciation of the asset through use and age. The proceeds will be invested in the

financial institution that purchases the vehicles and leases them to the vehicle operators. Interest on the investment will accrue to the City.

Expected gain or loss that will be realised or incurred by the municipality arising from the transfer of the asset

The actual purchase price paid by the financial institution for the vehicles is not the only, or even the primary, determinant of the benefit or otherwise of this transaction.

Apart from the management of risk, the key benefit will be determined by the level of fees charged by the chosen financial institution and the extent to which the tax benefits are able to be captured by the MyCiTi system through these transactions.

Given that the transaction entails minimal risk for the financial institution, and that such institution will be identified through a competitive tender process, it is envisaged that the City should be able to realise considerable benefit from this transaction in comparison with other options.

Based on a set of reasonable assumptions, financial modelling has indicated that for every R100 million worth of vehicles that are sold to the financial institution and the proceeds invested in the financial institution, slightly in excess of R30 million will remain at the end of the 12 year period over which the vehicle leases will run. This is partly attributable to the benefits arising from the tax treatment possible in terms of this arrangement.

Indicative values of MyCiTi Phase 1A initial fleet (excl VAT)

Basic info		Numbers			Purchase price (excl VAT)		Estimated value (excl VAT)		
Service	Vehicle size	Total	Already delivered 'delivered fleet')	Balance to be procured	Unit price (estimate)	Delivered fleet: Total price	Delivered fleet, est value @ 90% of purchase price	Total est value, still to be procured	Total value
Feeder	8m	27	0	27	1 295 445			34 977 015	34 977 015
	12m	165	0	165	1 599 178			263 864 370	263 864 370
Trunk	12m (basic + airport)	87	35	52	1 599 178	55 971 230	50 374 107	83 157 256	133 531 363
	18m	31	8	23	2 825 065	22 600 520	20 340 468	64 976 495	85 316 963
	Total	310	43	267	-	78 571 750	70 714 575	446 975 136	517 689 711

Assessment of the options regarding ownership of buses

From the updated Business Plan submitted to Council in July 2010 (Annexure C).

1. Objectives

Four options relating to ownership of the vehicles in Phase 1A of *MyCITI* were considered, with the objective of optimizing across three key objectives namely:

- (a) To minimize costs to the system;
- (b) To ensure that the city is not exposed to the risk of losing buses which it has supplied at below cost to the vehicle operating companies; and
- (c) To incentivise the vehicle operating companies to maintain and run the vehicles as well as possible.

2. The exceptional nature of Phase 1A

In the standard Bus Rapid Transit model the system generates sufficient revenue from fares that vehicle operators can be paid a fee per kilometre which covers the vehicle operating costs and the capital charges on the vehicle while also offering a profit assuming normal efficiency levels. Under this system the vehicle operators purchase the vehicles from the vehicle manufacturers and pay for them on terms they negotiate.

But in Phase 1A the system does not generate sufficient revenue to do this. Modelling shows that fare revenues can cover the operating costs of the vehicles as well as a normal level of profit. But subsidies will be required from sources other than ticket sales to cover the remaining costs.

National government has agreed that the vehicles can be paid out of the Public Transport Infrastructure and Systems Grant (PTISG), and this has already been done in respect of the buses purchased so far.

3. Important considerations relating to financial and tax impacts

3.1. Direct and indirect benefits of the respective approaches

Different approaches to the financing of buses impose different costs on different stakeholders. The objective should be to minimize the overall costs of buses to the system. If a particular approach enables the vehicle operators to benefit from a tax advantage this enables the city to pay them less for the provision of the service. Thus while the direct benefit is to the vehicle operator the city benefits indirectly – depending on the extent to which the city is able to capture these benefits through the negotiation process.

Similarly, where a bank is involved in a manner where it is able to benefit from a tax advantage this could be used to reduce the costs of the system as a whole – again,

depending on the extent to which city is able to capture these benefits through a tendering or negotiation process.

3.2. Depreciation benefits for tax purposes

A key element in designing an optimum approach to ownership arises from the way depreciation is treated in the tax system.

Taxpayers can deduct the value of the depreciation of assets from their taxable income and so reduce the amount of tax they are liable for. The depreciation is based on the value by which the asset depreciated whilst used for business purposes. The value by which the asset depreciated is usually determined by reference to the cost of the acquisition of the asset; however where the asset was acquired by way of a donation the value of the asset used to determine the depreciation is the market value of the asset at the time the asset was acquired for business purposes. The period over which an asset can be depreciated is based on guidelines drawn up by SARS for different classes of assets.

Even if the *MyCiTi* vehicle operating companies are given the vehicles free they can deduct the full value of the vehicles from their income over four years, subject to agreement from SARS that a four year period is reasonable in these circumstances. Thus they can deduct 25% of the value of vehicles per year from their taxable income for four years. Since company tax is payable at 28% of taxable income this translates into a benefit worth 28% of the value of the vehicles.

If the vehicle operator companies are sold the vehicles at market price they will have to charge the city more for the service they are providing since they will have to cover the interest and capital redemption costs of the vehicles. The additional amount payable to them by the city will be taxable. The interest component of this additional amount can be deducted from their taxable income as an expense; however they cannot claim the capital component as an expense and also claim the depreciation benefit.

Thus under the scheme whereby the vehicles are donated to the vehicle operating companies less tax is payable overall than when they are sold to the companies and the payment to the companies for their services is concomitantly higher.

The tax depreciation benefit is not available if the buses are owned by the City since the City does not have taxable income against which to make the deduction. However, if they are owned by a profit making financial institution which leases the vehicles to a vehicle operator the tax depreciation benefit is available to the financial institution.

Note that were the City to create a municipal entity to run the IRT service, as originally envisaged, the vehicles could be donated to such an entity, which, because it is a tax paying entity, would be able to benefit from depreciation allowances. This would have led to more options than those considered below; however, since such an entity does not exist at this stage these options are not presented or discussed.

4. The four options

The four options that have been considered are:

Option A	The City of Cape Town pays for the vehicles out of the PTISG in Phase 1A and transfers ownership of the vehicles at the start of the contract at no charge to the vehicle operators (VO), but with a call option whereby ownership reverts to the City under specified circumstances
Option B	The City of Cape Town pays for the vehicles out of the PTISG in Phase 1A and sells the vehicles to the vehicle operators on an instalment sale (hire purchase) basis so that ownership transfers to the VO at the end of the 12 year contract. The City pays the VO an additional monthly amount (compared to Option A) and the VO pays this back to the City in order to pay the interest and redemption on the buses
Option C	The City of Cape Town, having purchased the vehicles with the PTISG, retains ownership of the vehicles and leases them to the operators
Option D	The City of Cape Town, having purchased the vehicles with the PTISG, sells the vehicles to a secure financial institution at market price. The proceeds of the sale are invested with the financial institution as collateral for the vehicles which are then leased by the financial institution to the vehicle operator. The City pays the vehicle operators on a monthly basis out of the collateral investment it has placed with the financial institution. The bank, as owner of the vehicles, is able to benefit from the allowance arising from the vehicle depreciation. To the extent that it can be ensured that this benefit is passed on to the VO, the City needs to pay only a reduced amount to the VOs to enable them to pay for the vehicle lease.

4.1. Option A

Initially Option A was preferred. Under Option A the vehicle operators own the vehicles and thus have an incentive to maintain and run them optimally. There is also a significant tax advantage in that even though the operators have not had to pay for the vehicles they can claim an allowance for depreciation based on the real value of the vehicles. This depreciation advantage accrues over the first four years of the contract and is equivalent to 28% of the value of the vehicles.

For every R100 million worth of vehicles donated in Phase 1A the VOs overall tax liability would be reduced by R7 million per year for four years – a total of R28 million.

This allows the City to pay a lower rate per km to the VOs than would otherwise be the case – a benefit which results in less operating subsidy requirement.

However, the concern with Option A is that if the VOs go bankrupt the vehicles will be lost to the City – unless the City buys them again from the liquidator.

Option A was thus rejected.

4.2. Option B

Option B was considered because an instalment sale (hire purchase) arrangement allows the City to register a bond over the vehicles. If the VOs go bankrupt the City can call in the bond and claim the vehicles.

Under this option the VO has to make an additional payment each month which was not required under Option A. That is the VO must pay the interest and capital on the

loan for the buses. This means the City in turn has to pay an additional amount each month to the VO (which the VO pays back to the city). This amount which the City pays to the VO is taxable.

The tax payable on this amount can be reduced. Firstly, the interest component of the amount the VO now pays the city in terms of the instalment sale agreement can be claimed as a business expense. Thus, effectively, there is no net tax payable as a result of the interest component of the grant the city makes to the VO for vehicle purchase.

Secondly, under an instalment sale agreement a depreciation benefit can still be claimed by the purchaser even though ownership only passes to the purchaser at the end of the hire purchase period (in this case 12 years).

This depreciation benefit offsets the tax liability on the capital component of the grant the City makes to the VO for vehicle purchase.

However in Option A this depreciation benefit was available to offset tax liability on other income. Under Option B it has been used up in offsetting an element of the grant the City makes to the VO for bus purchase – a grant not required under Option A.

The overall amount of tax payable by the VO is thus significantly more under Option B than under Option A. The difference is, in effect, equivalent to the tax payable on the capital component of the grant the city makes to the VO for bus purchase.

It is also possible that this option falls foul of the MFMA, which does not allow the City to make loans to the public. The City may have to be registered as a financial services provider in terms of the National Credit Act.

4.3. Option C

Under Option C the City retains ownership of the buses and leases them to the VOs. This lease can be at a low rate. And there is no danger that the vehicles are lost.

The VOs will not be able to claim a depreciation allowance, but will be able to claim a tax deduction for the full amount of the lease payments made to the City. As a non-taxpaying entity the city is not subject to tax on the lease income but is also not able to claim the depreciation allowance as an expense for tax purposes (since it has no tax liability that could be reduced).

Under this arrangement the City could (in terms of its standard depreciation procedures) choose to use the additional amounts payable by the VOs to build up a cash backed reserve to provide for the replacement of vehicles. However, it then has to find the money elsewhere to pay the VO to enable the VO to pay for the lease.

The V's do not have the same incentive as in the previous two options to maintain and run the vehicles optimally - although this might be mitigated if the vehicles are transferred free of charge to the VOs at the end of the 12 year period. If this is done the VOs will, however, then be subject to income tax in the tax year during which ownership of the vehicles passes to them. The amount to be taxed will be equal to the original cash cost of the vehicles less a depreciation allowance which is determined according to the diminishing balance method at a rate of 20% per annum of the cost of the vehicles for the full duration of the leases.

To implement this scheme the City of Cape Town may have to be registered as a financial services provider in terms of the National Credit Act.

4.4. Option D

Under Option D a financial institution such as a bank, as a tax paying entity – and owner of the vehicles – is able to reduce its own tax liability by the amount the vehicles depreciate. It should thus be able to pass the benefit of this on to the VO by charging a lower interest rate to the VO. This means that the amount the City needs to pay to the VOs to pay for the lease would be reduced.

Under this option the vehicles could be given to the VOs at the end of the 12-year period thus giving them an incentive to run and maintain them well. However, if so, the VOs will be subject to income tax in the tax year during which ownership of the vehicles passes to them.

As explained under Option C the amount to be taxed will be equal to the original cash cost of the vehicles less a depreciation allowance which is determined according to the diminishing balance method at a rate of 20% per annum of the cost of the vehicles for the full duration of the leases. Based on current tax law, the VOs will then be able to claim a depreciation allowance based on the real value of the vehicles at that time (which value may be negligible).

The bank is highly unlikely to go bankrupt – thus the potential loss of vehicles by this mechanism is minimized.

A drawback for the City under this option is that the bank will charge a fee for the service and the bank may be required to verify the credit worthiness of each VO before it enters into any agreement with the VOs. However, investigation has shown that this fee will be limited assuming, as indicated, the City stands behind the lease payments and uses the capital proceeds from the sale of the vehicles as collateral in respect of the vehicles.

4.5. Results from financial modelling of the options

Option A has been excluded because of the risk of loss of the vehicles in case of the vehicle operator going bankrupt. Were this to occur a substantial investment made out of the PTISG would be lost.

Of the remaining options Option D is the most advantageous financially. This is based on the full tax benefit from depreciation that accrues to the bank being passed on to the system in the form of reduced lease charges, while the bank is paid a market related fee for the service. It is estimated that, based on reasonable assumptions in respect of fees and interest rates, and assuming all payments to the vehicle operators for the purpose of paying the lease are made out of the collateral account established with the proceeds of the sale of the vehicles to the bank, at the end of the 12 year period an amount of approximately R32 million will remain in the account for every R100 million of the original price at which the vehicles are sold to the bank.

5. Conclusion

Taking into account all three objectives mentioned above Option D is the preferred option. While Option A is potentially the most advantageous financially, it carries intolerable risk in that the vehicles, which will have been paid for out of the PTISG, might be lost to the system in the event the vehicle operating company goes bankrupt.

Based on modelling undertaken, Option D is the next most advantageous financially. Other advantages include the fact that the leasing of assets, such as vehicles, is a core business of many financial institutions, while the City does not customarily lease or sell vehicles on an instalment sales basis. Indeed, it is possible that the sale of vehicles on an instalment sale basis would not be permitted in terms of the MFMA.

Introducing a financial institution in this manner enables such institutions to become familiar with the system while also allowing the vehicle operators to build up a track record for future transactions. This is likely to be beneficial in future phases when the preferred model is implemented, whereby the vehicle operators buy the vehicles out of the per kilometre fee.