

**OUTSOURCING BASIC
MUNICIPAL SERVICES:
POLICY, LEGISLATION AND
CONTRACTS**

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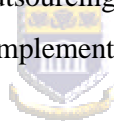
Abstract

Outsourcing basic municipal services: policy, legislation and contracts.

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Municipalities in South Africa are increasingly outsourcing municipal services, including basic municipal services such as water and sanitation services and refuse collection and disposal. The Constitution places onerous duties on municipalities to respect and promote human rights in the exercise of the powers and the performance of their functions. These duties are particularly prevalent when a municipality is deciding on the optimal service delivery mechanism for basic municipal services. It is thus crucial for the policy and legislative environment regarding municipal outsourcing to be firm and clear and for the municipality to ensure satisfactory implementation of outsourcing projects, including contract management.



The thesis examines the policy and legislative framework governing municipal outsourcing and describes the general features of a range of current South African outsourcing contracts. The analysis questions whether the policy and legislative framework are consistent in their objectives and assesses how these objectives are carried through and translated into the contract drafting and implementation phases of outsourcing.

The thesis makes recommendations as to how the regulatory environment can be improved to better facilitate outsourcing and in what respects the drafting and implementation of outsourcing contracts can be refined and enhanced.

Cape Town May 2005

Declaration

I declare that “Outsourcing basic municipal services: policy, legislation and contracts” is my own work, that it has not been submitted for any degree or examination in any other university and that all the sources I have used or quoted have been indicated and acknowledged by complete references.

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Date: 30 June 2005

Signed _____



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1 Chapter One: Introduction

1.1 Background

Over the last ten years the number of municipalities choosing to outsource essential services has increased markedly. The outsourcing ranges from effective “privatisation”, as in the case of long term concession contracts, to shorter term management or service contracts. An analysis of relevant government policy will reveal that this is a development that has been encouraged, if not driven, at a national government level. It also occurs within the context of an international trend, starting in the early 1990s, to regard outsourcing as a desirable alternative for public sector service delivery and infrastructure projects.

In South Africa, the impetus to investigate outsourcing options is given added weight as the country faces a significant municipal infrastructure backlog coupled with a lack of capacity and skills at the municipal level. Municipalities simply do not have access to sufficient public resources to meet the infrastructure needs of their communities, even for a basic level of service. Nor, primarily because of local government’s racially based history and the skewed allocation of resources, do many municipalities have the skills necessary to deliver the service even if sufficient capital were indeed available. The capital and skills backlog is thus an ever-present feature in any study regarding municipal service delivery. The introduction of private sector skills and resources naturally offer a potential solution to this problem.

Any study of the significance of the municipal resources and skills deficit on service delivery mechanisms cannot take place without understanding the new status of municipalities under South Africa’s Constitution¹. Whereas municipalities were previously merely a “function” of provincial government, under the Constitution they have undergone a fundamental transformation and are now an equal and autonomous “sphere” of government alongside national and

¹ The Constitution of the Republic of South Africa, Act 108 of 1996.

provincial government. Their new status has come hand in hand with onerous constitutional obligations, including the duty to deliver services, to ensure developmental local government and to realise socio-economic rights. Certain of these obligations derive directly from the Bill of Rights, the notable example being the right to water.

In summary then, municipalities face enormous challenges to ensure effective service delivery within a context of a lack of resources, lack of skills and weighty constitutional obligations. The trend to consider outsourcing as an appropriate service delivery mechanism, specifically the policy and legislative developments in this regard, have to be understood within this context.

1.2 Purpose, arguments and methodology of the thesis

1.2.1 Issues to be addressed

The thesis will attempt to arrive at an understanding of the policy and legislative regime governing municipal outsourcing and how this regime is being implemented in practice. In particular, the objective of the thesis is to seek an answer to two questions:

- does the legislation regulating outsourcing accurately reflect government's policy objectives?; and
- does the implementation of the legislation, specifically the contents and management of service delivery contracts, adequately translate these objectives into practice?

1.2.2 Significance of the issues

Why are these questions important? If one accepts that government's policy of encouraging municipalities to investigate alternative delivery mechanisms is correct and that outsourcing may indeed offer some solutions to municipal service delivery challenges, then it becomes critically important for legislation to adequately reflect this approach. If legislation does not translate these objectives into effective statutory provisions, then a door is closed on the ability and

flexibility of a municipality to consider all opportunities available to it to meet its obligations.

Similarly, if the implementation of the legislation by municipalities, evidenced primarily by the contents of their service delivery contracts and the management of those contracts, impedes or compromises the realisation of outsourcing objectives then the benefits outsourcing potentially offers may be lost.

Consideration also needs to be given to the risks associated with outsourcing. If the outsourcing contract is not carefully drafted these risks may not only nullify the whole purpose of outsourcing but may place the municipality at financial risk and, at worst, prejudice service delivery.

1.2.3 Argument presented

I will argue that:

- the new status of local government places significant constitutional obligations on municipalities to realise socio-economic rights and to ensure developmental local government;
- innovative solutions need to be found to address the significant infrastructure backlogs facing municipalities as well as their capacity and skills deficits. Outsourcing may, in appropriate circumstances, offer such solutions by the introduction of external expertise, financial resources and skills;
- government policy appears to favour outsourcing as a viable alternative service delivery mechanism for municipalities;
- current local government legislation does not adequately translate policy objectives into statutory provisions. In particular, instead of “encouraging” municipal outsourcing, the legislation appears intent on “discouraging” it. This is accomplished by a combination of particular statutory provisions placing obstacles in the way of outsourcing initiatives, together with a general statutory environment which almost guarantees

that outsourcing projects will be time-consuming, over-complicated, contradictory and expensive; and

- the actual implementation of outsourcing projects, specifically the provisions of existing outsourcing contracts and the management of contracts post-signature, reveal some shortcomings which potentially threaten the very objectives of outsourcing and could place the municipality and service delivery at risk. There is scope to improve the quality of service delivery contracts to better deal with key issues such as risk transfer, monitoring and skills transfer.

1.2.4 Methodology

I will use the following methodology in presenting the thesis. In this first chapter I will give a brief explanation of the wider context within which this study takes place. This will include a description of the new constitutional status and powers of municipalities and their resultant socio-economic and constitutional obligations followed by definitional issues, in particular, understanding what is meant by “outsourcing” for the purposes of the thesis.

In Chapter Two I will explore and analyse government policy on municipal outsourcing and in particular the policy approach government takes towards outsourcing, the benefits it sees as potentially being realised through this mechanism and what risks may need to be guarded against.

Chapter Three will analyse current municipal legislation on outsourcing and will compare and assess the efficacy of statutory provisions in meeting the policy objectives identified in Chapter Two. The statutory assessment will also identify what factors the legislation regards as driving outsourcing and what risks may be associated with the process. The statutory assessment reflects the law as at the time of the analysis, namely December 2004. The legislative environment has subsequently been supplemented by the promulgation, in April 2005, of regulations to the Local Government: Municipal Finance Management Act, 2003

(“the Finance Management Act”)². The new regulations deal with municipal public-private partnerships. The effect of these regulations on certain of the conclusions reached in the thesis will be dealt with in Chapter Nine.

Leading on from the analysis carried out in Chapters Two and Three, I will in Chapter Four compile a list of “drivers” and “dangers” associated with outsourcing. This list will thus briefly describe the perceived benefits, objectives and risks of outsourcing. I will compile the list primarily from the findings of the policy and legislative analysis, including any assumptions they may contain on the benefits or risks of outsourcing. The compilation of the list of “drivers” and “dangers” will thus not constitute a statement or finding on the merits or otherwise of outsourcing³.

Chapter Five will set the basis for the subsequent analysis of selected, current South African outsourcing contracts. In this chapter I will explain the methodology of the contract analysis, including a description of what categories of service provider are recognised in legislation and the types of contract which may be entered into. I will then briefly describe the nature and types of current contracts which were analysed as part of the study.

Chapter Six will cross-refer to the list of identified “drivers” and “dangers” and will assess how effectively or otherwise, actual South African contract provisions deal with them. I sourced a total of fifteen current contracts for this aspect of the thesis. The contract analysis will be a purely desk-top study and will thus not purport to constitute a comprehensive case study or comment on each contract nor a finding on the efficacy of implementation of any of the contract terms in reality. I will instead attempt to extract out and identify any common approaches in how contracts are being drafted, such as how they typically deal with “monitoring”, with “risk transfer” and so on.

² Act 56 of 2003.

³ No conceptual position is taken in the thesis on whether it is preferable to outsource essential municipal services or to perform them in-house.

The following chapter, Chapter Seven, will move on to the question of contract management post-signature and how various drivers and dangers are dealt with in practice. In this chapter I will place reliance on case studies and published material on selected South African outsourcing experiences. I will also evaluate how relevant contract terms are in the practical reality of contract implementation. This is in recognition of the fact that a well-drafted contract is only part, albeit a crucially important part, of the outsourcing picture. It may well be desirable to have a tightly binding contract, but the success of that contract could depend as much on the political will to implement and enforce it, as it will on the terms alone. In Chapter Seven I will therefore assess how closely practical reality on the ground meets the reality envisaged by the contract.

Chapter Eight will provide an overview of outsourcing internationally, particularly in the developing world. This chapter will assess whether global trends can potentially shed light on or influence the interpretation of the South African experience; alternatively whether international experiences may contain any warnings on risks associated with outsourcing.

Finally, in Chapter Nine I will summarise the conclusions reached in the thesis and will make certain recommendations based on those conclusions.

1.3 New status of municipalities

Before focusing on the subject matter of the thesis I will give a brief background on the new status of municipalities.

Local government has undergone a profound transformation over the last ten years since the advent of constitutional democracy in South Africa in 1994.

Historically, at local government level municipalities were race based and covered only urban nodes. As a result, many of the rural areas fell outside the jurisdiction of municipalities. Now, after a radical overhaul of local government, the previous scenario of race-based municipalities has been rationalised, in the year 2000, into six metropolitan municipalities, 47 district municipalities and 231 local municipalities. These new municipalities are now wall-to-wall across the country, bringing many

new communities and rural areas under the direct responsibility of local government.

The legislative framework has likewise changed fundamentally, with the promulgation of a whole suite of new legislation specifically focused on local government. The context within which municipalities deliver basic services, such as water, sanitation and waste removal, has therefore changed radically under the new Constitution. Historically municipalities were merely a “function” of provincial government – in other words their status was no more than any other “department” of provincial government. Now, however, municipalities form an autonomous and wholly separate sphere of government. This autonomy is both recognised and protected in the Constitution and is of sufficient force to enable local government to legally challenge the national or provincial sphere if that autonomy is threatened. Thus, municipalities have a constitutionally protected right to exercise executive authority over their functions without interference (except in certain clearly identified circumstances) from the national and provincial spheres of government⁴.



The functions over which municipalities exercise their executive authority are listed in Schedules 4B and 5B of the Constitution and cover a range of areas, from harbours, fire-fighting and markets to water, waste removal and health. In line with its new autonomy, local government has a wide discretion as to how it delivers these services.

Not surprisingly, the new and powerful status of local government has come hand in hand with equally significant constitutional duties, which are discussed below.

⁴ S 151(4) Constitution.

1.4 Constitutional context and socio-economic rights

Local government is bound by the Bill of Rights and thus has a duty to respect, protect, promote and fulfil the rights set out in the Bill of Rights⁵. Fulfilling these constitutional duties could take many forms, including “refraining” from doing something (e.g. *not* evicting someone from their home without a court order) to having a positive duty to act (e.g. supplying water and sanitation services – this being both a socio-economic right and an exclusive local government competence)⁶.

The upshot of this is that when performing its functions and exercising its powers, a municipality must be constantly mindful of its duties with regard to socio-economic rights. Regardless of which function it is performing, be it exercising its authority over amusement parks and beaches or removing waste, the municipality *must* ensure that the manner in which it performs these functions does not have an adverse affect on the respect, protection, promotion or fulfilment of any socio-economic right.



However, this duty is particularly prevalent when a municipality is delivering an essential service such as water and sanitation. This is because certain basic, or essential, services are by their very nature necessary pre-requisites for the enjoyment of a host of other rights. For example, if a person is denied access to adequate water, their enjoyment of most other human rights becomes almost irrelevant. As the White Paper on Local Government puts it:

Basic services enhance the quality of life of citizens, and increase their social and economic opportunities by promoting health and safety, facilitating access (to work, to education, to recreation) and stimulating new productive activities⁷.

If a municipality plans to outsource an essential service then it is clear, given this background context, that it must take extraordinary steps to ensure that it

⁵ S 7(2) Constitution.

⁶ Steytler et al (2003) pg 5.

⁷ Department of Provincial and Local Government (1998) par 2.

continues to fulfil its constitutional duties throughout the outsourcing process. The involvement of the private sector in the provision of basic services cannot and should not prejudice the community the municipality serves. The necessity for the municipality to act with extreme caution when outsourcing an essential service would therefore apply equally to the process of determining the appropriate service delivery mechanism, to selecting the best provider and, finally, to monitoring and reviewing performance under the service delivery agreement.

1.5 Defining outsourcing

1.5.1 Introduction

I will in the thesis analyse contract service arrangements with both private and public service providers. The term “privatizing”, apart from being politically loaded, is clearly too narrow a term for these purposes.

The legislation and policy documents make it clear that the use of external service providers may cover contractual arrangements ranging from, for example, a thirty year concession agreement to a three year management contract. Both the nature of the contract and the nature of the entity being contracted with may vary widely. Potential service providers recognized in the legislation range from community based organizations and municipal entities to totally private companies. The qualities and legal nature of these various service providers and different contracts will be discussed in more detail below.

1.5.2 Public-Private Partnership

What does “public-private partnership” (“PPP”) actually mean? This proves to be somewhat of an elusive concept, exacerbated by different people meaning different things when using the term. What does seem possible to say with some certainty is that it does *not* commonly mean the creation of a “partnership” in the legal sense, i.e. subject to a formal partnership agreement with all the legal consequences that flow from such an arrangement.

Given the historical opposition by the major union movements in South Africa to any form of “privatisation” one could interpret the use of the word “partnership”

when referring to the involvement of the private sector in municipal service delivery as an attempt to exclude this form of arrangement from “privatisation” generally. If this is correct, then this approach necessarily presumes that “privatisation” is restricted to incidences of wholesale transfer of a service and assets to the private sector. This type of narrow “privatisation” is effectively prohibited for basic municipal services⁸.

The 2000 White Paper⁹, which sets out a description of the typical forms of outsourcing contracts does not contain a specific category headed “public private partnerships”. However it refers to the various contract options under the generic term “municipal service partnerships”. If this approach were to be applied to all spheres of government, then “public-private partnership” presumably means all or any of the contract options, (including concession, lease management and service contracts) applicable at any level of government.

The primary piece of legislation dealing with outsourcing at a municipal level, the Local Government: Municipal Systems Act (“the Systems Act”), does not use the term “public-private partnership” at all¹⁰. In fact the Systems Act merely provides for the municipality contracting with an external entity. It makes no reference to the various forms that the contract may take (e.g. concession, lease, service contract etc).

However, rather confusingly, the Finance Management Act contains a whole section dedicated to “public -private partnerships”¹¹. It unfortunately does not define the term but, as this section of the Act specifically refers to the applicability of Chapter Eight of the Systems Act (being the chapter regulating outsourcing) it can be assumed that “public -private partnership” covers any of the various potential contractual arrangements between a municipality and the private sector.

⁸ S 14 Finance Management Act.

⁹ Department of Provincial and Local Government (2000).

¹⁰ Act No 32 of 2000.

¹¹ S 120.

What are the basic features of a PPP that may distinguish it from other contractual arrangements?

It has been suggested that PPPs display the following characteristics:

- they involve private sector participation in traditionally public sector investment projects;
- there is an emphasis on service provision as well as investment (i.e. it is not about investment alone);
- significant operational, financial and technical risk is transferred to the private sector; and
- there is some form of “co-operation between government and the private sector in the project”¹².

This last characteristic distinguishes a PPP from other arrangements such as privatisation, joint ventures or franchising. A PPP would therefore include mechanisms such as concessions and operating leases. Therefore, for the purposes of the thesis, the term “public-private partnership”, is taken to mean any one of a number of contractual options available between a municipality and the private sector, including concession and lease contracts and management and service contracts.

1.6 Power to choose service delivery options

Historically, how much scope did municipalities have in deciding which mechanisms were optimal for meeting its service delivery objectives?

There has in the past been little legislation regulating the determination of municipal service delivery mechanisms. Nor has there been any real attempt to prescribe procedures for a municipality to follow when determining appropriate external service delivery vehicles. The Promotion of Local Government Affairs

¹²IMF (2004) par 8.

Act¹³ granted municipalities the power to establish, or obtain an interest in, a company so long as either the main object or one of its objects was to perform a municipal function or service¹⁴. However, the municipality was required to systematically reduce its shareholding in the company over time.

The Local Government Transition Act¹⁵ authorized a municipality to contract with any outside party to exercise a municipal duty or power (with the exception of certain legislative powers such as raising levies or setting tariffs)¹⁶. These provisions have been repealed by the newly promulgated Finance Management Act.

The current legislative environment could not be more different. The procedures determining how a municipality decides on service delivery vehicles, selects particular providers and negotiates and enters into contracts have now become highly regulated, perhaps even overregulated. The primary source of all this regulation is found in Chapter Eight of the Systems Act but is also bolstered by provisions in the Finance Management Act and the Water Services Act¹⁷ (“the Water Services Act”).



What is behind this move to increased regulation over the outsourcing of municipal services?

¹³ Act No. 91 of 1983.

¹⁴ S 17D.

¹⁵ Act No. 209 of 1993.

¹⁶ S 10C(7)(a).

¹⁷ Act No. 108 of 1997.

2 Chapter Two: Policy

2.1 Introduction

The difficulties and challenges that exist in the field of municipal service delivery can be directly linked to South Africa's political past. As the White Paper on Local Government explained:

Under apartheid there was systematic under-investment in municipal infrastructure in black areas. This deprived millions of people of access to basic services, including water, sanitation, refuse collection and roads. Developmental local government has to address this backlog. Its central mandate is to develop service delivery capacity to meet the basic needs of communities¹⁸.

The extent of the backlog in municipal infrastructure and services was, in the year 2000, “conservatively” estimated as being in the region of R47 – 53 billion. Calculations showed that if this backlog was met using only public sector resources then “many communities will receive adequate services only in the year 2065...”¹⁹. Clearly a method of accelerating service delivery needed to be found and the use of private sector skills and resources was identified as a desirable option.

In other words, encouragement for the use of external service providers, be they public or private, seems a mix of both “push” and “pull” factors. The “push” factors arise either as a result of the lack of skills and/or lack of financial resources of particular municipalities (because of the historic lack of investment in the traditionally “black” areas). The “pull” factors are the stand-alone perceived merits of the outsourcing options, which exist regardless of the state of the municipality (e.g. running along business lines, separating authority from provider roles and so on). This is borne out by an international trend towards outsourcing in countries which do not have the same chequered history as South Africa and

¹⁸ Department of Provincial and Local Government. (1998), par 2.3.

¹⁹ Department of Provincial and Local Government. (2000), par 1.

whose municipalities therefore do not suffer the same skills and financial deficiencies. Thus, while local government was being transformed under the new constitutional dispensation and the time was ripe for the consideration of alternative service delivery strategies there was, simultaneously, an international trend encouraging the introduction of private sector skills and resources into the public arena.

Within the national and provincial spheres of government a sophisticated and comprehensive regulatory regime has been developed to facilitate and encourage the responsible investigation of public-private partnerships for both infrastructure and service delivery projects²⁰. Within the local government sphere, however, there is no equivalent to National Treasury's public-private partnership Manual and Standardised Provisions. Instead, policy on outsourcing has been developed outlining government's favourable approach to the consideration of outsourcing and this has been coupled with the promulgation of various pieces of legislation dealing, inter alia, with the necessary procedures a municipality must follow before it may consider outsourcing, the contents of service delivery agreements and the post-contract obligations of municipalities.

In the next section of the thesis I will describe and assess the two main policy documents which deal with municipal outsourcing, namely the White Paper on Local Government, 1998 and the White Paper on Municipal Service Partnerships, 2000.

2.2 White Paper on Local Government - 1998

2.2.1 Introduction

The first policy document in the new constitutional dispensation to deal with alternative municipal service delivery options is the 1998 White Paper on Local Government.

²⁰National Treasury (2004).

The White Paper takes a positive approach to outsourcing. Under, the heading “Choosing service delivery options” it is careful to point out that it does not specifically promote the private sector route over other internal options. It states that the choice of service delivery options should not be dictated simply by a preference for either “public” or “private” provision; the choice must be for whichever option, or combination of options would be most effective and appropriate for that particular municipality in meeting its objectives²¹. In other words, the White Paper is ostensibly neutral on *which* option is chosen, and is instead concerned with ensuring that new and innovative ways of delivering services are indeed investigated and that common risks inherent in the choice of certain options are avoided.

However, it is clear from the analysis below that the White Paper regards certain outsourcing options as possessing inherent benefits. It is therefore difficult to avoid the conclusion that it in fact encourages those options. This is enforced by government pronouncements on the issue at the time, such as that contained in a speech delivered by the then Executive Deputy President, Thabo Mbeki, which included the following commitment regarding PPPs:

Given both its limited fiscal resources, and international trends on good governance and efficient service delivery, let me emphasise once again that the government is committed to utilising public -private partnerships in the creation of social and physical infrastructure²².

The White Paper also notes the imminent launch of the Municipal Infrastructure Investment Unit (“the MIIU”) to advise municipalities on private sector investment in municipal infrastructure. This is a further indication of the commitment, at national policy level, to both capacitate and encourage municipalities to consider the involvement of the private sector in municipal service delivery.

²¹ Department of Provincial and Local Government. (1998), par 2.3.

²² Mbeki, Thabo (1998).

2.2.2 *Guiding principles*

The approach this White Paper takes is to start with a set of “guiding principles”, which are intended to assist municipalities in choosing the most appropriate service delivery mechanism for their communities²³. The guiding principles to be applied, in summary, are:

- accessibility of services (i.e. regardless of race, gender, disability etc);
- affordability (including pro-poor tariffs, appropriate service levels depending on economic sustainability and cross -subsidisation);
- quality of products and services;
- accountability (council must remain accountable);
- integrated development (i.e. poverty alleviation, job creation etc to be taken into account);
- sustainability (financial and environmental);
- value-for-money (i.e. both the cost of inputs and quality and value of outputs);
- ensuring and promoting competitiveness of local commerce and industry;
and
- promotion of democracy.



The White Paper highlights the need for a change in municipal service delivery, due to the overwhelming need to develop the social, economic and material circumstances of communities and to meet their basic needs. It therefore encourages municipalities to investigate new ways of delivering services in order

²³Department of Provincial and Local Government. (1998), par 2.1.

to meet this challenge, and in particular urges municipalities to consider outsourcing options.²⁴

2.2.3 *Outsourcing mechanisms*

The policy lists the various outsourcing mechanisms available for consideration (i.e. in addition to existing internal service delivery options), namely;

- corporatisation;
- public-public partnerships;
- partnerships with CBOs²⁵ and NGOs²⁶;
- contracting out (ranging from contracting out only specific aspects of a service to contracting out almost all aspects of the service);
- leases and concessions; and,
- transfers of ownership (privatization).



How does the policy describe the assumed benefits or “drivers” behind these various outsourcing options and what are the “dangers” associated with them?

2.2.4 *Corporatisation*

The White Paper includes both ringfenced “service units” and public utilities under this heading. As will be seen further on, in the Systems Act these concepts separate into two quite distinct service delivery options; the “business unit” (an internal service delivery option) and a “municipal entity” (an external and entirely separate entity, but controlled by the municipality)

²⁴Department of Provincial and Local Government. (1998), par 2.2.

²⁵Community based organisations.

²⁶Non-governmental organisations.

The White Paper argues that the benefits of this option are that it:

allows Council to set policy and service standards and hold the unit to account against those standards. It also offers greater autonomy and flexibility to the management of the service unit to introduce commercial management practices to the delivery system²⁷.

This shows a preference for the separation of the “service authority” and “service provider” roles and introduces a more “business-like” way of operating. The two underlying assumptions therefore appear to be that “flexibility” and a “commercial” management style are beneficial to service delivery and that the typical municipal way of operating tends not to exhibit these qualities.

What “dangers” does this White Paper identify as being associated with the corporatisation mode? Firstly, it makes the proviso that this option is better suited to municipalities with large areas of jurisdiction (for example, Metropolitan Councils), although it does not elaborate on why this would be the case²⁸.

Secondly, it highlights the importance of maintaining proper reporting and accountability mechanisms.



In summary then, this option is regarded as beneficial because of the advantages of separating the authority and provider roles and because the service can be run more along business lines and with more autonomy and flexibility. The danger is in ensuring that the municipality retains accountability and therefore proper reporting lines and accountability mechanisms are important pre-requisites.

2.2.5 Public-Public Partnerships

The benefit of this arrangement (which the White Paper does not describe in any great detail) is described as allowing “horizontal cooperation between municipalities to exploit economies of scale”²⁹. This concept evolved into Multi-jurisdictional Service Utilities in the Systems Act, which are service delivery

²⁷ Department of Provincial and Local Government. (1998), par 2.2.2.

²⁸ Department of Provincial and Local Government. (1998), par 2.2.2.

²⁹ Department of Provincial and Local Government. (1998), par 2.2.3.

entities established by agreement between two or more municipalities³⁰. Vertical cooperation (presumably with non-municipal, public sector bodies) will also “improve coordination at the point of delivery”³¹.

Both these concepts seem to presume a benefit of achieving greater operational efficiency and possibly, in the first instance, better value-for-money because of the municipalities taking advantage of economies of scale. A specific example of the Post Office potentially partnering with the municipality to perform revenue collection is given, again implying a gain of better efficiency when following this option³². The White Paper is, however, silent on any risks or dangers inherent in following this option.

2.2.6 Partnerships with CBO's and NGO's

The chief benefit in following this option is identified as the chance of “gaining access to external expertise and experience” and of stimulating local economic development³³. These organizations are regarded as potentially having capacity building skills and have an added advantage of being able to operate as effective intermediaries between the municipality and community because of their strong community base. Outsourcing can therefore potentially lead to a beneficial transfer of skills to the municipality and provide an effective service at the same time. As above, the White Paper does not elaborate on this option in great detail and does not identify any risks or dangers to be aware of when assessing the suitability of this option.

2.2.7 Contracting out

The prime benefit of contracting out, according to the 1998 White Paper is that this can “sometimes” offer economies of scale (i.e. offer better value-for-money) and “sometimes” provide better specialist expertise and experience than can be

³⁰ S 87 Systems Act.

³¹ Department of Provincial and Local Government. (1998), par 2.2.3.

³² Department of Provincial and Local Government. (1998), par 2.2.3 .

³³ Department of Provincial and Local Government. (1998), par 2.2.4.

offered by the municipality³⁴. In simple terms, this could be summed up as potentially offering the service “better and cheaper”. The White Paper is careful to say that this is only “sometimes” the case; it does not therefore make the underlying assumption that external service providers are necessarily always more efficient and better skilled. It warns, however, that where all, or most, aspects of the service are contracted out “the allocation of risk becomes a critical issue ...”³⁵. This is because, quite expectedly, the more risk a contractor takes on, the more compensation it will demand from the municipality. This could be either in the form of money or of added control and autonomy over the service.

An added danger area the White Paper identifies under the “contracting out” option is that of municipal capacity to manage the tendering, contract development and monitoring of the project. This option is most effective only if the municipality has the capacity to fulfil these functions and thus ensure that municipal objectives are met.

In summary then, the “driver” for contracting out would be because it could offer better value for money and superior expertise and skills. The important prerequisites are that the municipality ensures appropriate risk transfer (i.e. avoiding an unequal contract to the detriment of the municipality) and effective contract management and monitoring (i.e. ensuring, *inter alia*, that the municipality retains accountability).

2.2.8 Leases and Concessions

These are contracts most appropriate to municipalities where large-scale capital investment is required³⁶. As was noted above³⁷, public sector resources are simply insufficient to meet the significant municipal infrastructure backlog and alternative ways of accessing financial resources need to be explored. However, the White Paper warns against the inherent dangers of this option, saying that

³⁴ Department of Provincial and Local Government. (1998), par 2.2.5.

³⁵ Department of Provincial and Local Government. (1998), par 2.2.5.

³⁶ Department of Provincial and Local Government. (1998), par 2.2.6.

³⁷ See introduction to Chapter Two.

“...if poorly managed and structured, the risks of these partnerships are high...”³⁸. These potential risks are identified as³⁹:

- loss of accountability;
- prejudice to consumer rights;
- monopoly pricing;
- “cherry-picking” high-income users (to the detriment of the poor);
- poor quality services ; and
- unfair labour practices.

Because of the seriousness of these risks, the White Paper notes the need for national government to develop a regulatory framework for municipal public-private partnerships. It identifies the areas needing regulation as including, monitoring, oversight and consultative mechanisms, tendering and procurement processes, contractual arrangements, regulation of tariff setting and resolution of disputes⁴⁰.

2.2.9 Transfer of Ownership

This method of outsourcing entails the outright sale of municipal assets to the private sector together with all responsibility for management of the service. The White Paper notes that this is not an appropriate option for “core” (i.e. “basic”) municipal services, namely water, electricity and solid waste collection and disposal⁴¹. The reason for this is because of the fundamental importance of these services and the undesirability of losing ownership of the infrastructure and assets. This is presumably, though not expressly stated, because of the associated risk of loss of control when ownership passes to an external, non-public sector, entity.

³⁸ Department of Provincial and Local Government. (1998), par 2.2.6.

³⁹ Department of Provincial and Local Government. (1998), par 2.2.6.

⁴⁰ Department of Provincial and Local Government. (1998), par 2.2.6.

⁴¹ Department of Provincial and Local Government. (1998), par 2.2.7.

The underlying argument, therefore, is that the municipality should always retain ownership of assets associated with the delivery of basic services.

2.2.10 Conclusions on White Paper, 1998

The 1998 White Paper highlights the need for municipalities to change their approach to service delivery and specifically encourages municipalities to consider outsourcing as a potential service delivery mechanism.

Although purporting to remain neutral on whether internal municipal service delivery is preferable to outsourcing, the policy does contain various statements which reveal a positive approach to outsourcing and it describes many of the potential benefits outsourcing may offer. These include achieving a separation of provider and authority roles, a potential for greater efficiency, access to external skills and value for money. On the “danger” side, the White Paper warns of the importance of appropriate allocation of risk, the need for effective contract monitoring and the risk of a loss of accountability on the part of the municipality if service delivery is outsourced. For the longer term contracts, such as concessions or public-private partnerships, the White Paper stresses the importance for a strong regulatory framework to guard against the risks associated with such forms of contracting.

2.3 White Paper on Municipal Service Partnerships, 2000

2.3.1 Introduction

The White Paper on Local Government was followed, in 2000, by the White Paper on Municipal Service Partnerships⁴², which focuses exclusively on municipal service delivery options and builds on and refines the provisions of the previous White Paper. The overall stated objective of this policy is to ensure transparency and public participation, both in the process of determining service delivery mechanisms and in choosing specific service providers. It is also

⁴² Department of Provincial and Local Government (2000).

concerned with accessibility of services, progressive improvement in service standards, affordability and efficiency⁴³.

The Foreword of the policy document states that municipal service partnerships are “a key option that municipalities should consider in their efforts to rectify infrastructure deficits and disparities”⁴⁴. However, although encouraging the use of these partnerships, the policy document correctly notes that these options require a “clear and stable policy environment”⁴⁵. This is as much for the sake of the service providers and investors as it is for the municipality itself. It is this need for a firm and constant policy framework that the 2000 White Paper seeks to meet.

2.3.2 Benefits

What are the identified benefits of, or “drivers” for, outsourcing municipal services? The White Paper’s view of these drivers can be summed up as follows⁴⁶: outsourcing potentially offers greater efficiency in service delivery⁴⁷; access to specialist knowledge, expertise and skills the municipality otherwise would not have; the potential of lower costs to the municipality as a result of achieving economies of scale which otherwise would not be available; reducing certain operational costs, such as equipment rental and lease costs; getting better value for money as a result of the introduction of competition; greater certainty for budgets and planning as the municipality will know its costs in advance and will

⁴³ Department of Provincial and Local Government. (2000), par 1.

⁴⁴ Department of Provincial and Local Government. (2000), Foreword.

⁴⁵ Department of Provincial and Local Government. (2000), Foreword.

⁴⁶ Department of Provincial and Local Government. (2000), par 1.3.

⁴⁷ The assumption that use of an external service provider potentially leads to greater efficiency is not expanded on in the White Paper. It could be interpreted as meaning “efficiency” as a result of the service being run more along “business lines”. Alternatively it could be argued “efficiency” arises as a direct result of the presence of the other “drivers”, i.e. value-for-money, better expertise and skills and so on.

thus be better able to budget and plan ahead, and; social upliftment and/or economic development which will arise when partnering with CBO's or NGO's.⁴⁸

Again, as with the White Paper on Local Government, this policy document is careful to point out that outsourcing is not Government's "preferred" option for improving service delivery, it is merely one of many service options which should receive equal status⁴⁹. However, the underlying arguments and descriptions of the benefits outsourcing potentially offers certainly creates the impression of, if not a "preferred" option, certainly a highly desirable one.

2.3.3 Problem Areas

The 2000 White Paper identifies and describes a list of problem areas which need to be addressed if the objective of creating an enabling policy framework is to be met⁵⁰.

2.3.3.1 National and provincial intervention

Uncertainty as to the precise extent of the power of national and provincial government to intervene in the affairs of a municipality could be an inhibitor to the private sector's involvement in municipal service delivery. This would be relevant to issues such as tariff setting, which could naturally have a major impact in a service delivery agreement in that the service provider may require additional compensation to take on this risk.

2.3.3.2 Tariff setting and collection

The ability of municipalities to delegate tariff setting methodologies and tariff collection required clarification as this is crucial to lease and concession type contracts. Under the Local Government Transition Act it was unclear whether a

⁴⁸ Department of Provincial and Local Government. (2000), par 2.1.

⁴⁹ Department of Provincial and Local Government. (2000), par 2.1.

⁵⁰ Department of Provincial and Local Government. (2000), par 3.1.

municipality had the power to delegate tariff collection duties⁵¹. This led to some rather convoluted contractual arrangements to try and get around this problem.

2.3.3.3 Unclear Reporting Requirements

Unclear and fragmented reporting requirements (to various bodies under various pieces of legislation) could mean a municipality is confused on how exactly to ensure that reporting requirements are properly adhered to and thus that the legality of the public-private partnership is safe.

2.3.3.4 Guarantees

The authority of a municipality to provide guarantees and financial assurances to external service providers was very limited. Without this power a municipality could be restricted in its ability to structure an optimal financial arrangement with a service provider.

2.3.3.5 Multi-jurisdictional service areas

Without express legislative authority a municipality could not comfortably enter into an agreement with another municipality to jointly appoint an external service provider. The risk of such an arrangement being declared beyond the powers of a municipality and thus unlawful, would be a serious disincentive to a municipality when considering this option.

2.3.3.6 Procurement and Planning

Given the high risks associated with outsourcing, and the length and complexity of contractual arrangements, it was clear a more sophisticated planning and procurement process would be required. A municipality should consider its service delivery strategies as part of its Integrated Development Plan (“IDP”) process, which would then form part of its Municipal Infrastructure Investment Plan.

⁵¹ S 10C(7)(b), 10D and 10F Local Government Transition Act, 1993.

2.3.3.7 *Insolvency*

A real risk to an outsourcing contract is the insolvency of the service provider and thus the risk of service interruption. This is especially so as the legislation governing incorporated companies “tends to favour the liquidation of, rather than the reorganization of, insolvent enterprises”⁵². The White Paper therefore recommends that the service contract specifically provide for this scenario and put in place procedures to safeguard service delivery. This could be by granting “step-in” rights in accordance with a pre-arranged procedure.

In summary then, the above factors constitute a list of matters which need clarification and resolving in order to better facilitate the outsourcing option. It is not a list of the dangers or risks associated with outsourcing. In other words, it deals mainly with the problems in respect of the legal authority of the municipality to do certain things. However, certain of these listed matters or “problems” needing resolution, do contain an assumed, underlying “risk”. These can be summarized as the risk of adverse government action or intervention, the risk of inadequate procurement procedures and the risk of insolvency on the part of the service provider, which translates into the risk of possible service interruption.

In fact, this policy document does not deal in a systematic and methodical way with the risks inherent in each outsourcing option and leaves it instead for interpretation. For example, the policy notes that concession and lease agreements are the “most” risky types of outsourcing but does not elaborate in any detail what these risks are⁵³. Similarly, although the 1998 White Paper described certain of the risks associated with outsourcing options, it did not do so consistently or systematically. It could be argued, however, that the whole objective of the 2000 White Paper is to tighten up on the policy environment to “enable” and capacitate municipalities to follow the outsourcing option. In other words the 2000 policy is not intended to consider the risks and benefits of

⁵² Department of Provincial and Local Government. (2000), par 3.2.2.

⁵³ Department of Provincial and Local Government. (2000), par 4.3.

outsourcing *per se* and these issues would be more appropriately placed in the 1998 policy document.

2.3.4 Procurement process

The policy notes the need for feasibility plans when considering the desirability of an outsourcing contract, although these would vary in complexity depending on the nature and circumstances of each particular case. It then sets out different modes of procurement depending on the typical duration and monetary value of particular contracts⁵⁴. This, briefly, would involve a process of “formal competitive tendering” for longer-term contracts, “competitive negotiation” for medium-term contracts and “competitive solicitation” for short-term contracts⁵⁵. The White Paper also deals with the topics of public participation, corruption and material contract amendment and suggests that any corruption in the award or procurement processes of a particular contract should result in the contract being declared void *ab initio*⁵⁶. The importance of transparency in the procurement process is stressed, with the suggestion that tenderers, the community and other stakeholders be regularly informed regarding the procurement processes⁵⁷.

Finally, the problem of subsequent amendment or re-negotiation of the contract is highlighted, with the point being made that if the amendment or renegotiation results in a substantially changed contract, this defeats the whole purpose of the competitive bidding process⁵⁸. The White Paper suggests that a transparent and accountable amendment process be developed with a built in public participation process.

⁵⁴ Department of Provincial and Local Government. (2000), par 4.

⁵⁵ None of these provisions on procurement have found their way into the Systems Act, which instead has one formal competitive procurement process for all contracts regardless of duration or value.

⁵⁶ Department of Provincial and Local Government. (2000), par 4.9.

⁵⁷ Department of Provincial and Local Government. (2000), par 4.10.

⁵⁸ Department of Provincial and Local Government. (2000), par 4.11.

2.3.5 Conclusions on White Paper, 2000

The 2000 White Paper reveals a similar favourable approach to outsourcing as the 1998 White Paper did, going so far as to describe outsourcing as a “key option” to address the municipal infrastructure backlogs. This White Paper, however, focuses on what policy and legislative changes need to occur in order to facilitate outsourcing. An emphasis is placed on the importance of sophisticated procurement processes, including the need for feasibility studies.

During this process the 2000 White Paper describes the benefits outsourcing may offer, which include many of the factors described in the 1998 White Paper. These include the potential for greater efficiency, skills transfer, lower costs, value for money, certainty for budgets and social upliftment. It deals less with the risks associated with outsourcing but does place a strong emphasis on the importance of public participation and transparency in the process.

2.4 Policy conclusions



The policy documents outlined above show there is a real drive to urge municipalities to consider external service providers as potential partners in the delivery of municipal services. As pointed out above, although the policies are careful to state that no one service delivery option is preferred over another, one can find an implicit preference for external providers in certain instances.

In his Keynote Address at the launch of National Treasury’s Standardised Provisions in 2003, the Minister of Finance, Trevor Manuel, confirmed the government’s commitment to ensuring the success of public partnerships, saying, “We are serious about making public private partnerships work in South Africa. Deeply, profoundly, serious”⁵⁹.

However, government policy towards outsourcing within the local government sphere is not necessarily as straightforward as may appear in the policy documents. There appears to be some ambivalence in the stance towards the

⁵⁹ Manuel, Trevor (2003).

involvement of the private sector in municipal service delivery, perhaps hinting towards a deeper philosophical debate within government on the issue. In a recent budget speech the Minister for Provincial and Local Government, Sydney Mufamadi, delivered to the National Assembly, he stated that:

...the local government sphere should indeed become the provider-of-choice with regard to delivery of basic services. However, the limited capacity and resources of some municipalities are clearly an obstacle to action, whether in the areas of planning, budgeting and implementation⁶⁰.

This reveals perhaps a slight change of focus from that found in the policy documents; with in-house municipal service delivery, and not outsourcing, the clear preference for delivery of basic services. This shift in emphasis is certainly evident in the water and sanitation sector which explicitly prefers public service providers to private sector providers by statutorily obliging municipalities to first consider public sector providers before being allowed to consider the private sector⁶¹.



The caution shown for involving the private sector in water and sanitation service provision is seen again in a recent Department of Water Affairs and Forestry strategy document which, under the heading “Choosing water services providers”, begins with the warning that “Protecting consumer interests must be the key consideration when water services authorities consider how water and sanitation services should be provided.” It goes on to clarify that “The provision of water services by public institutions is preferred”⁶². That said, the participation of private players in the water sector is certainly not unwelcome. As Minister Ronnie Kasrils recently stated:

While privatization is an emotional and very much political issue in South Africa, the private sector has played and will continue to play an important role in water services. The challenges facing us are simply too big to be addressed by

⁶⁰ Mufamadi, FS. (2004).

⁶¹ S 19(2), Water Services Act.

⁶² Department of Water Affairs and Forestry. (2003). pg16.

government alone. We will, however, not sell our public water services infrastructure to the private sector but this is no obstacle to the private sector getting involved in a whole range of activities”⁶³.

Having outlined the policy approach to outsourcing and what it regards as the potential benefits and risks associated with this method of service delivery, it is necessary to establish whether the substance of the policy has been effectively translated into the legislative framework.



⁶³ Department of Water Affairs and Forestry (2003). Kasrils, R. Address to the African Investment Forum, April 2003. Quoted in Strategic Framework for Water Services (2003), pg19.

3 Chapter Three: Legislative framework

3.1 Overview of legislation

3.1.1 Introduction

Following the publication of the two White Papers described above, two Acts were passed which deal directly with the matter of outsourcing of municipal services and clearly attempt to address problems and meet the objectives raised in the policy documents. The two pieces of legislation are the Systems Act and the Finance Management Act. A significant revision of the Systems Act occurred with the promulgation of the Local Government: Municipal Systems Amendment Act, 2003⁶⁴. The amendments contained in this Act included revisions to the procedures and legislative context governing outsourcing.

Other, pre-existing legislation pertinent to outsourcing are the Constitution and the Water Services Act. The Constitution lays down the overall framework within which service delivery will take place and the Water Services Act contains sector-specific provisions relating to the outsourcing of water and sanitation services.

The primary legislative provisions regulating the outsourcing of municipal services are contained in Chapter Eight of the Systems Act, under the heading “Municipal Services.” This Chapter covers a range of topics, including tariff policies and by-laws, overall duties when providing municipal services, criteria and procedures for the assessment and choice of service delivery mechanisms, service delivery agreements, municipal entities and multi-jurisdictional service utilities. The Systems Amendment Act introduced further refinements to the outsourcing procedures, including detailed and comprehensive provisions on the requirements of feasibility studies. The Finance Management Act sets the legislative framework regulating municipal financial administration, budgeting, asset management, supply chain management and public-private partnerships. It contains provisions regulating the circumstance under which municipalities can

⁶⁴ Act No 44 of 2003.

enter into longer term contracts, provisions on contract management and monitoring and protection of assets.

3.1.2 Provision of municipal services

3.1.2.1 Definition of municipal service

Before analysing the legislation it is necessary to first clarify what is meant by the term “municipal services”? And, following on from that, what does a “basic municipal service” mean? This is important as the primary provisions regulating municipal outsourcing apply only to “municipal services”. By implication then, “non-municipal services” would enjoy far more flexibility (and less regulation) if outsourcing of that service were being considered.

As previously stated, municipalities have authority over a wide range of constitutionally mandated functions ranging from dog licensing, billboards and cemeteries to the ‘classic’ services of water, waste removal and electricity. The Constitution does not define “municipal service”. Given that the Systems Act contains a host of provisions regulating “municipal services” the question naturally arises whether all, or only some, of these functions are “municipal services” for the purposes of the Act. For example, ones knows quite instinctively that a service such as refuse collection falls within the definition of a municipal service, but does the same apply to, for example, “amusement facilities” and “pontoons”?

The term “municipal service” has recently been legislatively defined by way of an amendment to the Systems Act⁶⁵. Previously the Systems Act contained no definition of municipal service. The insertion of a definition in 2002 followed close on the heels of a Cape Town court case which interpreted “municipal service” very restrictively and limited it to meaning a service for which a charge is levied or is capable of being levied against an identifiable end user⁶⁶. On appeal

⁶⁵ S 35 Local Government Laws Amendment Act, 2002.

⁶⁶ South African Municipal Workers Union v City of Cape Town and others 2002 (10) BCLR 1083.

the Supreme Court of Appeal in 2003⁶⁷ rejected such a limited definition of municipal service, but by that time the new definition had been inserted

The Systems Act now defines a “municipal service” as a service a municipality provides “to or for the benefit of the local community” and irrespective both of whether it delivers the service itself or externally and of whether fees, tariffs or charges are levied for the service⁶⁸. Unfortunately, this definition does not really take the matter much further and still does not make it clear if any of the Constitutionally listed 4B and 5B functions are excluded from the definition and thus from the ambit of the Systems Act.

Fortunately, the definition of “basic service” is far narrower and clearly applies to only a few municipal functions. A basic service is defined in the Systems Act as a “municipal service that is necessary to ensure an acceptable and reasonable quality of life and, if not provided, would endanger public health or safety or the environment”⁶⁹.

It is clear therefore that services such as potable water supply, sanitation and waste removal do indeed fall within the ambit of the Systems Act and specifically Chapter Eight, which deals with service delivery and outsourcing of services. Whether electricity supply is also a “basic service” for the purposes of the Act is not as readily ascertained. One could certainly argue that provision of electricity is necessary to ensure an “acceptable and reasonable” quality of life but whether it would comply with the additional definitional criteria of endangering public health, safety or the environment if it were not provided is not as easily answered. However, on the basis that common alternatives to the use of electricity, namely wood fires, use of paraffin and the like can certainly pose a danger to health, safety and the environment, for the purposes of the thesis electricity provision is included within the ambit of a “basic service”.

⁶⁷ South African Municipal Workers Union v City of Cape Town and others 2003 (4) All SA 348 (SCA).

⁶⁸ S 1 Systems Act.

⁶⁹ S 1 Systems Act.

3.1.2.2 *Duty to provide municipal service*

In recognition of the constitutional obligations placed on municipalities, specifically in relation to service delivery and developmental local government, the Systems Act chapter⁷⁰ on municipal services commences by placing an explicit and far-reaching “general duty” on municipalities to deliver services. In some respects this general duty merely repeats the existing constitutional obligations of the municipality. However, in other respects it places further, quite onerous, obligations on municipalities.

One of the constitutional “objects” of local government is to “ensure the provision of services to communities in a sustainable manner”⁷¹. A municipality must “strive” to achieve this object within its financial and administrative capacity. It also has a developmental duty under the Constitution to give priority to the basic needs of the community and to promote social and economic development in its administrative and budget planning processes⁷². The “general duty” in section 73 confirms a municipality’s duty to “give effect” to the Constitution but goes further and positively obliges a municipality to “give priority to the basic needs of the community”, “promote the development of the local community” and, most importantly, “ensure that all members of the local community have access to at least the minimum level of basic municipal service”.

Municipal services must, furthermore, be equitable, accessible, sustainable (both environmentally and financially), promote efficient use of resources and be provided in a manner that is conducive to the improvement of standards of quality over time. Finally, municipal services must be regularly reviewed for possible “upgrading, extension and improvement”. Hence, captured under the “General Duty” is almost the entire policy objective regarding the provision of municipal services. It is useful to be reminded that the entire Chapter Eight must be read subject to, and in the context of, this overarching and not insubstantial “general

⁷⁰ S 73 Systems Act.

⁷¹ S 152 Constitution.

⁷² S 153 Constitution.

duty”. So when a municipality outsources a municipal service, it must ensure that the service delivery agreement contains provisions which do not impede or compromise the municipality’s ability to meet these obligations.

3.1.2.3 *Tariff Policy*

The duty to provide services is closely linked to the setting of tariffs. The Act obliges a municipality to adopt and implement a tariff policy and then sets out a list of “principles” with which the policy must comply⁷³. An analysis of the principles reveals first and foremost a desire to ensure affordable services to the poor, a desire for fairness, a desire for sustainability and, finally, the promotion of economic development.

Certain of these principles are peremptory and others discretionary and it is important to briefly list them as they could certainly be of relevance when analyzing current service delivery agreements. This arises, *inter alia*, because of the importance of achieving value for money and affordability in any outsourcing project. For example, the need for the private sector to ultimately make a profit must always be balanced against the obligation to provide basic services (including “free services” in certain circumstances). Also, as will be seen in Chapter Six, some contracts attempt to interfere with the municipality’s tariff setting power and try and introduce criteria which influence tariff setting in the financial interests of the external service provider.

Peremptory provisions which the tariff policy is obliged to contain, include:

- users to be treated equitably ;
- amount users pay should generally be in proportion to their use;
- poor households to have basic services through tariffs covering operating and maintenance costs only, special tariffs for low use or any other type of subsidization;

⁷³ S 74 Systems Act.

- tariffs must be cost reflective;
- tariffs must ensure financial sustainability;
- environmental objectives (e.g. recycling) must be encouraged; and
- any subsidisation must be disclosed.

Provisions the policy may contain include:

- a surcharge may be added to a tariff;
- special tariffs may be allowed for commercial and industrial users to promote local economic development; and
- tariffs may differentiate between different categories of user.

3.2 Choosing a service provider - Systems Act

3.2.1 Overview of Assessment Procedure



The assessment procedure to be followed prior to actual service provider procurement is primarily found in the Systems Act. Unlike the White Papers, the Systems Act does not make a distinction between different types of outsourcing contracts, such as management contract versus concession or lease contract. What the Act does distinguish between is the nature of the mechanism the municipality will be using for service delivery. These fall into two categories – “internal mechanisms” and “external mechanisms”.

Internal mechanisms are merely variations of the internal structures of the municipality and involve no outside party at all. For example, an internal mechanism could be a ring-fenced business unit or just a department of the municipality⁷⁴. An external mechanism on the other hand ranges from “public sector” type mechanisms (such as a municipal entity, another municipality or

⁷⁴ S 76(a) Systems Act.

organ of state) to “community based” entities (such as CBOs or NGOs) and, finally, to private entities⁷⁵.

A municipality can choose whether to deliver a service using an internal or external mechanism, but must follow an elaborate two stage assessment process (detailed below) before making such a decision. If an external mechanism is chosen then a competitive selection process applies to non-public sector entities. The Act then requires the municipality to enter into a comprehensive and tightly regulated service delivery agreement with the preferred external mechanism, regardless of whether it is a public or private sector entity⁷⁶. Throughout this process, from assessment to selection to contract, the objectives of ensuring public participation and transparency are repeatedly emphasized.

3.2.2 “Trigger” for Assessment Process

The assessment process a municipality must follow when deciding on a service delivery mechanism is set out under section 78 of the Systems Act. This assessment and review process can be “triggered” by a number of factors set out in section 77. If any one of these factors is present, it is then obligatory for a municipality to follow the onerous section 78 process. Triggers include, for example, if a new service is to be delivered or if a review is requested by the local community using mechanisms established under the Systems Act.

Section 77 has been amended recently to, *inter alia*, make allowance for municipalities that had already outsourced a municipal service prior to the commencement of the Act⁷⁷. This cured what had been somewhat of an anomaly for those municipalities already using an external service delivery mechanism prior to the Systems Act coming into force. Previously the Systems Act read as if assuming that a municipality had not outsourced municipal services at all. Under the new amendment, if a service is already being delivered by an external mechanism, then the comprehensive review and assessment process in section 78

⁷⁵ S 76(b) Systems Act.

⁷⁶ S 81 Systems Act.

⁷⁷ Local Government Laws Amendment Act, 51 of 2002.

must be followed if the service delivery agreement is due to end within the next twelve months or if the service is to be significantly upgraded, extended or improved and this has not been covered by the service delivery agreement⁷⁸.

This is a significant development and a powerful protection against various potential risks which could be encountered when outsourcing as, firstly, it guarantees public participation before any decision can be made to significantly increase the scope of a contract and, secondly, it makes it more difficult for an external entity to unfairly take advantage of its power as the incumbent service provider by demanding it also supply the new area/new service and, thirdly, it obliges the municipality to actively reconsider its service delivery options at the end of a contract and not passively rely on the external entity to either continue or be substituted by another external entity. This is by virtue of the fact that the assessment process forces a municipality to fully explore its own capacity to deliver the service before it may consider external options.

3.2.3 Section 78 Assessment



If one of the section 77 triggers is present, then the section 78 process must commence. Section 78 sets out both the process and criteria for deciding on which mechanism to use for a particular service. It is important to note that the process is a two stage one; first an assessment of “internal” mechanisms, then an assessment of “external” mechanisms.

3.2.3.1 Assessment Phase One

The assessment of internal options requires the municipality to assess the following;

- the direct and indirect costs and benefits of choosing an internal mechanism⁷⁹;

⁷⁸ S 77(b) Systems Act.

⁷⁹ S 78(1)(a)(i) Systems Act.

- the impact of an internal mechanism on the environment, health, well-being and safety, development, job creation and employment patterns in the municipality⁸⁰;
- the current and future potential capacity of the municipality to deliver services using an internal mechanism⁸¹;
- the extent to which administrative reorganization and human resource development could assist in providing the service internally⁸²; and
- the views of organized labour⁸³.

Finally, the municipality may take into account any “developing trends in the sustainable provision of municipal services generally”⁸⁴. At this stage of the assessment process it is not yet necessary to call for public comment. This first assessment process contains two features which point to a bias towards internal service delivery. Firstly, it positively obliges the municipality to look for ways to deliver the service using an internal mechanism. This is shown by the explicit obligation to assess both current *and* future capacity to deliver the service internally. But it does not stop there; the municipality must also consider whether human resource development and re-organisation of its administration may create sufficient capacity to deliver the service internally. The effect of this is that a municipality cannot merely rely on a *current* lack of capacity as justification to deliver services externally; instead it has to actively investigate if it can reorganize its administration and thus find a way of doing so internally.

A second feature pointing to bias is that, with the way section 78 is worded (i.e. always referring only to an assessment of “internal” options) and within the context of section 78 as a whole (i.e. specifically only placing assessment of

⁸⁰ S 78(1)(a) Systems Act.

⁸¹ S 78 (1)(a)(ii) Systems Act.

⁸² S 78 (1)(a)(iii) Systems Act.

⁸³ S 78(1)(a)(v) Systems Act.

⁸⁴ S 78(1)(b) Systems Act.

“external” options in the second assessment phase) it appears that a comparative analysis of “internal” versus “external” options in the first phase is effectively prohibited. This makes the first section 78 assessment process somewhat artificial, as it is difficult to conduct a thorough analysis of a particular option if you cannot compare it against its alternative. The approach section 78(1) appears to take is one which argues; if the municipality can on the face of it deliver the service internally then, even if an external option could theoretically offer added advantages, these become irrelevant.

The two features of the first assessment phase described above therefore reflect an apparent bias towards the use of an internal mechanism as a first choice for municipal service delivery. However, despite this apparent bias it is important to note that the Systems Act places no restrictions on the municipality’s ability to proceed to the second phase of the assessment process. Once the first assessment has been completed, the municipality:

may - (a) decide on an appropriate internal mechanism; or (b) before it takes a decision on an appropriate mechanism, explore the possibility of providing the service through an external mechanism mentioned in section 76(b)⁸⁵.

On the face of it then, the bias implicit in the first assessment phase is relatively easily circumvented with perhaps the main negatives being added costs (in not being able to investigate internal and external options simultaneously) and time implications. In other words, the council is not obliged to choose an internal option, even if the study reveals that the municipality is capable of providing the service internally. However, whether the first phase study needs to show at least *some* rationale justifying an exploration of external options is unclear.

⁸⁵ S 78(3) Systems Act.

3.2.3.2 *Assessment Phase Two*

Before the second phase of the assessment process can commence the local community must be given notice of the municipality's intention to investigate external options⁸⁶. The Act thus allows the municipality to investigate and decide on an internal service delivery mechanism without public participation⁸⁷.

Section 78(3) then lists the criteria to be used in the assessment. These are an almost exact repeat of the criteria contained in the first phase except they are applied to an external mechanism, namely; a cost/benefit analysis, likely impact on environment, health, well-being, safety, development, job creation and employment patterns and then the capacity and potential future capacity of the service providers to furnish the skills, expertise and resources necessary to provide the service⁸⁸. The views of organized labour must again be assessed as well as the views of the local community. The local community is therefore included twice in the process thus far; once in the notification of intent to explore and then in the invitation to express views.

Initially, this is all the Systems Act required when a municipality was considering using an external service provider. However, an amendment to the Act in 2003 has added quite significantly to this second phase of the process⁸⁹.

⁸⁶ S 73(a) Systems Act.

⁸⁷ Is the assumption therefore that this is a "safer" option? What about circumstances where there is non-delivery by the municipality and an external mechanism would offer great benefits for the public?

⁸⁸ S 78(3)(b) Systems Act.

⁸⁹ S 11 Local Government: Municipal Systems Amendment Act, 44 of 2003.

3.2.3.3 Feasibility Study

The municipality is now obliged to also conduct a detailed “feasibility study” and the results of this study “must” be taken into account when a municipality makes its decision on whether to use an internal or external service delivery mechanism⁹⁰.

The feasibility study must include the following matters:

- a clear identification of the service in question;
- the number of years the service is likely to be outsourced;
- projected outputs;
- an assessment of how the outsourcing will provide value for money;
- how it will address the needs of the poor;
- how it will be affordable;
- how it will transfer appropriate technical, operational and financial risk;
- and,
- an assessment of the impact on staff, assets, IDP and budgets.



It is clear the feasibility study is intended to prevent a municipality from rashly deciding to go ahead with outsourcing without carefully considering the future impacts of the decision, specifically in the context of the needs of the poor, affordability, value for money and appropriate risk transfer. The requirements of the feasibility study imply that the decision to outsource cannot be made solely on commercial principles, but must also take place within a wider context of the

⁹⁰ S 78(3)(c) Systems Act.

municipality's constitutional obligation to give priority to the basic needs of the community⁹¹.

To fully comply with the requirements of the feasibility study requires the municipality to complete a relatively complex study. For this reason, and presumably to assist specifically those municipalities with a capacity problem, the amendment includes a provision allowing national or provincial government to assist both in carrying out the feasibility study, and in preparing service delivery agreements. Any assistance national or provincial government may offer is subject to an agreement between the municipality and the other organ of state, so that the Act does not allow national or provincial government to become involved without the consent of the municipality⁹².

3.2.3.4 *Decision on internal or external mechanism*

After having conducted the section 78(3) assessment and feasibility process, a municipality must then "...decide on an appropriate internal or external mechanism, taking into account the requirements of section 73(2) in achieving the best outcome"⁹³. If the municipality decides on an internal service delivery mechanism, then the municipality is obliged to allocate sufficient resources for the proper provision of the service and must ensure transformation of the service as required by the Systems Act⁹⁴.

If the municipality decides on an external mechanism, then the procedure is effectively split into separate procedures for "public sector" type providers and those in the private sector. Public participation obligations remain the same however.

⁹¹ But see comment on the Finance Management Act below which *does* seem to base the decision solely on commercial principles.

⁹² S 78(6) Systems Act.

⁹³ S 78(4) Systems Act. Section 73(2) is the provision obliging municipal services to be equitable, accessible, financially and environmentally sustainable, prudent in use of resources and regularly reviewed for possible improvement or extension.

⁹⁴ S 79 Systems Act.

3.3 Contracting with a service provider

3.3.1 Procurement

3.3.1.1 Introduction

The procurement of an external service provider must take place within a competitive environment, unless that provider is a public sector entity. The process is therefore separated into two distinct processes depending on the nature of the entity decided upon. Both processes however require public consultation and transparency. This of course assumes that the municipality knows ahead of the procurement process that it wants to contract with either a public or private sector entity. Given that a public sector provider could be equally effective in providing a service and may in fact want to provide the service to that municipality, it does not seem that it would be barred from participating in a competitive process.

The procurement process also recognizes the complexity of service delivery agreements and thus builds in a negotiation process and option for the municipality to move to the next ranked bidder if the negotiations fail.

3.3.1.2 Public Participation Pre-Service Delivery Agreement

“Before” a municipality may enter a service delivery agreement with an external service provider (public or private), it must :

establish a programme for community consultation and information dissemination regarding the appointment of the external service provider and the contents of the service delivery agreement. The contents of the service delivery agreement must be communicated to the local community through the media⁹⁵.

This provision originally only applied to service delivery agreements for “basic” municipal services. Now, after amendment in 2003, the onerous public participation obligations apply to *all* service delivery agreements, revealing a

⁹⁵ S 80 (2) Systems Act.

greater emphasis by the legislature on transparency and public participation in the outsourcing process.

3.3.1.3 Procurement of “public sector” service providers

A competitive bidding process is not required if the municipality decides to appoint a municipal entity, another municipality or a national or provincial organ of state as its external service provider⁹⁶. If the municipality decides on entering into a service delivery agreement with another municipality, then that other municipality is likewise required to conduct a detailed feasibility study before it may enter into the agreement⁹⁷.

3.3.1.4 Procurement of “private sector” service providers

The municipality is required to follow a competitive bidding process for all service providers not falling within the definition of a municipal entity, another municipality or national or provincial organ of state⁹⁸. The procurement process must be “fair, equitable, transparent, cost-effective and competitive”⁹⁹ and must “minimize the possibility of fraud and corruption”¹⁰⁰. The process must also comply with the requirements of the Finance Management Act and the Preferential Policy Framework Act¹⁰¹. Again, the importance of public input and information sharing is emphasized by the requirement that the procurement processes “make the municipality accountable to the local community about progress with selecting a service provider, and the reasons for any decision in this regard”¹⁰².

The need to promote small and emerging businesses is also built into the process, as is the authority of the municipality to show preference to those categories of

⁹⁶ S 80(1) Systems Act.

⁹⁷ S 80(3) Systems Act.

⁹⁸ S 80(1)(b) Systems Act.

⁹⁹ S 83(3) Systems Act.

¹⁰⁰ S 83(1)(c) Systems Act.

¹⁰¹ Act No. 5 of 2000.

¹⁰² S 83(1)(d) Systems Act.

service provider previously the subject of unfair discrimination¹⁰³. Naturally, the objectives of small business empowerment or preferential procurement may not necessarily coincide with the need to be competitive (i.e. of finding the “cheapest” offer). The municipality will have to find a way of balancing these potentially conflicting objectives in its procurement process. It is assisted in part by the provisions of the Preferential Procurement Policy Act, which guide a municipality on the weightings to be given in the evaluation process to pure commercial objectives (i.e. price) and those of social upliftment or redress respectively.

It is peremptory for the municipality to apply “the criteria listed in section 78” when selecting a service provider. The need to assess the views of organized labour and the local community form an important part of the section 78 process, as does the conducting of a detailed “feasibility study”¹⁰⁴. Whether these are intended to be included in the “criteria” to be applied when selecting a service provider is unclear. As far as the local community is concerned, it is part of the process anyway, given the requirements of section 80 and 83(1)(d), which makes it a somewhat moot point. But is it necessary to invite and assess organised labour’s views when making the selection of a service provider? Also, section 78 comprises two separate processes, each with their own criteria. Presumably the municipality only has to apply the criteria set out in section 78(3) and not the criteria contained in section 78(1) when making a selection, given that it is in the process of selecting an external service provider.

Having made a selection, the municipality must then enter into a negotiation and agreement process with the prospective service provider¹⁰⁵. Here the Act recognizes the need for the municipality to be able to exercise some flexibility in negotiating the final details of the service delivery agreement with the prospective service provider. Service delivery agreements are notoriously complex and it would be remarkable if the parties were able to enter into a binding agreement based on the bidding documents alone. However, protection for the other bidders,

¹⁰³ S 83(1)(e) and s 83(2) Systems Act.

¹⁰⁴ S 83 (4) Systems Act.

¹⁰⁵ S 84 Systems Act.

and for the integrity of the process, is built in with the proviso that any changes agreed to in this negotiation process cannot have the effect of materially altering the bid. It must be remembered that these provisions apply only to bidders following the competitive process, i.e. non-public sector providers.

It is also a possibility that the municipality and prospective service provider are unable to reach agreement on the final terms of the service delivery agreement. The Systems Act allows the municipality “after a reasonable time” of attempting negotiation, to move on to negotiations with the next-ranked service provider instead.

3.3.2 Contract content

3.3.2.1 Introduction

Having completed the assessment and selection process, the municipality must enter into a service delivery agreement with the external mechanism¹⁰⁶. This requirement applies equally to “public sector” type mechanisms (such as municipal entities or another organ of state) as it does to a totally arm’s length private company. There is also no distinction made as to the type of contract involved. The requirements therefore apply to all outsourcing contracts, be they concessions, leases, management or service contracts or private-public partnerships.

Section 81 of the Systems Act sets out the responsibilities of municipalities when providing services through service delivery agreements. When considering the peremptory requirements of this section the clear and overriding theme is that of ensuring a municipality remains fully accountable for the service. This is in line with the policy position in the two White Papers and reflects concern for perhaps the biggest risk of outsourcing, namely that of the municipality contractually divesting itself of its accountability to the community it serves. Finally, the Finance Management Act contains provisions relevant to certain contracts and to

¹⁰⁶ S 81 Systems Act.

matters which would directly impact on contracts, such as asset protection and guarantees.

The Systems Act, in this and other sections, forces a municipality to remain focused on its community and obliges it to monitor the contract and consider its constitutional duties on an ongoing basis.

The peremptory requirements of a service delivery agreement under section 81 of the Systems Act oblige the municipality to:

- regulate provision of the service in terms of section 41¹⁰⁷;
- monitor performance and implementation of the agreement¹⁰⁸;
- comply with Chapter 5 and 6 IDP and Performance Management requirements if the service is a development priority or objective in the IDP¹⁰⁹;
- control and set tariffs in accordance with a tariff policy¹¹⁰;
- ensure uninterrupted delivery in the best interests of the community¹¹¹;
- ensure the contract contains dispute resolution mechanisms¹¹²;
- ensure continuity if the service provider unable to perform because of insolvency, judicial management or other reasons¹¹³; and
- take over the service and assets at the expiry of the service delivery agreement¹¹⁴.

¹⁰⁷ S 81(1)(a) Systems Act.

¹⁰⁸ S 81(1)(b) Systems Act.

¹⁰⁹ S 81(1)(c) Systems Act.

¹¹⁰ S 81(1)(d) Systems Act.

¹¹¹ S 81(1)(e) Systems Act.

¹¹² S 81(2)(bA) Systems Act.

¹¹³ S 81(2)(d) Systems Act.

3.3.2.2 *Regulating, Monitoring and Performance Targets*

Of course, it is easy enough for a service delivery agreement to make the bald statement that the municipality will remain responsible for the service and will “monitor” the contract (as most, if not all, service delivery agreements do say). What does this mean in practice? What does effective monitoring mean? For example, a municipality could read an annual performance report and regard that as “monitoring”. Clearly the legislators saw a need for a more detailed set of obligations to ensure effective monitoring. The risk of a failure to monitor could, apart from adversely affecting accountability, also negatively impact on the objectives of achieving efficiency and value for money.

After confirming that the municipality “remains responsible for ensuring that the service is provided to the local community”, section 81(1) obliges a municipality to regulate the service and monitor and assess the implementation of the agreement in accordance with section 41 of the Systems Act. Section 41, which falls within Chapter Six of the Act¹¹⁵, obliges a municipality to establish a performance management system for its political structures, office bearers and its administration and obliges it to establish mechanisms to monitor and review this performance management system. The core components of the performance management system, and thus the minimum requirements for regulating and monitoring a service delivery agreement are as follows. The municipality must:

- set key performance indicators (KPI’s) to measure performance with regard to the municipality’s development priorities and objectives of its IDP¹¹⁶;
- set measurable performance targets for the priorities and objectives¹¹⁷;

¹¹⁴ S 81(2)(e) Systems Act.

¹¹⁵ The chapter on “Performance Management”.

¹¹⁶ S 41(1)(a) Systems Act.

¹¹⁷ S 41(1)(b) Systems Act.

- monitor performance by measuring performance against the KPI's and targets and must monitor and review performance at least once a year¹¹⁸;
- take steps to improve performance if the targets are not met¹¹⁹; and,
- establish a process of regular reporting to council, other political structures, political office bearers, staff of the municipality, the public and appropriate organs of state¹²⁰.

Finally, the system must be set up in such a way that it will serve as “an early warning indicator of under-performance”¹²¹. What does this mean for a service delivery agreement? Clearly a simple statement that the municipality will “monitor” the agreement will not suffice. The agreement would have to set KPIs and performance targets to enable the municipality to fulfil its monitoring requirements. The contract would also have to set in place a procedure to deal with a scenario where performance targets are not met by the service provider. The municipality would need access to information regarding performance on an ongoing basis to enable it to make the “regular” reports to its political structures, administration and the public and to enable the system to serve as an early indicator of poor performance.

The setting of KPI's can also not merely be left to the parties to decide or left to the prospective service provider to set in its business plan. The Systems Act requires a process of community involvement in the setting of KPIs and performance targets¹²². The Minister of Local Government may also prescribe certain “general” KPIs, which a municipality would then be obliged to include in its performance management system¹²³. A municipality is obliged to notify its

¹¹⁸ S 41(1)(c) Systems Act.

¹¹⁹ S 41(1)(d) Systems Act.

¹²⁰ S 41(1)(e) Systems Act.

¹²¹ S 41(2) Systems Act.

¹²² S 42 Systems Act.

¹²³ S 43 Systems Act.

administration and the public of its KPIs and performance targets and must have the performance measurements audited internally and by the Auditor-General¹²⁴.

In terms of the latest amendments to the Systems Act, a municipality is obliged to prepare an annual performance report¹²⁵. This report must specifically reflect the performance of “each external service provider during that financial year.” Furthermore, the report must compare the performance for that year with the performance and targets set for the previous year. Finally, it must set out the measures taken to improve performance.

Section 81(1)(c) obliges the municipality to perform its functions and exercise its powers in terms of Chapter 5 (Integrated Development Planning) and Chapter 6 (Performance Management), if the municipal service falls within a development priority or objective under the municipality’s IDP.

Of course, all these requirements do not necessarily have to be set out in detail in the service delivery agreement; the obligations remain the municipality’s regardless of whether they are reflected contractually or not. However, the contract would at least have to contain provisions to facilitate, and not impede, the municipality in the fulfilment of these obligations. The municipality should not be left in a position where, for example, it is unable to effectively measure performance of the service provider and ends up having to pay the service provider extra for the requisite information to enable it to perform its monitoring role.

3.3.2.3 *Tariffs*

Section 81(1)(d) obliges a municipality to control the setting of tariffs. This is in any event a power that is constitutionally incapable of being delegated. However, to allow for flexibility the Systems Act does allow the service provider to adjust tariffs, but only within limitations set by the council¹²⁶. Given the real, and

¹²⁴ S 45 Systems Act.

¹²⁵ S 46 Systems Act.

¹²⁶ S 81(3) Systems Act.

perceived, risk of an external provider being profit driven and ultimately pushing tariffs up, this provision (although unnecessary, as a provision to the contrary would be unconstitutional) serves as a reminder that the exclusive right to set tariffs remains with the municipality.

It must be remembered that a municipality's discretion on tariff setting must be exercised within the confines of its tariff policy, which has to reflect certain principles listed in section 74 of the Systems Act. This includes provisions regarding services to the poor (such as life line tariffs, subsidisation and tariffs only covering operating and maintenance costs), equity, sustainability and promotion of local economic development. This will be a crucial balancing act for a municipality to follow when outsourcing a municipal service. The national and provincial government have a power (in certain circumstances) to cap the upper limits of a municipal tariff (whether this power is constitutional or not is perhaps questionable)¹²⁷. This could naturally have a significant impact on a service delivery agreement and certainly adds an element of uncertainty regarding the ability of the parties to contractually guarantee future income levels. This was one of the issues identified by the 2000 White Paper as requiring clarification in order to ultimately encourage consideration of outsourcing.

However the Finance Management Act recognises the negative effect this may have on a long term service delivery agreement and provides that in a long term contract where there is a periodic escalation of payments, the capping of upper limits will not apply if it impairs the municipality's ability to meet those escalation payments¹²⁸. It is not clear how this would dovetail with the power of the Minister under the Systems Act to make regulations regarding upper limits on tariffs¹²⁹.

¹²⁷ S 86A(1)(c) Systems Act.

¹²⁸ S 43 Finance Management Act.

¹²⁹ S 86A Systems Act.

3.3.2.4 *Continuity of Service*

Section 81(1)(e) obliges the municipality to “generally exercise its service authority so as to ensure uninterrupted delivery of the service in the best interest of the local community” and, more specifically, obliges it to ensure continuity if the service provider finds itself in trouble (be it insolvency or otherwise) and take over the service and all assets at the end of the agreement¹³⁰.

The policy objectives of these provisions are clear – the continuity of the service can under no circumstances be threatened as a result of outsourcing of a service and the service delivery agreement would clearly have to incorporate provisions to cover these issues.

3.3.2.5 *Dispute Resolution and Amendment*

The latest amendment to the Systems Act includes a further peremptory provision, which obliges the parties to the service delivery agreement to include a clause providing for dispute resolution mechanisms¹³¹. This echoes section 116 of the Finance Management Act, which similarly requires a contract with a non-public sector entity to contain “dispute resolution mechanisms”.

As for amendment of the agreement, section 81(4) entitles the parties to agree to an amendment. However, if the agreement was reached after a competitive bidding process the municipality must give notice to the local community of the intention to make an amendment and the reasons for the amendment. The community must then be invited to make representations to the municipality on the proposed amendment. This section must be read with section 116(3) of the Finance Management Act, which also obliges the municipality to give notice to the community of a proposed amendment and invite public comments (although this only applies to contracts with non-public sector entities). However, section 116 also obliges the municipality to table the proposed amendment in council. Although not specifically stated in either Act, it is presumed that these provisions

¹³⁰ S 81(2)(d) and (e) Systems Act.

¹³¹ S 81(2)(bA) Systems Act.

apply to material amendments only and not to minor amendments, of which there could be many over the course of a long term contract.

Finally, once the municipality has entered into the service delivery agreement, it is obliged to notify the public of the name of the service provider, details of the service and of the place where copies of the agreement can be inspected.

3.3.2.6 *Discretionary Provisions*

Apart from the peremptory provisions contained in section 81 of the Systems Act, there are also various discretionary provisions specifically allowing the municipality to assign certain duties and functions to the service provider by way of service delivery agreement. These functions/duties include:

- developing and implementing service delivery plans within the framework of the IDP;
- operating, managing and providing the service;
- undertaking social and economic development related to the service;
- customer management; managing its own finances (budgeting, accounting etc); and,
- collecting service fees for its own account in accordance with councils credit control policies (this was previously prohibited by law, leading to unnecessarily complex financial arrangements in service delivery agreements).

The municipality may also transfer funds to the service provider to subsidise services to the poor¹³². This, however, must be done using a transparent system subject to performance monitoring and audit. As far as staff are concerned, the municipality may transfer or second staff to the service provider (subject to the

¹³² S 81(2)(b) Systems Act.

applicable labour legislation) and subject, further, to the agreement of the staff member concerned¹³³.

3.4 Municipal Finance Management Act: Legislative overlay

3.4.1 Introduction

As seen above, the Systems Act sets out a detailed, somewhat cumbersome and time-consuming “pre-procurement” assessment process. Certain aspects of the process are also not entirely clear. However, the complexity of this process has increased significantly with the recent promulgation of the Finance Management Act. A brief description of the requirements of this Act insofar as they relate to regulating the outsourcing process will be set out and an attempt will be made to establish where they may “fit” in with the Systems Act process.

3.4.2 Three year contracts

Section 33 of the Finance Management Act applies to contracts having “budgetary implications” beyond three years. Given the usual duration of service delivery agreements, it is envisaged that most outsourcing contracts would fall within the parameters of this section. This is especially so as even “shorter-term” service delivery agreements (i.e. two to three years) will often allow the contract to be extended, either by agreement or at the option of one of the parties, which almost invariably means the contract duration will exceed three years.

Before council can approve a contract of this nature, the municipality must publicise the draft contract, prepare an information statement summarizing the municipality’s obligations and invite comments from the public. The municipality must also solicit the views of National and Provincial Treasury, the national Department of Local Government and the national department concerned if the contract is for the provision of water, sanitation or electricity. The council must take the views of all these entities into account and must also consider the projected financial obligations for each year of the contract and the impact of

¹³³ S 81(2)(c) Systems Act.

these financial obligations on future tariffs and revenue¹³⁴. This is a clear duplication of some of the specific requirements of the Systems Act feasibility study required under section 78(3).

Given that section 33 presumes the municipality is aware it is about to enter into a contract of longer than three years duration, it is assumed that this Finance Management Act assessment and public comment process should occur at least *after* the municipality has made a decision to outsource in terms of section 78(4). The fact that the municipality must make the “draft” agreement public and must summarise the municipality’s obligations, implies that the Systems Act procurement process has been concluded and a prospective service provider selected. If this is so, then the community comment and participation requirements overlap with those in the Systems Act and the timing and content of the Finance Management Act assessment do not really make sense. In effect the municipality would conduct its detailed feasibility study when deciding whether to choose an external service provider under section 78(3), it would then apply the feasibility study criteria again when selecting a prospective provider in the actual procurement process. Finally, it would again apply and assess certain of the financial criteria after selection of the prospective provider, but before entering into the final service delivery agreement.

Of importance is the requirement that, before entering into the agreement, council specifically adopt a resolution confirming that the municipality “will secure a significant capital investment or will derive a significant financial economic or financial benefit from the contract”¹³⁵.

Given that this section effectively prohibits the municipality from entering into a service delivery contract without such a resolution, how does one correlate this emphasis on “significant” financial benefit to considerations, for example, of environmental impact, of accessibility of services to the poor, of skills transfer, of equity and improved service levels? It appears that, whereas the Systems Act

¹³⁴ S 33(1)(b) Finance Management Act.

¹³⁵ S 33(1)(c) Finance Management Act.

attempts to enforce socio-economic considerations into the assessment process, the Finance Management Act makes it a pre-condition that not only “financial benefit” but “significant” financial benefit be proven before a municipality can enter into a service delivery agreement. This could have a powerful and possibly unintended impact on the ability of municipalities to outsource services, even if there are compelling reasons to do so and even if there is some (though not “significant”) financial benefit.

Section 33(3) provides that all contracts “may not be withheld from public scrutiny”, a repeat of the public notification requirements of the Systems Act under section 84(3). The only exception would be if the Promotion of Access to Information Act¹³⁶ provides otherwise. Finally, the contract can only be entered into if council approves the entire contract exactly as it is to be executed¹³⁷. This could prove to be somewhat of an obstacle to the contract negotiation and finalisation process as, in complex and lengthy contracts, it is often necessary to make slight changes and adjustments right up to contract signature. The parties will have to ensure this process reaches its conclusion some weeks earlier than the actual signature date so that sufficient time is allowed for the draft contract to go through the council procedures.

3.4.3 Municipal Entities

As discussed above, municipal entities are set up as external service delivery vehicles and are essentially entities over which the municipality has effective control. The entity could be a private company, a service utility (created by a bylaw) or a multi-jurisdictional service utility (created by two or more municipalities). The Finance Management Act requires a municipality to conduct a detailed assessment before such an entity can be formed¹³⁸. The assessment must consider the impact of a municipal entity on staff, assets and liabilities.

¹³⁶ Act No.2 of 2000.

¹³⁷ S 33(1)(c) Finance Management Act.

¹³⁸ S84(1) Finance Management Act.

The municipality is also required to publicise the assessment, invite comments from the local community and organized labour and get the views of national and provincial treasury, the national and provincial departments for local government and the MEC for local government¹³⁹. The council has to take all this into consideration before establishing a municipal entity.

How does this assessment and public participation process dovetail with that required by section 78 and section 80(2) of the Systems Act and that of section 33 of the Finance Management Act, given that they could quite feasibly all apply at the same time? Because a municipality cannot “plan ahead” to outsource a service, it presumably must complete the section 78(3) Systems Act process first and make an “in principle” decision to establish a municipal entity and only then investigate actually setting it up. So, for example, the views of organized labour would technically have to be invited three times; firstly under the investigation of “internal” options¹⁴⁰, then under the investigation of “external” options¹⁴¹, and finally (if a municipal entity is chosen) before the establishment of that municipal entity. Also, if that municipal entity was to enter into a service delivery agreement for longer than three years, then the views of national and provincial treasury, department of local government and so on would have to be procured both before establishing the municipal entity and after its establishment, but before it entered into the contract.

3.4.4 Public-private partnerships

The Finance Management Act sets out the conditions and process for public-private partnerships but does not define this term¹⁴². The Systems Act does not distinguish public -private partnerships from other service delivery arrangements. Public-private partnerships would also mostly be of greater duration than three years, meaning that the feasibility study and public participation processes

¹³⁹ S84(2) Finance Management Act.

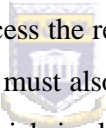
¹⁴⁰ S 78(1) Systems Act.

¹⁴¹ S 78(3) Systems Act.

¹⁴² S120 Finance Management Act.

required by section 120 would be in addition to those required by section 33 of the Finance Management Act and Chapter 8 of the Systems Act (in fact section 120 specifically states that both Chapter 8 and section 33 must be complied with)¹⁴³.

Section 120 requires yet another feasibility study to cover issues such as strategic and operational benefits, nature of the parties' roles, how the contract will provide value for money, be affordable, transfer appropriate risk and impact on current and future budgets and revenue flows. It must also look at how the municipality will be able to monitor, manage and enforce the contract¹⁴⁴. After the feasibility study is concluded the municipality must submit the study to the council for a "decision in principle" on whether to continue with a public-private partnership¹⁴⁵. Then follows another public participation process entailing the procuring of comments from the public, National Treasury the national Department of Local Government and the responsible sectoral national department (if it is for provision of water, sanitation or electricity services)¹⁴⁶.

Finally, one must throw into the process  the requirement that particulars of any proposed service delivery agreement must also be included when a municipality tables its annual budget, a process which is also open for public submissions¹⁴⁷.

3.4.5 *Contracts*

The Finance Management Act at section 116 contains provisions relating to contracts and contract management which apply to a service delivery agreement between a municipality and a private external entity (i.e. section 116 would *not* apply to a service delivery agreement between a municipality and a municipal entity or another organ of state). Included in this section is the requirement of periodic review of the contract once every three years¹⁴⁸. There are also further

¹⁴³ S120(3) & (7) Finance Management Act.

¹⁴⁴ S120(4) Finance Management Act.

¹⁴⁵ S 120(6) Finance Management Act.

¹⁴⁶ S 120(6) Finance Management Act.

¹⁴⁷ S 17 Finance Management Act.

¹⁴⁸ S 116(1)(b)(iii) Municipal Finance Management Act.

monitoring duties over and above those contained in the Systems Act – the accounting officer of the municipality must ensure the contract is properly enforced and that performance of the contractor is monitored “on a monthly basis”¹⁴⁹. The accounting officer must also establish capacity in the municipality to ensure these duties are fulfilled and to ensure over-seeing of the day-to-day management of the contract. The accounting officer must regularly report on the performance and management of the contract to the council¹⁵⁰.

There is a clear overlapping of these monitoring duties with those arising out of the Systems Act and it is not clear what the thinking behind this was, given that these extra monitoring obligations do not apply to all service delivery agreements. Section 116 also obliges the municipality to include provisions for termination of the contract for non- or under-performance on the part of the service provider¹⁵¹.

3.4.6 Protection of Assets

The Finance Management Act prohibits a municipality from transferring ownership of any capital asset required to provide a minimum level of basic service¹⁵². It also for the first time allows a municipality to provide security for a debt or contractual obligation where that contract involves a third party making capital expenditure on property, plant or equipment which will be used for achieving the municipality’s objects in terms of section 152 of the Constitution¹⁵³. This would clearly apply to service delivery agreements such as concession or lease contracts where the external entity will fund infrastructure improvements or construction.

The Finance Management Act then sets out a list of potential ways to provide security (such as lien, mortgage etc) and included in the list is that of the municipality “undertaking to retain revenues or specific municipal tariffs...at a

¹⁴⁹ S 116(2) Municipal Finance Management Act.

¹⁵⁰ S 116(2) Municipal Finance Management Act.

¹⁵¹ S 116(1)(b) Municipal Finance Management Act.

¹⁵² S 14 Finance Management Act.

¹⁵³ S 48 Finance Management Act.

particular level or at a level sufficient to meet its financial obligations”¹⁵⁴. This raises the question of whether a municipality is competent to fetter its future tariff-setting discretion. Given that the power to set tariffs in its own discretion is a power arising directly from the Constitution, it could be argued that the municipality will always retain the power to adjust the tariff as it sees fit.

Finally, section 48 contains provisions specifically protecting the assets required for the provision of basic services.

3.5 Specialist contracts: Water and sanitation

The Water Services Act contains provisions regulating the outsourcing of water services which must be read in addition to the Systems Act and Finance Management Act requirements. The most significant difference in the assessment and selection process of potential providers is that a municipality is obliged to first consider public sector providers before it is allowed to look at the private sector¹⁵⁵.



The municipality is required to publicise its intention of entering into or renewing a contract with an external provider and the potential water services provider must disclose any other interests it may have with the municipality and what rate of return on investment, if any, it will gain from the contract¹⁵⁶. The Minister of Water Affairs and Forestry has recently published regulations governing contracts entered into with external water service providers¹⁵⁷. The regulations stipulate various provisions that must be included in a water services contract, many of which overlap with Systems Act and Finance Management Act requirements (for example, setting performance targets, annual reports, dispute resolution mechanisms, protection of assets and so on). Furthermore, the regulations prohibit a contract from exceeding thirty years in duration. The regulations also

¹⁵⁴ S 48(2)(g) Finance Management Act.

¹⁵⁵ S 19(2) Water Service Act.

¹⁵⁶ S 19(3) Water Service Act.

¹⁵⁷ Regulations to Water Services Act (2001).

make it obligatory for the contract to “provide an incentive” for the service provider to perform efficiently and effectively¹⁵⁸.

Although adding to and to some extent duplicating the requirements of a municipality when wanting to outsource, the provisions of the Water Services Act are not all that difficult to insert into the overall Systems Act outsourcing procedure, unlike the many problems that arise in attempting to dovetail the Finance Management Act with the Systems Act.

3.6 Conclusions on legislative framework

3.6.1 Introduction

The legislative framework does not correlate with the policy objective of facilitating outsourcing as it has created an outsourcing process that is overly complicated, non-user friendly and full of duplications and overlaps. Within the process itself there is an apparent bias towards in-house service delivery as opposed to outsourcing, which likewise is contrary to the policy objectives. Policy objects on outsourcing are also not fully translated into water and sanitation sector policy and legislation. These conclusions are elaborated on below.

A further feature of the legislative framework is that it appears to be more process driven than focussed on the practicalities and detail of contract negotiation, contract formation and the key provisions to provide for in those contracts. The framework as it stands, would be of little help in actually assisting municipalities to formulate outsourcing contracts.

Balanced against these indications of ambivalence in the legislative framework to outsourcing, it must be noted that other plans are in the pipeline which reflect and confirm the policy approach of encouraging municipal outsourcing. A Municipal Desk will be created in National Treasury’s PPP Unit to assist in meeting the Finance Management Act obligations, the Municipal Infrastructure Investment

¹⁵⁸ S 9 & s12 Regulations to Water Services Act (2001).

Unit will continue to provide technical assistance to municipalities, interim regulations will be drafted with pilot municipalities (with application of section 120 of the Finance Management Act being delayed for non-pilot municipalities), Practice Notes will be drafted on various aspects of the process, Municipal PPP Regulations will be drafted and finally additional Practice Notes will be drafted to cover procurement and contract management¹⁵⁹. There is therefore a concerted plan to put in place a comprehensive regulatory framework with strong support mechanisms for the implementation of municipal outsourcing projects.

3.6.2 Complex process

The scale of legislative control and regulation over municipal outsourcing is breathtaking. This probably arises from a well-intentioned desire to guarantee total transparency in the process and ensure municipalities do a thorough assessment before outsourcing and so avoid any common risks or pitfalls. However, there seems to be a real danger that the legislation has gone too far and made the process too cumbersome, expensive and time-consuming to be effectively implemented. This is particularly so considering the added onerous requirements of the recently promulgated Finance Management Act. For example, depending on which outsourcing options are chosen, there are potentially at least three different public commenting processes and at least three, all slightly different, assessment and/or feasibility studies to be conducted.

To compile a sensible “step by step” procedure for outsourcing and so ensure compliance with the various legal provisions would be a difficult task indeed. Given the view historically held by organized labour on the question of outsourcing, labour could quite feasibly leap at the chance to mount a legal challenge to the process if possible. The municipality would therefore be well advised to ensure that their assessment process is entirely compliant and risk-proof. But, if there is lack of clarity on how the process is actually supposed to work in the first place, an element of risk is introduced which could, in theory,

¹⁵⁹ PPP Quarterly (June 2004).

sway a municipality against the outsourcing route for those services over which labour holds strong views.

3.6.3 *Bias within process*

Also, although the policy at national level unequivocally encourages a municipality to consider the use of external mechanisms in municipal service delivery, the assessment process a municipality must follow when deciding on service delivery options does not entirely reflect this objective¹⁶⁰. In fact, the process can be interpreted as preferring the consideration and use of internal service delivery options rather than those of outsourcing. This is because a municipality is effectively prohibited from doing a contemporaneous comparative analysis of internal options versus external options, arguably the most logical and effective way to weigh up the options.

Because the municipality is only allowed to consider external options after its council has considered and resolved on the “internal” option assessment, it could be argued that a municipality is effectively prohibited from making any future plans to outsource a service. To do so before actually following the section 78 assessment process would be to risk the integrity of the process and thus make it open to legal challenge. On this point, therefore, the policy and legislation do not complement each other as one would have expected.

3.6.4 *Tariff setting not made certain*

The 2000 White Paper noted that in order to facilitate a firm regulatory framework to encourage outsourcing, there would have to be certainty on tariff setting.

However, the Systems Act does not reflect this objective as it authorises another sphere of government to set limits on tariff increases. This introduces an element of uncertainty into any outsourcing initiative and particularly one where a private entity is relying on tariff income to fund an infrastructure project.

¹⁶⁰ S 78(1) Systems Act.

3.6.5 Water and sanitation biased to in-house delivery

The water and sanitation sector also reveal ambivalence towards outsourcing and in some respects contradict the policy positions contained in the 1998 and 2000 White Papers. The White Papers specifically encourage outsourcing, including the involvement of the private sector where appropriate. The water and sanitation legislation and policy, however, take the view that the public sector and specifically municipalities, are the provider of choice.

3.6.6 Identifying drivers and dangers

Finally, an analysis of the legislative framework does point to some of the underlying assumptions on the risks typically associated with outsourcing and which were regarded as warranting legislative protection. Some examples include: provisions prohibiting asset stripping, showing the need to protect municipal assets; the detailed provisions on monitoring showing the need to avoid a loss of accountability; the many provisions on public participation showing the need to ensure public buy-in; the many and comprehensive provisions on feasibility studies and assessments revealing concern to avoid the potential financial risks to outsourcing and ensure value for money; and the tariff policy provisions showing a concern for the impact of outsourcing on the poor and the need to ensure affordability.

In the next chapter, the various “drivers” and “dangers” referred to or implied in the policy and legislative framework are set out in more detail and their various features and qualities elaborated on. An understanding of what the drivers and dangers mean is necessary in order to judge the efficacy of outsourcing contract provisions and contract implementation.

4 Chapter Four: Drivers and Dangers

4.1 Introduction

Given the contents and assumptions behind the policies and relevant legislation pertaining to outsourcing; what factors drive the move to encourage consideration of outsourcing? And, conversely, what dangers or risks do policy and legislation recognise as being necessarily associated with this form of service delivery. It is necessary to identify these factors as they will be an important tool in assessing the relevance and efficacy of current outsourcing contracts in meeting the objectives of outsourcing.

The most important drivers could be grouped under the following headings:

- Capital investment
- Value for money
- Greater efficiency
- Skills transfer
- Risk transfer



The “dangers”, or potential risk areas, on the other hand, could be grouped as follows:

- Accountability (monitoring and regulation)
- Public buy-in (public participation, transparency, amendment)
- Consumer protection (affordability, credit control)
- Inappropriate risk allocation (discussed under “Risk transfer” above)
- Protection of service environment (continuity of service provision, assets, dispute resolution)

4.2 Drivers

4.2.1 Capital Investment

The prospect of access to outside capital to fund an infrastructure project is possibly the most obvious reason for a municipality to consider an outsourcing option. The White Papers discussed above set out the background and reasons for the considerable infrastructure backlog in South Africa and highlight the lack of public sector resources to effectively meet this backlog.

Concession or lease contracts are the typical mechanisms used when a private sector entity funds a capital expenditure project. However, these long-term “capital investment” contracts are notoriously complex and thus potentially risky. The White Paper on Local Government identified various common risks associated with these contracts, including a loss of accountability, prejudice to consumer rights and monopoly pricing¹⁶¹.

The Municipal Infrastructure Investment Unit noted that the latter half of 2002 saw a dramatic and unprecedented increase in investigations for municipal public-private partnerships of a large, long-term and capital intensive nature¹⁶².

The financial arrangements and negotiations between the municipality, private service provider and the financiers/bankers in these types of contracts can naturally be very intricate. In recognition of this, and in an apparent attempt to give the municipality added flexibility to reach the optimal contractual arrangement, the Finance Management Act has granted municipalities additional powers relating to these issues. The municipality is specifically authorised, for example, to provide security for the municipality’s contractual obligations where these arise as a result of “capital expenditure by other persons on property, plant equipment to be used by the municipality or such other person for the purpose of achieving the objects of local government...”¹⁶³. The Finance Management Act

¹⁶¹ Department of Provincial and Local Government. (1998), par 2.2.6.

¹⁶² MIU & NBI (November 2002).

¹⁶³ S 48(1)(c) Municipal Finance Management Act.

then goes on to list the manners in which municipalities may provide this security including, for example, the ceding of any future municipal revenue, retaining tariffs or other charges at specific levels and allowing revenue intercepts to ensure dedicated payment to lenders or investors¹⁶⁴.

4.2.2 Value for Money

4.2.2.1 Introduction

An outsourcing contract must offer value for money otherwise there can be no real justification for the municipality having entered into it. It is one of the key drivers for outsourcing; the promise of an external service provider often being to provide a better service at a lower cost¹⁶⁵. However, “value for money” cannot be judged solely on financial terms, as important as these are. It is as much a question of what you are getting for your money as it is a question of what you are spending. The 1998 White Paper identifies value for money as one of the “guiding principles” to be applied when considering service delivery strategies and describes it as concept including both the cost of inputs and the quality and value of outputs¹⁶⁶. It, however, only went so far as to say that the option of contracting out municipal services could “sometimes” offer economies of scale¹⁶⁷.

Therefore “value for money” can actually become a relatively complex concept. This is borne out by the experience in the United Kingdom, which has implemented a longstanding and sophisticated PPP programme. A recent paper noted that “Research and contemporary debate has not fully reached an agreement about what is meant by VfM [value for money]”¹⁶⁸. It went on to note that, in many cases the local government provided a unique service to the community and thus the development of performance indicators only became necessary after the

¹⁶⁴ S 48(2) Municipal Finance Management Act.

¹⁶⁵ The 2000 White Paper identifies both the potential for lower costs and the prospect of better value for money as specific reasons to consider outsourcing

¹⁶⁶ Department of Provincial and Local Government. (1998), par 2.1.

¹⁶⁷ Department of Provincial and Local Government. (1998), par 2.2.5.

¹⁶⁸ Illidge et al (2000).

introduction of private sector participation. This could well be the case in South Africa as well. The ability to be able to effectively compare the “value” of service provision as between public and private provider is therefore difficult.

What “value” one places on particular outcomes is not necessarily an objective exercise either. Thus, in the UK, “[h]ow each public spending authority establishes VfM is not entirely clear”. This is a fact acknowledged by the UK Department of the Environment, Transport and the Regions, which concedes that the precise methodology for assessing value for money may differ depending on the type, size and complexity of the particular project¹⁶⁹.

4.2.2.2 *Legal requirement*

The Systems Act enforces considerations of value for money into the pre-procurement assessment process, by virtue of the cost/benefit analyses that must be conducted during both the “internal” and “external” assessment phases. More significantly, the amendment to the Systems Act, which introduced the necessity for a feasibility study, specifically requires the municipality to consider whether an external mechanism would offer “value for money”¹⁷⁰. This necessity to consider “value for money” implications is duplicated in the Finance Management Act which likewise requires this issue to be considered before a municipality may consider entering into a public private partnership¹⁷¹.

The concept of value for money is also directly linked to the issue of risk transfer. As a recent article put it: “Value for money increases each time a risk is transferred to the private sector in order to manage resources more effectively”¹⁷².

Having said that the concept of value for money is not solely a financial one, the legislation does require the existence of “significant financial benefit” before such

¹⁶⁹ Illidge et al (2000).

¹⁷⁰ S 78(3) Systems Act.

¹⁷¹ S 120 Municipal Finance Management Act.

¹⁷² NBI (April 2003).

a contract may be entered into¹⁷³. This highlights the legislature's obvious concern to ensure that the overall objective of the contract is not lost in the outsourcing process and, therefore, that a proper and unequivocal determination is made that the municipality *does* indeed stand to financially benefit from the contract. The importance of considering the financial impact of outsourcing contracts is again found in the provision that obliges the municipality to assess the impact of the contract on the municipality's future tariffs and revenues¹⁷⁴.

4.2.2.3 *Competition*

A key element underlying the concept of value for money is that of competition. The process of selecting a service provider in a competitive bidding environment should ensure the most cost effective of available potential providers is chosen, thus maximising the benefit to the municipality. There is clearly little justification in outsourcing a municipal service if the cost of doing so exceeds that of the municipality providing the service itself. Competition can also be directly linked to efficiency. This has been noted by the National Business Initiative in its statement that:



Private sector service delivery is not automatically more efficient than public service delivery. It is the introduction of competition that provides the incentive for efficient operation and the potential for profit that encourages entrepreneurship and innovation¹⁷⁵.

The importance of competition in the procurement process is recognized and emphasized in the policy documents and specifically in the legislation¹⁷⁶. As has been discussed above, the legislation requires the municipality to follow strictly regulated procurement processes which are intended to ensure the integrity of the process, fairness, competitiveness and transparency and which ensure the process is not tainted by undue influence or corruption.

¹⁷³ S 33 Municipal Finance Management Act (See discussion re section 33 above).

¹⁷⁴ S 33 Municipal Finance Management Act .

¹⁷⁵ NBI (February 2003).

¹⁷⁶ The Systems Act and Finance Management Act.

However, the procurement selection process is not solely driven by which bidder offers the best deal. Other factors, such as preferential procurement and local economic development must also come into the evaluation equation. The requirements of the Preferential Procurement Policy Framework Act do however ensure that “price” remains the central and most heavily weighted of all evaluation criteria¹⁷⁷.

4.2.2.4 *Measurable Outcomes*

How does a municipality ensure that a contract does in fact continue to offer value for money? To properly assess if value for money is being achieved requires a contract containing clear and measurable outcomes. If a contract does not contain these clearly defined outputs then it will simply not be possible to measure whether value for money is actually being achieved.

The significance of this issue is given added importance by the fact that outsourcing contracts are usually for relatively long periods of time. During the contract period circumstances may, and usually do, change. The effect may be a slow adjustment over time of service targets or other outputs to take into account the changing service environment. If the municipality is unable to monitor and assess the impact of these variations it will be unable to ensure that value for money continues to be achieved.

It therefore stands to reason that one prerequisite for ensuring continued value for money is the existence of efficient and comprehensive record keeping and reporting on the part of the service provider and diligent monitoring on the part of the municipality. The obligation on the municipality to monitor service delivery is in any event an important pre-requisite for it to ensure it remains accountable to its community. This is discussed in more detail under the “Accountability” section below.

¹⁷⁷ Preferential Procurement Policy Framework Act No. 5 of 2000.

4.2.3 *Efficiency*

Outsourcing offers a further potential benefit - that of achieving greater efficiency. The reasoning behind this idea is that "...better management in the private sector, and its capacity to innovate, can lead to increased efficiency; this in turn should translate into a combination of better quality and lower cost services"¹⁷⁸. The benefit of efficiency is specifically identified in the 2000 White Paper as one of the factors which should encourage a municipality to consider outsourcing¹⁷⁹. The 1998 White Paper takes the approach that running a service on "commercial" or "business" lines offers the prospect of greater efficiency. The underlying assumption is presumably that municipalities are prone to bureaucracy and inflexibility in the way they do business.

In fact, the approach the policy documents take is that a mere separation of the "authority" and "provider" role will lead to greater efficiency, even in circumstances where a non-private sector service provider is used¹⁸⁰. This philosophy is reflected in water sector legislation, which makes the separation of "authority" and "provider" roles a peremptory requirement¹⁸¹. It also constitutes one of the key principles informing the "institutional vision" as described in DWAF's "Strategic Framework for Water Services". The benefit of separating the provider and authority role, according to this Strategic Framework, is that doing so reduces the potential for conflicts of interest which may necessarily arise as a result of self-regulation. It also helps improve the clarity of objectives and responsibilities¹⁸².

Whether the private sector is indeed necessarily more efficient than the public sector is certainly not proven. As a recent IMF report argues, "much of the case for PPPs rests on the relative efficiency of the private sector. While there is an

¹⁷⁸ IMF (2004), par 1.

¹⁷⁹ Department of Provincial and Local Government. (2000), par 1.3.

¹⁸⁰ Department of Provincial and Local Government. (1998), par 2.2.2.

¹⁸¹ S 20 Water Services Act, 1997.

¹⁸² Department of Water Affairs and Forestry (2003), pg 10.

extensive literature on this subject, the theory is ambiguous and the empirical evidence is mixed”¹⁸³.

4.2.4 Skills Transfer

Perhaps one of the most important advantages in outsourcing is the potential of transferring skills and expertise to an under-capacitated municipality. If one were to attempt to describe the central problems facing municipalities in meeting their service delivery obligations, the two overarching features would be, first; a lack of financial resources to meet the infrastructure backlog and, second; a lack of skills to effectively deliver the service.

Skills transfer therefore offers the highly desirable prospect of empowering a municipality to effectively meet its future service delivery obligations without the need for external help. One must, however, make a distinction between an external service provider having superior skills and the actual transfer of those skills to the municipality. If the under-capacitated municipality does not take advantage of skills transfer from an external provider then it risks being locked into using that, or other, external providers for the service, as it would become increasingly unable to take over service delivery at expiry of the contract.

The 1998 White Paper identifies skills transfer as one of the chief benefits of using community based organizations or non-governmental organizations as service providers¹⁸⁴. It also regards this as an associated benefit of the “contracting out” option, although it does not consider this as a given and qualifies the statement by saying that it may “sometimes” be the case that contracting out offers better specialist expertise¹⁸⁵. Likewise, the 2000 White Paper describes skills, specialist knowledge and expertise as specific reasons supporting a municipality’s decision to consider outsourcing¹⁸⁶.

¹⁸³ IMF (2004), par 25.

¹⁸⁴ Department of Provincial and Local Government. (1998), par 2.2.4.

¹⁸⁵ Department of Provincial and Local Government. (1998), par 2.2.5.

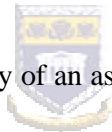
¹⁸⁶ Department of Provincial and Local Government. (2000), par 1.3.

4.2.5 Risk Transfer

Risk has been defined as “...any factor, event or influence that threatens the successful completion and operation of a project in terms of cost, time or quality”¹⁸⁷. This means risk covers a wide range of possible events; from a pipe burst, to an interest rate hike to political interference. The risks most commonly associated with public sector projects include, very briefly, political risk, contract variation, cost overruns, poor modelling and projections and bureaucratic management¹⁸⁸.

A recent IMF report suggests the following categories of risk apply to PPPs, although these may overlap to some extent and are not necessarily comprehensive:

- *construction risk* (design problems, building cost overruns, project delays);
- *financial risk* (variability interest rates, exchange rates, factors affecting financing costs);
- *performance risk* (availability of an asset, continuity and quality of service provision);
- *demand risk* (need for services); and
- *residual value risk* (re future market value of an asset)¹⁸⁹.



Residual value risk is less of an issue in PPPs in South Africa in the essential services sector, as core assets have to remain in the ownership of the municipality. These five categories can be broken down into any number of sub-categories, showing how complex the balancing of the various risks can be. Sub-categories could include risks such as sub-contractor risk, interest rate risk, insurance risk,

¹⁸⁷ Akkawi (2001).

¹⁸⁸ Illidge et al (2000).

¹⁸⁹ IMF (2004) par 20.

planning risk, latent defect risk, political risk, regulatory risk, utilities supply risk, resource risk, working capital risk – and so the list goes on¹⁹⁰.

Risk transfer can be regarded as both a possible benefit of outsourcing and, at the same time, as a potential danger area requiring careful consideration and treatment. On the benefit side, if risk is allocated appropriately then the municipality operates in a more “certain” environment as it knows its costs ahead of time. It therefore enjoys the advantage of being able to budget and plan ahead more effectively¹⁹¹. Also, in certain cases, such as a large construction project, a municipality is not necessarily ideally suited to bear all the related risks with a project of this nature. Managing the risks associated with a large construction project would not fall within the scope of the normal day to day operations of a municipality and would thus arguably be better suited to a private sector entity experienced in these projects. It has been suggested that key risks, which should usually be transferred to the private sector include construction cost, completion risk and operational risk¹⁹².



On the danger side, inappropriate transfer of risk could have a disastrous impact on a municipality. An ill-considered transfer of risk could put the municipality at undue financial risk and have a negative knock-on effect on value for money and affordability. As one of the policy documents notes, risk transfer is important as the more risk a contractor is forced to take on, the more compensation it will demand¹⁹³. Compensation could be in the form of more money, alternatively it could mean the contractor demands more autonomy in the contract.

Risk transfer is therefore not simply about the municipality trying to push as much risk the contractor’s way as possible; it is about finding the right balance, which may differ in each case, between the cost of risk and where it is most appropriately placed. The appropriate allocation of risk is therefore a complex

¹⁹⁰ PPP Quarterly (September 2002).

¹⁹¹ Department of Provincial and Local Government. (2000).

¹⁹² Grant-Thornton (2004).

¹⁹³ Department of Provincial and Local Government. (1998).

and thorny area and would have to be the subject of careful negotiation between the parties. For example, there is no reason why an external service provider should be put in a better risk position than if they were operating normally in the commercial sector. The allocation of risk should therefore be appropriate to the respective duties each party is taking on and would vary depending on the nature and length of the contract in question.

It is not surprising therefore, that both the Systems Act¹⁹⁴ and the Finance Management Act¹⁹⁵ make the appropriate transfer of technical, operational and financial risk an essential factor to be considered in any outsourcing process.

4.3 Dangers

4.3.1 Accountability

One of the greatest dangers in outsourcing a service is the risk of a loss of accountability on the part of the municipality. The municipality, no longer face to face with its community and one step removed from actual service delivery, may be tempted to divest itself entirely of its responsibility to the consumers. In other words, it may be inclined to remain passive and just leave the contractor to get on with the job. This poses a grave threat to the interests of the community which the municipality serves. It therefore makes sense that national policy ensures that “accountability” is included in the list of “guiding principles” to be applied when a municipality considers service delivery mechanisms¹⁹⁶. This is also a risk particularly associated with long term lease and concession type contracts¹⁹⁷.

Probably the most effective way a municipality can ensure it remains accountable to its community, is by monitoring the contract and service provider’s performance effectively. The municipality can also strengthen accountability by ensuring the service provider is contractually bound to comply with the

¹⁹⁴ S 78 Systems Act.

¹⁹⁵ S 120 Municipal Finance Management Act.

¹⁹⁶ Department of Provincial and Local Government. (1998), par 2.1.

¹⁹⁷ Department of Provincial and Local Government. (1998) par 2.2.6.

municipality's policies, such as credit control policies, pro-poor policies and so on.

The importance of reporting and monitoring is a constant theme in the policy documents and legislation. For example, national policy emphasises that a “contracting out” option for service delivery is only effective if the municipality has capacity to monitor the contract¹⁹⁸.

As seen in the overview of legislation above, there are a host of provisions which place positive obligations on the municipality to perform its monitoring and regulatory duties effectively. These include detailed and comprehensive regulating and monitoring duties related to contract performance and enforcement¹⁹⁹, and a detailed list of reporting and monitoring duties specifically applicable to municipal entities²⁰⁰. The capacity of the municipality to monitor, manage and enforce the contract is also built into the assessment process before a municipality may enter into a public-private partnership²⁰¹. Despite the comprehensive monitoring obligations currently in place, the legislation contemplates the imposition of *further* monitoring obligations by way of ministerial regulation²⁰².

Finally, the importance of effective monitoring is again emphasised by the legislature going beyond a general obligation to “monitor” and actually placing detailed and specific monitoring obligations on the municipality. This is found in the provision in the Finance Management Act which obliges the accounting officer of a municipality or municipal entity to monitor the contract “on a monthly basis” and to establish capacity in the municipality to “oversee the day-to-day management of the contract²⁰³”.

¹⁹⁸ Department of Provincial and Local Government. (1998) par 2.2.5.

¹⁹⁹ S 81 Systems Act.

²⁰⁰ S 93B and 93C Systems Act.

²⁰¹ S 120 Municipal Finance Management Act.

²⁰² S 86A Systems Act.

²⁰³ S 116 Municipal Finance Management Act.

4.3.2 *Public buy-in*

The analysis of policy and legislation above reveals a strong emphasis on the importance of public participation and transparency²⁰⁴. Although the policy and legislation does not spell out the risks if public participation and transparency are not built into the process, the obvious consequence is both a threat to the country's democratic principles and to the success of the outsourcing project itself. At worst, public unhappiness with outsourcing could lead to service boycotts, damage to infrastructure and thus prejudice to service delivery itself²⁰⁵.

The Systems Act and Finance Management Act ensure the public is closely involved in the process of determining service delivery mechanisms by informing them of the intention of considering external service providers, by setting up proper mechanisms for public participation and by inviting their comment at various stages²⁰⁶. Depending on the nature of the contract and which mechanism is chosen, the public could be invited to make representations or comment on at least three separate occasions before an outsourcing contract is finalised. Likewise, the public are kept closely involved in the procurement and selection process²⁰⁷. Both the Systems Act and Municipal Finance Management Act contain provisions that ensure the service delivery contract is available to the public²⁰⁸.

²⁰⁴ One of the “overall stated objectives” of the White Paper on Municipal Service Partnerships is to ensure transparency and public participation in choosing mechanisms and specific service providers.

²⁰⁵ The White Paper on Local Government, 1998, identifies prejudice to consumer rights and unfair labour practices as possible risks in concession contracts.

²⁰⁶ See for example section 78 of the Systems Act and sections 33 and 120 of the Finance Management Act.

²⁰⁷ The White Paper on Municipal Service Partnerships notes the importance of keeping tenderers, the community and other stakeholders informed in procurement process. See also section 83 of the Systems Act.

²⁰⁸ For example, sections 80(2) and 84 of the Systems Act and section 33 of the Municipal Finance Management Act.

Public participation does not end with the signing of the service delivery contract. The national policy correctly notes that if a later amendment to a contract has the effect of materially altering the contract then the whole purpose of competition is negated²⁰⁹. The legislation recognises this principle and ensures that the municipality is obliged to conduct a public participation process if a material amendment to a service delivery contract is contemplated²¹⁰.

4.3.3 Consumer Protection

4.3.3.1 Affordability

Another strong theme revealed in the policy and legislation is a concern for the consumer, specifically for the needs of the poor and thus the importance of ensuring the service remains affordable if outsourced. This concern for affordability is also reflected in the national policy for free basic services.

The tariff policy a municipality is obliged to adopt contains many provisions obliging the municipality to consider the needs of the poor when setting tariffs²¹¹. “Affordability” is also a specific factor a municipality must consider when conducting its feasibility study to determine service mechanisms, as is the issue of how outsourcing will “address the needs of the poor”²¹². This issue can also be influenced by inappropriate risk transfer. If the municipality takes on an inappropriate amount of risk and, as a result, suffers economic hardship, it may be forced to raise tariffs and thus negatively affect affordability. Although this is not explicitly stated in the policy documents, the fact that the private sector is essentially profit driven could create a tension between its “business principles” and the requirement of affordable services, (including free basic services and lifeline tariffs for the indigent). The risk is that the desire for profit, or even merely for cost effectiveness, may threaten affordability.

²⁰⁹ Department of Provincial and Local Government. (2000), par 4.11.

²¹⁰ S 77 Systems Act and s 116(3) Municipal Finance Management Act.

²¹¹ S 74 Systems Act.

²¹² S 78 Systems Act and s120 of the Municipal Finance Management Act.

Affordability is thus closely linked to the setting of tariffs. Although the municipality will always retain sole authority to set tariffs it is undeniable that an outsourcing contract may impact on the municipality's discretion in this regard. In fact, from the analysis of the contracts below it is apparent that some contracts purport to grant the service provider some power over the setting of tariffs in order to balance prospective shortfalls in the contract. If tariffs are liable to being hiked to account for contractual difficulties or future unknown risks, then the overall value for money which the contract initially offered may be weakened.

This makes it imperative that the contract, as far as possible, ensures certainty in this regard. One way of providing more certainty is to ensure that there is an appropriate allocation of risk between the parties and that those parties taking on the risk take out appropriate insurance to guard against it. This should go some way to heading off unexpected tariff hikes.

4.3.3.2 Customer Care

The risk of monopoly pricing and “cherry picking” high income users to the detriment of the poor is specifically identified as a risk in concession and lease contracts²¹³. In theory however, the obligations imposed on the municipality regarding the factors it must take into account when adopting its tariff policy and its power to set its own credit control and indigent policies should limit the risk of unfair treatment of consumers.

4.3.4 Protection of Service Environment

4.3.4.1 Continuity

The fact that a municipal service will not be contracted out forever, be it because the contract expires or is cancelled early as a result of breach, means that there is a real risk to continuity of service delivery when the time comes for the

²¹³ Department of Provincial and Local Government. (1998), par 2.2.6.

municipality (or other service provider) to take over the service²¹⁴. This is an especially crucial risk when the service is a basic municipal service. A community is unlikely to tolerate interruption of a service such as water and sanitation for a few hours, let alone a day or days. It is therefore not surprising that the municipality is legally obliged, when entering into a service delivery agreement, to ensure “continuity” and uninterrupted service delivery²¹⁵. The legislation does not, however, contain detailed provisions suggesting how to limit this risk.

“Continuity” or risk of interruption is not necessarily a risk restricted to the unexpected (or even expected) termination of the contract; it could also be a risk faced in an emergency event if the service provider is not capable of handling the event adequately. This would therefore be an additional factor to be considered when entering into a service delivery agreement with an external provider.

4.3.4.2 *Asset protection*

A municipality’s ability to provide a service is only as good as the assets it owns to provide that service. It is therefore recognized that it is undesirable to transfer ownership of core service assets, something which is now outright prohibited by legislation²¹⁶. When outsourcing a service the operation, possession and control of these assets falls into the hands of an external entity. The obvious risk is that the assets are not adequately repaired and maintained. In the worst-case scenario, an external provider may perform the minimum amount of short-term maintenance and repair work to see the assets through to the end of the contract term, leaving the municipality with a nasty surprise when it ultimately regains possession.

²¹⁴ The White Paper on Municipal Service Partnerships identifies service interruption as a result of the insolvency of the service provider as a real risk.

²¹⁵ S 81 Systems Act.

²¹⁶ See the White Paper on Local Government, 1998 and section 14 of the Finance Management Act which prohibits the disposal of capital assets used to provide basic services.

The concern for protection of service assets is reflected in a variety of provisions in the legislation, including a duty on the municipality to take over the assets at the expiry of the contract²¹⁷, a prohibition on prejudicing the use of a basic service asset if that asset has been used as security²¹⁸ and a specific obligation to protect assets in the water sector²¹⁹. The Minister is also granted the power to make future regulations specifically regarding the prohibition on asset stripping²²⁰.

4.3.4.3 *Dispute resolution*

Given the complexity of outsourcing contracts and the many and varied duties of the parties, it is highly likely that from time to time disputes will arise between the parties. Without adequate dispute resolution mechanisms the parties will be operating in a vacuum and would either have to make up procedures as they went along or follow the expensive and time-consuming option of the courts²²¹.

Without clear rules of engagement there would be a real risk of a breakdown in the relationship between the parties and, even worse, the potential of service interruption if the dispute concerned technical issues and required speedy resolution.



Given the complexity of issues faced in a service delivery agreement, it is not uncommon for some issues to be the subject of future agreement between the parties as and when they arise. Without effective dispute resolution procedures, these “by future agreement” provisions could otherwise become problematic. The municipality is therefore legally obliged to ensure the service delivery agreement

²¹⁷ S 81 Systems Act.

²¹⁸ S 48 Finance Management Act.

²¹⁹ Regulation 11, Water Services Provider Contract Regulations (August 2001), Water Services Act.

²²⁰ S 86A Systems Act.

²²¹ The White Paper on Local Government, 1998, specifically identifies the importance of including dispute resolution procedures in lease and concession contracts to avoid the inherent risks of failing to do so.

contains dispute resolution mechanisms between the municipality and service provider²²².

4.4 Conclusions on drivers and dangers

The process of identifying and describing typical drivers and dangers in outsourcing reveal the many pitfalls that await an ill-considered or poorly planned outsourcing initiative. The drivers and dangers are also clearly inter-related and interdependent, so that a poor risk allocation could trigger a host of other outsourcing “dangers” (such as loss of value for money and affordability). The nature of the “dangers” particularly, adds emphasis to the importance of the feasibility study in the outsourcing process.

Generally, there also appears to be some agreement on the nature of the potential benefits which can be achieved by outsourcing and the commonly encountered risks which need to be guarded against. In this respect, the policy and legislative framework are by and large in harmony. However, it must be noted that in neither the policy nor the legislation is there any attempt to definitively identify and describe each risk and potential benefit. The risks and benefits instead have to be inferred or “read in” to the documents.

Having identified and described the various drivers and dangers, the next step is to evaluate how current outsourcing contracts deal with these issues. As a preliminary step, it is necessary to outline the methodology of the contract analysis, the different categories of service provider and the various types of contract which may arise in this analysis. This is dealt with in the following chapter.

²²² S 81 Systems Act.

5 Chapter Five: Contracting out

5.1 Purpose of analysis

Having identified the most important objectives behind the outsourcing initiative, and their associated risks, it is important to assess how current contracts deal with these matters. Clearly, if contracts fail to translate the objectives into effective contract provisions, then the very reason for outsourcing may be threatened. No matter how efficient and comprehensive an outsourcing “process” may be and how valid the feasibility studies, if the contract ultimately entered into is not carefully drafted to take all these factors into account, the whole process threatens to become a waste of time and resources. The contract thus becomes one of the key features to ensure the success or otherwise of an outsourcing initiative.

5.2 Methodology

The contract analysis will seek to identify and describe the typical features of current South African municipal outsourcing contracts. The contracts will thus not be analysed on a case by case basis and the analysis will not purport to be a comment on the efficacy or otherwise of particular contracts. Having described how the contracts typically deal with particular aspects pertaining to the “drivers” and “dangers”, any noteworthy or unusual features of particular contracts will be described if relevant to the issue at hand.

I analysed a total of fifteen contracts for the purposes of the study. A fair number of these contracts were obtained with some difficulty, despite the fact that they should be accessible to the public. As the methodology and purpose of the contract analysis was not to reach an authoritative analysis or “case study” on each contract, the identity of the actual contracting parties is not relevant. What is relevant is the nature and duration of the contract, the sector within which it falls and the category of contracting party, in other words whether it is a contract with a private company for example, or a community based organisation.

I obtained certain of these contracts only after I had explained the methodology I would be using and after having given assurances that the particular contracting parties would not be identified in the thesis. Given the time constraints for the thesis, there was neither time nor opportunity to attempt to compel municipalities to hand over their contracts through other legislative procedures. Although not all contracts were obtained on the basis that the contracting parties would not be identified, I do not identify any of the parties in this chapter and Chapter Six. Contracting parties are identified under Chapter Seven, when I analyses case studies already in the public arena. In any event, I submit that nothing is added to the contract analysis if actual contracting parties are identified as my objective is to extract out “common drafting themes” and generic terms and not to deal with contract-specific issues.

The fifteen contracts, set out more fully in Appendix A, cover a wide range of categories of external service provider, including contracts with private companies, with municipal entities, public sector entities and community based organisations. The categories of contract include concession contracts, management and service contracts (including revenue collection) and short-term service contracts. The contracting municipalities range from various metropolitan municipalities to small, rural local municipalities. Appendix A also details the sectors within which the contracts were entered into. These were primarily water and sanitation contracts but also included refuse collection and disposal and electricity provision.

The analysis also attempts to take into account, where appropriate, both the type of contract entered into and the nature of the external entity. The features of a concession agreement with a private sector provider would and should, for example, be somewhat different to a service contract with a municipal entity. I will attempt to take these various factors into account and assess if they translate into differences in the actual contract terms.

The analysis will also take into account, as a comparative tool and only where appropriate, the provisions of the National Treasury Standardised Public-Private

Partnership Provisions (“the Standardised Provisions”)²²³. The Standardised Provisions were born out of a lengthy consultative process, which included input from international consultants and which specifically drew on the experience in the United Kingdom and the standardised provisions published by Her Majesty’s Treasury. Although these Standardised Provisions are intended to cover public private partnerships in the national and provincial spheres of government only, the principles and concepts behind the suggested contract terms can equally, and very usefully, be applied to partnerships in the local government sphere. This is particularly so on more generic issues such as the appropriate transfer of risk and performance monitoring requirements.

It is worth noting that the Standardised Provisions are intended to cover service agreements entered into with private companies and not public sector entities. It is apparent that many municipalities are contracting with public sector entities (such as water boards or municipal entities) for the provision of basic municipal services. However, certain general provisions and principles such as satisfactory risk allocation, adequate monitoring provisions and the like should translate and apply equally to a contract with a public sector entity²²⁴.

Finally, there are certain limitations to any desk top contract analysis. For example, the most difficult “danger” to adequately evaluate without a thorough understanding of the background and context of a particular contract is the issue of risk transfer. As pointed out earlier, risk transfer is a balancing act with (in theory at least) the municipality facing an increasingly expensive contract with the more risk it attempts to transfer. So, to properly appreciate the efficacy of risk allocation in a particular contract, one would need to understand the wider context within which that risk allocation took place. However, even here there are certain “general rules” regarding the appropriate transfer of certain generic risks, which can usefully be used to get an idea of how risk is being dealt with in current

²²³ National Treasury (2004).

²²⁴ For ease of reading, when referring to the Standardised Provisions the thesis will refer to “municipality”, when the Standardised Provisions would in fact have been referring to a national or provincial department or institution.

contracts. Certain risks, such as vis major and material adverse governmental action, should be capable of more generic treatment than others which are service and contract specific.

5.3 Categories of Service Provider

5.3.1 Introduction

Before commencing with the contract analysis, it is important to understand the range of potential service providers recognised by legislation. The different service providers may exhibit particular features which could impact on the contract analysis. The thesis examines outsourcing contracts with external entities only. It does not extend to the internal service delivery mechanisms described in the Systems Act²²⁵.

As will be seen below, the nature of external entities can vary widely, from a fully independent, private company to a wholly municipal-owned entity. Under this heading only an overview of the fundamental characteristics of each possible external entity will be set out. The possible impact these different entities are likely to have on the terms and conditions of actual service delivery agreements will also be briefly considered. For example, when contracting with a private company as opposed to a wholly-owned municipal entity the question of transfer risk may be quite different.

The possible external service providers recognized in legislation have been arranged under the following categories, each of which will be discussed in turn:

- community based and non-governmental organizations;
- municipal entities;
- public sector providers; and
- private sector providers.

²²⁵ Such as ring-fenced business units or service departments.

Because of the comprehensive and lengthy provisions regarding municipality entities (and the fact that these have been recently amended) the section on municipal entities will necessarily be far more detailed than the others.

5.3.2 *Community Based and Non -Governmental Organisations*

5.3.2.1 Nature

Community based and non-governmental organisations are recognised by the Systems Act as potential external service providers²²⁶. The proviso is that the organisation must be “legally competent” to enter into an agreement. In other words a CBO cannot merely comprise a loose grouping of community members; the community is obliged to organise themselves into a more formal structure with legal capacity to enter into agreements. This means that the actual legal structure of the organisation could take many different forms; including a company, an association, a trust, a partnership and so on.

5.3.2.2 Contract Implications



The 1998 White Paper regards these contracts as being well-suited to skills transfer. However, this is probably more relevant to a specialist NGO rather than a CBO. The CBO contract, focussed as it typically is on social upliftment and local economic development, could in fact result in the municipality contracting with a less skilled external entity. If this is so, then one would expect a contract to, *inter alia*, ensure comprehensive support and monitoring on the part of the municipality, with the municipality retaining perhaps far more risk than it would in other service delivery agreements. Because of the CBO potentially not starting the contract with pre-existing specialist service delivery skills, one would also expect a contract more focussed on clearly defined inputs rather than outputs (contrary to most PPPs) with the possibility of this changing as the CBO gained more experience and expertise in the particular service area.

²²⁶ 76(b)(iv) Systems Act.

5.3.3 *Municipal Entity*

5.3.3.1 *Introduction*

Although entirely separate from the municipality, the municipal entity is tightly regulated by both the Systems Act and Finance Management Act.

The Systems Act sets out detailed statutory duties and responsibilities governing a municipality if it decides to establish a municipal entity²²⁷. A brief description of some of these responsibilities and duties are set out below, from which it will be clear that an attempt is made to ensure that the municipality retains accountability for service provision and the success of the municipal entity despite the fact that the municipality has outsourced the function.

The municipality is explicitly obliged to ensure the municipal entity “is managed responsibly and transparently, and meets its statutory, contractual and other obligations”²²⁸. It must also ensure there are clear channels of communication between the municipality and the municipal entity. In fact, the Act provides that the “official” line of communication between municipality and entity operates between the chairperson of the board of directors and the mayor of the entity and the municipality respectively²²⁹.

A variety of provisions oblige the municipality to ensure that performance objectives and indicators are both established and met, that effective monitoring takes place, that effective and fair procedures are put in place for the appointment and removal of directors and that measures are in place to ensure effective governance of the municipal entity generally. Although the municipal council appoints the board of directors, councillors and officials from that municipality are prohibited from holding office as a director in the municipal entity. The same prohibition applies to members of the National Assembly, provincial legislature and to permanent delegates to the National Council of Provinces. Other

²²⁷ Parts 5, 6 and 7 of Chapter 8A Systems Act.

²²⁸ S 93A Systems Act.

²²⁹ S 93D Systems Act.

disqualifications are those to be expected for any director, such as being of unsound mind, an unrehabilitated insolvent and so on.

Although councillors and officials are prohibited from exercising powers as directors of the municipal entity, the municipality is obliged to designate a “municipal representative” to represent the municipality as an “observer” at board meetings and to exercise shareholder rights at shareholder meetings. The municipality’s mayor is also authorized to call for a general or shareholders meeting at any time to call the board of directors to account²³⁰. The official Code of Conduct applicable to councillors and municipal staff members, is also made applicable, with the necessary changes, to the directors and staff members of the municipal entity²³¹.

The Finance Management Act likewise contains many provisions regulating the conduct of municipal entities. For example, the duties and responsibilities of the municipality’s “accounting officer” (its municipal manager) apply in turn to the chief executive officer of the municipal entity. In fact, the Finance Management Act contains an entire chapter dedicated to municipal entities covering financial governance, accounting officers, reports and reportable matters and general matters such as borrowing of money and financial problems²³².

The actual form a “municipal entity” may take has undergone a significant revision from that initially envisaged by the Systems Act. This follows on statutory amendments to the Systems Act promulgated in 2003²³³. Before the 2003 amendments a municipal entity could have taken a range of forms, from a trust to a fund, to a separate company. What made the entity a “municipal” entity was the extent to which the municipality could exercise control over that entity. With the new amendments, however, the range of possible municipal entities is

²³⁰ S 93D Systems Act.

²³¹ S 93L Systems Act.

²³² Chapter 10 Finance Management Act.

²³³ Local Government: Municipal Systems Amendment Act, Act No. 44 of 2003.

restricted to one of only three options; a private company, a service utility or a multi-jurisdictional service utility. Each of these will be discussed in turn.

It is also worth noting that a municipal entity is not restricted to performing only a “municipal service” within the meaning of Chapter 8 of the Systems Act. A municipal entity is entitled to perform any function or power that a municipality is legally competent to perform.

5.3.3.2 Private Company Municipal Entity

The provisions regarding private companies and municipal entities are relatively convoluted, but are a little easier to unravel if it is remembered that it is not the purpose or main function of the company which dictates whether it is a “municipal entity”, instead it is a question of whether the municipality controls that company. In other words, under the Act, two private companies could theoretically be set up, both performing precisely the same municipal service, for example refuse collection. However, if one company is controlled by a national organ of state (with the municipality only holding a lesser share) and if the other is controlled solely by the municipality, then only the company controlled by the municipality would be deemed a “municipal entity” for the purposes of the legislation.

A municipality may do one of two things to initiate participation in a private company; it can first establish a private company itself; or, second it can acquire an interest in a pre-existing company²³⁴. However, a municipality may only exercise either of these powers:

for the purpose of utilizing the company as a mechanism to assist it in the performance of any of its functions or powers referred to in section 8²³⁵.

Section 8 referred to in the extract above encompasses all functions and powers, including incidental powers and functions, conferred or assigned by the Constitution. This therefore goes much further than just the “municipal services”

²³⁴ S 86C(1) Systems Act.

²³⁵ S 86E Systems Act.

found in Schedule 4B and 5B of the Constitution²³⁶. It must furthermore show that there is a need to perform the functions or powers “in accordance with business practices” in order to achieve its objectives²³⁷.

The municipality may either exercise “effective control” over a company, or it may hold a “lesser”, non-controlling, interest²³⁸. The Act strictly regulates the extent to which the municipality can hold such a “lesser” interest in a private company, particularly in cases where a company is part-private, part-public owned. There appears, therefore, to be an underlying preference for a municipality to rather hold minority interests in “public” held companies. For example, there is no restriction on a municipality holding a non-controlling share in a company if the other shareholders are other organs of state²³⁹. But there is an outright prohibition on the municipality holding a lesser interest in a company which is under the effective control of any entity other than an organ of state²⁴⁰. The only time a municipality is authorized to hold a non-controlling interest in a private company which has some “private” shareholders, is if those private shareholders do not exercise effective control over the company. Control must vest instead with another organ of state²⁴¹.

Thus, only if the company is controlled by a municipality/ies will it be considered a “municipal entity” for the purposes of the Systems Act. Companies controlled at the national and provincial level will instead fall under the auspices of the Public Finance Management Act²⁴².

²³⁶ It is also not clear in any event if all the listed functions in Schedule 4B and 5B are “municipal services” for the purposes of the Systems Act.

²³⁷ S 86E Systems Act.

²³⁸ “Effective control” is defined in section one of the Systems Act as the power of a shareholder either, (a) to appoint or remove the majority of the board; or, (b) to control the majority of voting rights at a general meeting.

²³⁹ S 86C(2) Systems Act.

²⁴⁰ S 86C(2) Systems Act.

²⁴¹ S 86C(2) Systems Act.

²⁴² Act No 1 of 1999.

If the company is wholly owned by the municipality, that municipality may only dispose of the company under the terms of the Finance Management Act. If the municipality wants to dispose merely of an interest it holds in a company, then section 14 of the Finance Management Act applies. This is the section prohibiting the disposal of capital assets needed to provide a minimum level of basic municipal service. The municipality disposing of its interest must also make sure that its disposal does not have the effect of placing any other municipality holding an interest in that company in contravention of section 86C(2)²⁴³.

Importantly, a municipal entity is prohibited from performing any activity beyond the powers and functions of the municipality under section 8 of the Systems Act. This means that a municipality cannot authorize its municipal entity to, for example, perform other profit-generating functions to boost its income if the municipality would not be legally competent to perform those functions itself²⁴⁴. This section only applies to a “municipal entity”, so that a municipality could in theory hold an interest in a company performing other “non-municipal” functions, if that company was controlled by another organ of state.

5.3.3.3 *Service Utilities*

A service utility is a separate legal entity established by the passing of a municipal by-law. The entity is a juristic person and is under the sole control of the municipality. The service utility has no competence to perform any function other than those conferred by the by-law. In this sense, the service utility really is a creature of statute with no inherent autonomy other than that strictly described in the by-law. It can only be disestablished by a further by-law and all assets and liabilities then vest with the municipality.

Again, as with the private companies, a service utility could be set up to perform any of the municipality’s functions, not only that of delivery municipal services. The municipality must also justify a decision to establish a service utility by

²⁴³ Namely, that the municipality left behind is not left holding an interest in a company controlled by an entity other than an organ of state.

²⁴⁴ S 86D(2) Systems Act.

demonstrating that to do so will enable it to perform a power or function “more efficiently” and will “benefit the local community”²⁴⁵.

5.3.3.4 *Multi-jurisdictional Service Utility*

A multi-jurisdictional service utility is an entity created by agreement between two or more municipalities with the purpose of performing municipal powers or functions in their areas or parts of their areas²⁴⁶. The utility is governed by a board of directors appointed by each participating municipality. The Act obliges the municipalities to include in the written agreement provisions regarding the consequences of termination of the agreement, withdrawal of a particular municipality, distribution of assets and liabilities on winding up and the inclusion of compulsory written reports on the activities and performance of the utility²⁴⁷.

5.3.3.5 *Contract Implications*

The fact that the municipality effectively exercises ultimate control over the municipal entity means this service provider falls somewhere between an internal service mechanism (such as a municipal department or business unit) and an external public sector entity such as a water board. Because the municipality “owns” the municipal entity, it is unlikely to watch from the sidelines as the entity encounters financial or operational difficulties. This makes the risk profile of these entities somewhat different to a private sector entity. Also, because the municipal entity is so closely and inextricably linked to the municipality, it would not be inappropriate, for example, for the entity to be involved in and give input into, the municipality’s policies, by-laws, budgets and future service strategies. However, for a private company to do so may well be inappropriate.

Unlike other external entities, because of the nature of the municipal entity it would also not be inappropriate for the service delivery agreement to run

²⁴⁵ S 86I(1) Systems Act.

²⁴⁶ S 87 Systems Act.

²⁴⁷ S 89 Systems Act.

indefinitely. Of course, the municipality would and should always reserve the right to terminate the agreement if necessary.

5.3.4 Public Sector Provider

5.3.4.1 Nature

Public sector providers could take a number of forms, including national or provincial organs of state, traditional authorities, water services committees and licensed service providers recognized in national legislation²⁴⁸. The Act does not refer to “public sector” providers as a separate category and I do so merely to distinguish them from municipal entities (a very particular type of public sector provider) and fully private sector providers. In the water sector a water board has become a relatively common public sector service provider. Although a water board traditionally provides bulk water to municipalities, some have also been successfully and increasingly providing retail services on behalf of municipalities.

5.3.4.2 Contract Implications



A public sector provider’s functions and objectives would not entirely mirror that of a particular municipality and the contract would thus have to recognize this more arm’s length relationship. As a public sector provider’s objective should always ultimately be to benefit the public in some way, there should theoretically be less need for contractual protection against actions prejudicial to the public interest.

As the municipality does not own or exercise any control over the public entity, issues such as reporting and monitoring, continuity of service and continued accountability on the part of the municipality need to be thoroughly covered in the contract. The fact that a public sector provider is typically not profit driven means the contract would not have to put mechanisms in place to prevent profit motives prejudicing other objectives of the contract, such as affordability, life-line tariffs and the like. The public sector provider is also likely to possess excellent skills

²⁴⁸ S 76(b) Systems Act.

and expertise in its particular service sector. One would therefore expect some mechanism to ensure skills transfer from the public sector entity to the municipality. Also, because the entity is already “publicly” focused, the risk of a lack of public buy-in is (in theory at least) lessened. It is therefore unlikely to be necessary for this external entity to perform specific “community” projects as found in some private sector contracts (such as building soccer fields or libraries and the like).

5.3.5 *Private Company*

5.3.5.1 Nature

The private service provider is, quite simply, any private institution, be it a company, close corporation, partnership or the like, which is “legally competent to operate a business activity”²⁴⁹. The legal nature and structure of the private entity is not relevant to the thesis; it is the fact that it is entirely “privately” owned that is a factor to consider when analyzing particular service delivery contracts.

5.3.5.2 Contract Implications



Contracting with a private company represents a true arm’s length relationship, which will require a contract leaving no doubt regarding the parties’ respective roles, strict reporting and monitoring provisions and a very clear delineation between the parties’ roles as “authority” and “provider” respectively. The importance of allocation of risk is highest with this entity.

It would be inappropriate for a private company to exercise veto power, or even undue influence, over the municipality’s duties regarding the approval of policies, strategies and future decisions regarding service delivery. This is because the company’s accountability is ultimately to its shareholders and it could well have an interest in extending a contract for as long as possible (so long as the contract is profitable) or of amending the contract to its advantage. The municipality

²⁴⁹ S 76(b)(v) Systems Act

would therefore need to ensure that it has the capacity to take over service delivery at the end of the contract period and is not locked in to using the private company indefinitely.

As the use of a private company comes closest to the concept of true “privatization” and is often a tough sell to the community affected (who fear tougher credit control methods and tariff hikes) the contract will need to ensure that steps are taken to try and ensure public buy-in, to allay fears and to achieve excellent communication channels between the consumers and the service provider. The contract will often include provisions obliging the company to dedicate money to community upliftment projects (such as funding social projects or building community facilities) and to the use of local labour wherever possible.

5.4 Categories of Contract

5.4.1 Introduction

Just as external service providers may vary widely, so too can the contracts that the parties enter into. Set out below is a brief description of some of the typical outsourcing contracts available to municipalities. The descriptions are based on those found in the 2000 White Paper. It must be remembered that these are not fixed categories and a service delivery contract could be a combination of any of the following contract types.

5.4.2 Service Contract

The municipality will pay the service provider a fee to manage a particular aspect of a municipal service, such as billing or repair and maintenance. Of course, a grey area may be created regarding the applicability of Chapter Eight of the Systems Act in cases where a very small or insignificant aspect of a service is outsourced. Chapter Eight regulates the outsourcing of a municipal service and sets vigorous processes to be followed when an outsourcing route is followed. But when does a function cease to be a municipal “service” for the purposes of this Act? For example, it appears highly unlikely that the servicing and repair of vehicles necessarily required for the provision of water and sanitation services

would qualify as a “municipal service” liable to follow a section 78 assessment process.

In fact, even though the 2000 White Paper mentions maintenance and billing as possible subjects of a service contract, it is by no means clear that Chapter Eight outsourcing regulation would automatically apply to contracts of this nature. Of course, that said, the nature of such a contract remains an “outsourcing” one even if there is a possibility that the section 78 process does not have to be followed.

Service contracts are usually short-term contracts of only one to three years. The White Paper suggests that these contracts would be suitable for involving CBOs and NGOs, presumably because they should be relatively self-contained and thus fairly easy to monitor and control. They would also not involve the risks associated with longer-term capital investment projects, nor would they necessarily require the service provider to consider long-term service strategies.

5.4.3 *Management Contract*



In a management contract the service provider will assume responsibility for all aspects of a particular service except those involving capital costs. Chapter Eight outsourcing provisions will therefore always apply to these contracts. There is also not a great conceptual difference between a “service” and a “management” contract. Both require the service provider to manage an aspect of the service; a management contract merely excludes less from the whole service than the service contract does.

Given the more onerous responsibilities placed on the service provider in these contracts, it is not surprising that they are usually of longer duration than service contracts. Typically they will last for between three to six years, but this can vary quite widely from case to case.

According to the 2000 White Paper, these contracts would usually specify payment of a fixed fee with a variable component built in if the service provider meets or exceeds the performance targets and the service provider would usually not take the risk of tariff collection.

5.4.4 Lease

The municipality will lease the assets necessary to provide the service to the service provider on a long term lease. The service provider will be responsible for management of the whole service including maintenance and repair and will often also take the risk of revenue collection. Usually, the service provider will not be responsible for new infrastructure or for the replacement of assets. The duration of the contract will range from between eight to fifteen years.

5.4.5 Build Operate Transfer (BOT)

The service provider designs and builds a facility for the provision of a municipal service and then operates, maintains and repairs it on a long term basis. The facility then reverts to the municipality at the end of the contract. The municipality will usually pay the service provider a fee, with the municipality remaining responsible for tariff collection.

5.4.6 Concession



A concession agreement may apply to just one facility or to the entire system of a particular service. The concessionaire takes responsibility for all aspects of the service, including the design, construction and financing of a facility or the system. The service provider will usually collect and retain all service fees and will take the collection risk. The concessionaire will then pay the municipality a concession fee, which may or may not vary depending on actual revenue collected. Unlike the BOT, the municipality retains ownership of all existing facilities and those built by the concessionaire during the contract revert to the municipality at the end of the concession period.

The contract will usually last between twenty-five and thirty years.

5.5 Conclusion

In this Chapter I have described the two sets of variables to consider when analysing outsourcing contracts; namely the nature of the service provider and the nature of the contract. A concession contract with a private party will necessarily exhibit different characteristics to a short term service delivery contract with a

municipal entity. In the next chapter I will assess how current outsourcing contracts have dealt with the “drivers” and “dangers” of outsourcing while taking into account, where appropriate, the variables of the nature of each contract and the status of the contracting parties.



6 Chapter Six: Contracts and “drivers” and “dangers”

6.1 Introduction

This chapter will analyse current South African outsourcing contracts to assess how they typically deal with the “drivers” and “dangers” previously identified as being the primary motivators behind the policy and legislative provisions on outsourcing. As described in the introduction to Chapter Five, it is important to assess how current contracts deal with these matters as, if a contract fails to translate the outsourcing objectives into effective contract provisions, then the very rationale for outsourcing may be threatened.

The categories and types of contracts which form the basis of this analysis are set out more fully in Appendix A but can be briefly summarised as follows:

- Two long term water services contracts with private companies;
- Two long term water concessions with private companies;
- Three management and service contracts with municipal entities in the water, solid waste and electricity sector;
- Four water management and services contracts with water boards;
- Four shorter term, solid waste service contracts with CBOs.

The contract analysis will proceed in the order in which the “drivers” and “dangers” were dealt with in Chapter Four.

6.2 Capital Investment

6.2.1 *Suggested Contract Requirements*

The driver of “capital investment” is unlike the other objectives and risks inherent in outsourcing discussed below. The contract either contemplates capital

investment or it does not. So this objective is either met or not and no negative inference can be reached by its absence. What is of interest is to analyse how many outsourcing contracts have this as their objective.

Of course, if the service provider *does* offer capital investment, the way the finance is structured and the many financial and legal consequences that flow from such deals need careful analysis; but these complexities necessarily fall outside the scope of the thesis.

6.2.2 *Contracts and Capital Investment*

According to records compiled by the Municipal Infrastructure Investment Unit, during the period 1999 to 2003 the unit assisted in the completion of approximately thirty five municipal outsourcing projects (these were in respect of all municipal services and not just “basic” services)²⁵⁰. Of these thirty five projects, only twelve constituted capital expenditure projects and of the twelve “capex” projects six were in the water sector and one in the waste sector. The rest of the capex projects fell under other municipal service areas such as cemeteries and airports.

This means that from 1999 to 2003 approximately seven outsourcing projects for basic services involved the provision of capital expenditure. This represents a relatively small fraction of the actual outsourcing projects completed. It is not yet clear what proportion of projects currently in the pipeline will involve capital expenditure on the part of the service provider.

6.2.3 *Conclusion*

Capital infrastructure outsourcing projects for basic services appear to be relatively rare in the municipal sphere. This is surprising, given the well-documented and serious infrastructure backlog for municipal services.

In Chapter Seven of the thesis, which analyses particular case studies of municipal outsourcing projects, details are given as to how the “capital investment”

²⁵⁰ Municipal Infrastructure Investment Unit. “Completed Projects”.

objective has weakened in particular cases. This occurred in circumstances where a changing contract environment led to an agreed reduction of initial capital investment projections. As these adjustments were made after contract renegotiations, the current contract terms are not all that relevant, as the negotiation process and not the contract itself, determined the extent to which capital projections were reduced.

6.3 Value for Money

Value for money is a concept necessarily inter-linked with many other factors. The chief prerequisites for achieving value for money are; the existence of actual financial benefit to the municipality in purely monetary terms; the presence of competition in the procurement process; and clear and measurable outcomes.

The element of competition takes place before the contract is actually entered into and thus falls outside the scope of this analysis which is a purely “paper based” analysis of contract terms. However, given the relatively strict regulatory environment governing procurement, especially at this scale, it seems unlikely that a private sector entity would be selected without at least the semblance of a competitive process being followed. Failure to do so would effectively be unlawful and would thus jeopardize the entire outsourcing project. Whether the competitive process itself is tainted by undue influence, corruption or the like is an issue falling beyond the scope of the thesis.

As far as actual financial benefit is concerned without an in-depth knowledge of the financial context of each contract it is effectively impossible to assess whether actual financial benefit will in fact be secured in each particular case. One would need, for example, to understand the profitability of the service, the state of the assets (will they be costly to repair and maintain?), the estimated future service demand, possible future developments needing services and so on. More importantly, one would need information regarding the cost and value of the inputs versus outputs when the municipality was providing the service in-house.

The general exception to this problem are the provisions contained in the contracts with CBOs which typically provide very detailed specifications and which are

individually priced and paid for monthly. This means the municipality can maintain a continuous and detailed record of the cost (inputs) of the contract and compare these with the very specific outputs generated. This is of course made easier by the fact that the CBO contracts are for refuse collection. If they were for water and sanitation services they would probably not be as easy to assess.

However, if one is to assume that each municipality will at the commencement of the contract, at least on the face of it, stand to gain financial benefit from the contract – this state of affairs can be put at risk if the contract, for example, transfers undue risk to the municipality (leading to unexpected future expenses), or leaves certain aspects of the contract for future determination by the parties and these aspects have significant financial consequences. The contracts will therefore be assessed on whether the ‘assumed’ financial benefit at the commencement of the contract will potentially be put at risk because of particular provisions in the contract. This necessarily falls under other headings, such as “Risk Transfer”, discussed below.

Finally, the contracts must contain measurable outcomes as, failing this, the municipality will be unable to assess whether it is in fact achieving value for money and would just have to take it on faith. This is particularly problematic for longer-term contracts where the technical, operating and financial environment could change significantly over time. This requirement to monitor outcomes is also of course the chief prerequisite to ensure that the municipality remains accountable for the service. The issue of measuring and monitoring outcomes will therefore be dealt with under the heading “Accountability” below on the understanding that poor monitoring provisions will not only prejudice accountability, but will also put value for money considerations at risk.

6.3.1 Conclusion

It is not possible to assess whether the requirement for financial benefit is being met in each contract analysed from a desk top study alone. What can, however, be assessed is whether any contract provisions pose a potential threat to a pre-existing financial benefit. A threat to the “value for money” objective can come from many other quarters, such as inappropriate allocation of risk or insufficient

contract monitoring. Value for money considerations will thus necessarily be referred to within the discussions under the relevant headings below.

6.4 Efficiency

6.4.1 Suggested Contract Requirements

Efficiency is a difficult concept to tie down in a contract. The selection and procurement process should at least ensure that the contractor has the necessary skills and expertise to perform the contract. And the contract will of course oblige the contractor to perform the service to particular standards. The municipality will, however, have to ensure that the contract contains provisions such as clear performance targets, penalties for non-performance and possibly incentives for excellent service. This will enable the municipality to make an objective judgement on how efficient the contractor's performance actually is.

This again, as with "value for money" above, highlights the importance of effective monitoring and of the municipality setting clear contract outcomes. This aspect will therefore be covered fully under the "Accountability" section below, which deals with monitoring and performance provisions in the contracts.

6.4.2 Contracts on Efficiency

Only one contract, Contract G, being a long term contract for water services with a municipal entity, actually contains a section headed, and dedicated to, the issue of "efficiency". However, most of the other contracts contain similar provisions under general duties - obliging the service provider to perform efficiently, economically and so on.

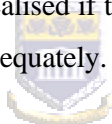
Contract G, apart from choosing to focus on "efficiency" as an isolated concept, also shows innovation in its provision for a "benchmarking study" to take place at the option of the municipality. This is a study designed to enable the municipality to compare the service provider's cost structures and tariffs with other similar municipalities and so assess how efficient the service provider is being and whether the municipality is receiving value for money.

As will be seen under the section dealing with monitoring provisions below, this contract also contains detailed performance indicators, making it all in all comparatively sophisticated in its treatment of the “efficiency” objective.

The Water Services Act requires that a service delivery agreement contain an incentive for efficient and effective performance²⁵¹. While some of the contracts have penalties for poor performance, none in the water sector contain clear incentives for good performance. Ironically, the only contract which does entitle the service provider to keep efficiency benefits is Contract E, a refuse collection and disposal contract with a municipal entity.

6.4.3 Conclusion

As with the “value for money” driver, efficiency is inter-related to other important contract provisions, primarily those relating to effective contract monitoring, setting of performance targets and penalising poor performance. Efficiency is thus an objective which should be realised if the necessary underlying contractual framework has been provided for adequately.



6.5 Skills Transfer

6.5.1 Suggested Contract Requirements

Ideally, in a contract with an under-resourced municipality lacking the necessary skills and expertise to deliver the municipal service optimally itself, the contract would set out a clear programme describing how the transfer of skills would take place from the service provider to the municipality, such as joint training, mentoring and so on.

This requirement would of course not be present in contracts where outsourcing is driven by other objectives or where the municipality has the necessary skills to perform the service itself but chooses not to. This would almost invariably be the case for Metropolitan Councils.

²⁵¹ Regulation 12, Water Services Provider Contract Regulations (August 2001).

6.5.2 *Contracts and Skills Transfer*

Surprisingly, all but two of the contracts are silent on the issue of skills transfer. Perhaps the idea is that skills transfer will happen automatically, by the municipality's mere association with a skilled service provider. If so, this may be a rather dangerous assumption to make. If skills are not adequately transferred to the municipality then the danger of a lack of "continuity" also arises. If the municipality is unable to gain the necessary capacity to deliver the service effectively, then it will be unable to continue service delivery at the expiry of the contract.

The two contracts which do focus on this issue are Contract J and Contract K, being short term water services contracts entered into with water boards. The contracts have been recently drafted, Contract K as recently as 2004, so this is hopefully indicative of a trend that will lead to the issue being taken more seriously.

Both contracts oblige the service provider to conduct training and mentorship campaigns and other programmes to build capacity and transfer skills. However, the provisions regarding skills transfer lack any real detail. For example, no particular person or structure is made responsible for the training/mentorship, no timelines or targets are set for when the training will take place, how often and in what manner, no indication is given of the nature of skills required (e.g. management or operational) and no method is set for determining whether the training has in fact been successful.

6.5.3 *Conclusion*

There is little evidence of the contracts treating skills transfer as an important factor in the outsourcing objectives. At best, the contracts pay lip-service to skills transfer and do not attempt to create anything other than widely worded and vague obligations on the part of the contracting parties.

6.6 Risk Transfer

6.6.1 Introduction

The balancing of risk in an outsourcing contract is a complex issue and has the potential to weaken or threaten the very rationale for entering into the contract. So, unless one has a full understanding of the history and context of the agreement and details of the financial modelling behind the project, it is difficult to be prescriptive about risk transfer when looking at particular contracts. “Appropriate” risk transfer will necessarily vary depending on the nature and context of each contract. As a recent IMF report put it, “Assessing risk transfer is difficult given the multitude of risks to which PPPs are exposed and the complexity of PPP contracts”²⁵². So what can a purely desk-top review of contracts terms on risk hope to achieve?

As seen below, the PPP Standardised Provisions have useful suggestions regarding common, almost “generic”, risk scenarios. This primarily covers how the parties should deal with the risk events of *vis major* (also known as “acts of God”)²⁵³ and material adverse governmental action. These are matters of relevance to every outsourcing project and so the suggested terms are compared with those found in the sample contracts.

Also, certain risks almost intuitively seem to belong with one party or another. For example, purely operational or day-to-day business risks, such as the risk of supply of consumables necessary to provide the service (e.g. chemicals for water treatment) should typically reside with the service provider. “Completion risk”, namely the risk of time or cost overruns on completion of construction of infrastructure, would also typically reside with the private contractor²⁵⁴.

It is also of interest to assess how the contract deals with the interrelationship between a risk event occurring, the cost of that risk and how it may influence

²⁵² IMF (2004).

²⁵³ Typically events such as fires, earthquakes, civil commotions, war, nuclear fallout and the like.

²⁵⁴ PPP Quarterly (September 2002).

tariffs. A fine balance must always be found between guaranteeing the service provider a certain revenue stream and the municipality's exclusive power to set tariffs. It is clearly unacceptable from a governance perspective (and is also potentially unlawful) for an external entity to attempt to usurp a municipality's power to determine tariffs. But it is equally fair for a service provider to require some certainty regarding future income, especially if the power to influence the level of income resides solely within the power of the other contracting party. It is therefore relatively common for the contract to confirm the municipality's right to set tariffs but to then place an obligation on the municipality to meet shortfalls if the tariff income does not meet the contract cost.

6.6.2 General Risk Transfer

The Standardised Provisions contain some specific recommendations (in no particular order) regarding risk transfer. The service provider should bear the environmental risk (e.g. contamination, pollution) as it will have recourse under common law, the constitution and environmental law against the polluter²⁵⁵. It should also bear the risk of assessing the need for the replacement and maintenance of assets²⁵⁶, for the performance of its subcontractors²⁵⁷ and for the supply of utilities unless the supply of those utilities falls within the competence of, in this case, the municipality²⁵⁸. The service provider should also be responsible for taking out insurance to mitigate the risks it faces in performing the service, with the municipality's responsibility being limited to satisfying itself that the insurance is sufficient to cover the company's obligations²⁵⁹.

Most of the municipal outsourcing contracts comply with all these recommendations, with the exception of environmental risk, which is usually borne by the municipality and not the service provider.

²⁵⁵ National Treasury (2004), pg 85.

²⁵⁶ National Treasury (2004), pg 119.

²⁵⁷ National Treasury (2004), pg 127.

²⁵⁸ National Treasury (2004), pg 92.

²⁵⁹ National Treasury (2004), pg 159.

The contracts typically contain generic indemnity provisions protecting the municipality from claims arising from the contract which are not as a result of any negligence or act or omission on the municipality's part. They also almost without fail oblige the service provider to take out appropriate insurance to cover the usual risks, such as coverage for assets and public liability insurance. Although the service provider almost invariably takes on these insurable risks, it must be remembered that the insurance costs are of course factored into the contract or tender price.

The contracts almost without exception contain a general provision stating that the service provider provides the services entirely at its own risk. This is then the "default" risk position and the contracts then go on to detail all the circumstances which reverse or limit this general transfer of risk. As will be seen, these "subject to" provisions in many contracts can quite significantly water down the actual risk transferred to the service provider. This protection of the service provider against a host of risks can take a number of forms. It could be effected by letting the service provider change its business or operating plan to take into account the changing circumstances, it could be done by way of a review of the base charge the service provider is entitled to or it could be by forcing a review of tariffs (i.e. therefore increasing the revenue stream to cover the costs associated with the risk event).

6.6.3 Amendment of Business Plan

Many of the contracts allow the service provider to make amendments to its annual business or operational plan on the occurrence of certain risk events (or at least *request* an amendment). This in effect allows the service provider to constantly adjust (and reduce) its service obligations to accommodate any difficulties which may arise during the contract term. The service provider is therefore constantly cushioned against suffering any detriment if these risks occur.

Examples of common factors which potentially justify an amendment to a business plan (or its equivalent) include; "Financial constraints" of the service

provider (a very widely worded concept)²⁶⁰; legislative amendments²⁶¹; “unforeseen circumstances”²⁶²; damage to the system²⁶³; adverse governmental action²⁶⁴; and changes to credit control or tariff policies²⁶⁵. Many of these provisions are found in the relatively short term water services contracts with water boards.

There appear to be two problems with this approach. Firstly, the risk events which justify a request for an amendment to a business plan are often so widely or vaguely worded that they would include almost any conceivable risk event. This is especially so in the case of the almost limitless category of “unforeseen events”. The protection offered by these provisions is powerful and significant²⁶⁶. It would therefore be preferable to limit the ability of the service provider to amend its business plan to only very clearly defined events. Matters such as “unforeseen events” seem better suited to falling under the scope of *vis major* provisions.

The second problem with this approach is that many contracts do not allow the municipality discretion whether to approve an amendment to a business plan or not. Instead, if the parties cannot agree to an appropriate amendment after one of the risk events has occurred dispute resolution mechanisms kick in, effectively taking the matter out of the municipality’s hands²⁶⁷. As will be seen below, the same method is used in contracts which allow a revision of base charges during the contract term to take into account changing circumstances.

6.6.4 Amendment of Service Provider Charge

It is not only the business plan which is prone to amendment to take into account changing circumstances. In other contracts, the service provider’s base charge is

²⁶⁰ Contract H, Contract I, Contract J and Contract K.

²⁶¹ Contract J and Contract K.

²⁶² Contract I, Contract H, Contract J and Contract K.

²⁶³ Contract I, Contract H.

²⁶⁴ Contract K, Contract I.

²⁶⁵ Contract H and Contract I.

²⁶⁶ As is the protection afforded by allowing tariff and base charge review.

²⁶⁷ Contract K, Contract H, Contract I.

similarly capable of being amended to protect the service provider from unpleasant future events.

It should be noted that the Standardised Provisions specifically warn against allowing a company to request a review of its payments during the contract term to take into account the risk of unforeseen circumstances²⁶⁸. This is discouraged as it could have a negative impact on both value for money and affordability.

Two of the contracts containing these provisions illustrate these issues well.

6.6.4.1 Contract D – water concession with private company

Contract D, a long term water concession contract, specifically allows pre-planned periodic reviews of its base charge²⁶⁹. The “charge” is a figure calculated according to a complicated formula and is intended to reflect the revenue the company requires to ensure its viability. It should theoretically be equal to the service tariffs but if it differs the company is protected from any shortfall as the municipality must, after following a negotiation process, ultimately pay the difference.



The five year base charge review takes into account the company’s debt service level ratios, the whole cost structure of the company and its performance. Importantly, if the municipality does not agree on the base charge amendment, the matter is taken out of its hands and decided by an independent panel made up of an accountant, an engineer and an actuary. The proviso is that this panel is barred from making a decision that the new charge should in fact be lower than the existing one, the review can only lead to a higher charge. The municipality therefore sees no benefit if the contract is more cost efficient or profitable than initially projected and the company is offered total protection if revenue streams are insufficient to ensure viability.

²⁶⁸ National Treasury (2004), pg 149.

²⁶⁹ The base charge is reviewed every five years.

The charge can also be modified, inter alia, if bulk water costs change, in cases of material adverse governmental action, if there is a change by SARS regarding any deduction claimed by the company or (the catch-all phrase again) on the occurrence of “any event which actually or will prospectively affect” the company’s revenues, costs or general economic position. This catch-all phrase does not even require the “event” to be unforeseeable. The company is also protected from high Consumer Price Index (“CPI”) rates as, if the CPI exceeds 15%, the company can ask the municipality for a 6 monthly escalation instead of an annual escalation.

By implication then, these all become risks which the municipality must bear. The proviso to this is that the municipality is entitled to reject a claim for a charge increase if, inter alia, the need arises from a difference between actual and projected service demand, low payment levels of consumers or inefficiencies on the part of the company. The risks the service provider takes on in this case therefore fall within closely defined categories, unlike the risk allocation placed on the municipality.



On the face of it then, the service provider is taking on the “demand risk” and “consumer payment risk” in the contract. These are significant and key risks in any outsourcing contract. But, elsewhere in the contract, this risk transfer is also weakened by the provision that if actual water demand differs from that projected, or if consumer payments differ from the projections, then the company is entitled to adjust its capital expenditure programme. This is repeated in the provision that allows an adjustment of the capital works programme to take cognizance of actual payment level achieved by the company. The company is therefore offered direct relief to mitigate this risk.

6.6.4.2 Contract G – long term water services contract with municipal entity

Another contract allowing periodic review of contract charges is Contract G, a 20 year contract for water services with a municipal entity. As with Contract D, the concession contract with a private company, the charges apply for five year periods. These charges are defined as the level at which tariffs need to be set to ensure the requisite revenues for every five year period. The municipality when

setting tariffs must “have regard” to these contractually agreed charges, but it specifically exercises its own discretion when setting tariffs. As with many of the other contracts, if there is a shortfall between the tariffs and the contract charges then the municipality must ultimately pay the difference.

The charges are renegotiated every five years and, if the parties cannot agree on the new charge, the matter goes through a dispute resolution procedure. Factors which justify a renegotiation of the charge include “any event” which is beyond the service provider’s control and which does (or will) affect revenues, costs or the general economic position of the entity. However, certain risk factors are specifically excluded from this provision – in other words they become risks which the service provider must bear. These include; the risk of incorrect demand projections for the first five years of the contract; the risk of capital expenditure costs being higher than expected for the first three years of the contract and; the risk of low levels of cost recovery (this being a risk which the service provider bears throughout the contract period).

The risk allocation contained in these two contracts points both to a potentially inappropriate allocation of risk but also a risk allocation which is difficult to interpret as a result of not being described in a clear and precise manner. Some risks are explicitly and clearly placed on the shoulders of the service provider, only to be watered down and complicated by later provisions ostensibly reversing part of that risk allocation.

6.6.5 Conditional Service Obligations

The contracts more often than not also protect the service provider against other risk events by making service provision “subject to” the existence of certain pre-existing conditions. Some examples of the types of risk included in these provisions are set out below²⁷⁰.

²⁷⁰ It is important to note that these clauses are over and above the quite comprehensive protection the service provider enjoys from the risks of *vis major*, adverse governmental action and other risk events justifying charge or tariff amendments. These are discussed elsewhere.

- The service provider, in this concession contract with a private company, is relieved of providing the service to particular standards (of efficiency and/or fairness etc) as a result of a problem with availability of resources, the duty of consumers to pay reasonable charges and the nature topography and zoning of land. In an “emergency situation” (which includes water pollution, bulk water supply restriction, drought and operational emergency) then the emergency plan gets implemented at the cost of the municipality. In this case therefore, the company is effectively wholly protected against even foreseeable risks such as drought, water pollution and interrupted bulk water supply²⁷¹.
- The company, in this long term water concession contract, is obliged to provide the services to ensure “affordability”, “regularity” and so on, but again “subject to” adequate raw water, consumers paying the tariffs and the topography of the land. The same applies to an emergency situation or if there is an inadequate supply of electricity. The company is also not liable for a lack of performance if the company requires additional financing and the municipality does not approve this²⁷².
- The service provider in this water services contract with a water board is under a duty to supply the services efficiently but “subject to” the availability of raw water and the capacity of water services system²⁷³.

²⁷¹ Contract C. However the municipality is specifically not liable for the company’s failure to acquaint itself with all information regarding water services conditions, assets, general conditions, regulatory matters etc, and the municipality gives no commercial warranties. It is recorded that the company did a due diligence prior to the contract and the water services and works are thus taken voetstoots.

²⁷² Contract D. How one would link a particular lack of performance with a general lack of funding is difficult to conceptualise but in any event, it appears the municipality takes the risk for any errors in the projected financing requirements of the project.

²⁷³ Contract H contract. The Contract I, Contract K and Contract J contracts contain very similar provisions.

This is an indirect method of risk allocation. The alternative would be to explicitly spell out which risks each party bears.

6.6.6 *Tariff Amendment*

Another apparently common method of protecting the service provider against risks is to allow review and amendment of tariffs on the occurrence of particular events. Some of the “events” or circumstances which justify a request for the review and/or amendment of tariffs are very widely worded and include; increased bulk water costs²⁷⁴, material adverse governmental action/legislative changes²⁷⁵, emergency situation²⁷⁶, “any event” (whether foreseen or not) beyond the control of the company which affects operating costs – (specifically including classic “operating risks” such as higher prices for components)²⁷⁷, unforeseen population settlement patterns²⁷⁸, “unforeseen circumstances”²⁷⁹ and “any event, occurrence, circumstance or condition” occurs which affects the operation, maintenance and recovery of income costs of the company²⁸⁰.

A notable feature of many of these contracts is the tendency to attempt to fetter the municipality’s tariff setting powers. The fact that service providers are often protected against a shortfall if tariffs are set too low means that there should in theory be no need to try and control how those tariffs are set²⁸¹. For example, Contract H, a water services contract with a water board, provides that the municipality “agrees to an extraordinary review of and adjustment of tariffs...” on

²⁷⁴ Contract C, Contract K, Contract H, Contract K.

²⁷⁵ Contract C, Contract I, Contract K, Contract H, Contract K.

²⁷⁶ Contract C.

²⁷⁷ Contract C.

²⁷⁸ Contract C.

²⁷⁹ Contract I, Contract K, Contract H, Contract K.

²⁸⁰ Contract I, Contract K, Contract K.

²⁸¹ Contracts which include a provision protecting the service provider against a shortfall if tariffs are not set to a sufficient level include Contract D, Contract H, Contract I, Contract K and Contract J.

the occurrence of certain events. This could be interpreted as a positive obligation to amend the tariffs²⁸².

Contracts I and K, also water services contracts with a water board, provide that “in addition” to other factors the municipality must take into account when setting tariffs, the municipality “shall base” tariffs on the service provider’s business plan and budget. Again this reads as a peremptory provision.

In Contract C, the concession contract with a private company, it is specifically provided that tariffs cannot be changed to offset deficits caused by “entrepreneurial risks”²⁸³. Nor can tariffs be changed if actual water demand is different to that projected by the company or if there are errors in the company’s five year plan or because of any inefficiencies on the part of the company²⁸⁴. However, as seen above, in this contract the service provider is entitled to request an extraordinary review of tariffs if components become more expensive or if “any event” affects operating costs. It is difficult to see which entrepreneurial risks would fall outside the scope of this very wide description. The contract also provides that new factors can only be introduced into the tariff determination formula “if both parties agree”, a provision which appears to constitute an intrusion into the municipality’s legislative autonomy.

6.6.7 Performance Guarantees

A few of the contracts oblige the service provider to furnish a performance guarantee as a protective measure against the risk of breach²⁸⁵. Of course it must

²⁸² This provision, ostensibly obliging the municipality to agree to a tariff adjustment, is also present Contracts I and K.

²⁸³ A rather wide concept which is not defined in the contract.

²⁸⁴ As discussed later, tariffs were ultimately amended chiefly because of a difference between actual and projected water demand.

²⁸⁵ For example Contract C requires a performance guarantee of R5 million for the first five years and then adjusted down for the rest of the contract period as a reducing percentage of turnover. Contract H (a much shorter term contract) requires a guarantee of R1 million (not reducing) and Contract I only R200 000. Contract K is a bit different in that it does not set a fixed sum - in order

be borne in mind that the performance guarantee can only be called upon if the service provider actually breaches the contract. In risk events such as *vis major*, material adverse governmental action and a host of specifically defined events (varying from contract to contract)²⁸⁶ the service provider is specifically relieved of its obligations to the extent that the risk event prevents them from complying with the contract. The presence of these events will therefore not place the company in breach, thus quite seriously limiting the actual circumstances in which the company would be deemed to be in breach.

Contract D, a concession contract with a private company, is a little different in that any money called on from the performance guarantee does not go unconditionally to the municipality. In this contract a performance guarantee of R7.5 million (with annual escalation as per the Consumer Price Index) must be lodged. The municipality can call on the guarantee if the company defaults, but any money paid to the municipality under this guarantee is not the municipality's to do with as it wishes. The money must be deposited into a joint interest bearing account held by the municipality and the "lenders" (i.e. the financial backers of the company). The money in this account is then paid out according to a list of priorities, the first being to rectify damage to the works as a result of company breach or *vis major*, then to the cost of putting in a substitute entity (if this were ever to occur) and finally to any amounts due to the municipality in terms of a lease or finance agreement. If, at the end of the contract, there is any money left in this account, it is then paid back to the company.

6.6.8 *Vis Major*

The Standardised Provisions also recommend dealing with *vis major* events in a quite different way to that found in the current municipal service contracts. The Standardised Provisions make a distinction between different categories of *vis*

to mitigate the risk of service interruption, the service provider must provide a guarantee of 10% of the annual operating budget of the municipality.

²⁸⁶ Such as "availability of resources, nature and topography of land and duty of consumers to pay reasonable charges – see Contract C.

major events, whereas the municipal contracts make no such distinctions. It is worth looking at the Standardised Provisions as they expect the service provider to take on far more risk under this category than currently appears to be the case at the municipal level.

Firstly, the Standardised Provisions limit *vis major* events to a restricted set of circumstances, namely events which are likely to have a material adverse effect on a party and which are uninsurable²⁸⁷. These would include events such as war, civil war, terrorism and nuclear, chemical or biological contamination. Because these risks are such unusual events, the Standardised Provisions recommend that the risk of them occurring be shared between the parties.

Then the Standardised Provisions recognize what are called “relief events”. These are events beyond the service provider’s control but for which it must bear the financial risk. The company is thus expected and/or forced to deal with the risk by either trying to insure against it, plan around it or do risk assessments for it²⁸⁸. “Relief events” would be events such as fire, flood, earthquake, strike, lockout, accident at the works and so on, being events that last a finite time. All the service provider can hope for under a “relief event” is a temporary relief of service obligations. In other words it enjoys relief from the right the municipality would otherwise have had to terminate the contract or claim damages for non-performance. The service provider should have *no* right to any form of compensation for any losses it may suffer as a result of the fire/earthquake etc, not even an extension of the contract term for a period equal to the *vis major* incident.

This is a significantly different approach to that found in the current municipal service contracts. The municipal contracts, on this issue, are far more favourable to the external service provider.

²⁸⁷ National Treasury (2004), pg 201.

²⁸⁸ National Treasury (2004), pg 186.

6.6.8.1 Definition of *vis major*

Firstly, none of the contracts make a distinction between different types of *vis major* event. If the event qualifies as one of *vis major*, then the same contract provisions apply, whether it falls in the war/terrorism category or the fire/flood/earthquake category. One contract, a long term water services contract with a private party, was quite unusual in including a classic operational risk in its definition of *vis major*; namely the disruption of essential supplies such as chemicals required for water treatment²⁸⁹.

In Contract C, a concession contract, a *vis major* event relieves both parties of their contractual duties, but the definition of what constitutes *vis major* encompasses a wide range of events which go further than would typically be expected. These include protests or boycotts against the “idea” of water services being supplied privately²⁹⁰, water pollution, acts or omissions by government, utility interruptions and interruption or restriction in water supply. By implication then, because the company is relieved of its duties if these events occur, the municipality effectively takes them on. The contract also specifically provides that the municipality bears all “uninsurable” risks.

A contract can also “deem” an event *vis major*. Contract D, a long term concession contract, provides that if insurance is not available at a “commercial price” and the parties cannot agree on a way forward, then the company has a right to cancel the contract or go ahead and not insure. If the event subsequently occurs it will be regarded contractually as an event of *vis major*.

Contract G, a long term water contract with a municipal entity, unlike most of the other contracts, does impose an important proviso on the service provider’s ability to rely on a suspension of its obligations and in this sense the contract is certainly more in line with the Standardised Provisions. In this contract a *vis major* event relieves both parties from their contractual obligations, however the service

²⁸⁹ Contract A.

²⁹⁰ Other contracts, such as Contracts H and K, also include “consumers boycotts” as a *vis major* event.

provider can only rely on this relief if the *vis major* event could not have been “prevented, limited or minimized”. This places an explicit and quite onerous duty on the service provider to investigate all measures available to it to mitigate these risks. If it fails to do so, then it bears the risk of the negative effects of a *vis major* event²⁹¹.

6.6.8.2 Termination and Extension

The contracts almost invariably allow for a suspension of the contractor’s (and municipality’s) duties in so far as they are unable to perform as a result of the *vis major* event. Thus the contractor is relieved of its contractual obligations for both non-insurable events and for what the Standardised Provisions calls “relief” events. Furthermore, almost every contract allows for the right for termination if the *vis major* event continues for a particular period of time²⁹² or for an extension of the contract equal to the period of duration of the event²⁹³.

6.6.8.3 Financial Compensation

Some contracts even allow the contractor to claim financial compensation for the financial effects of the *vis major* event. In Contracts A and B, both long term water services contracts with private parties, this is the case, with the municipality being obliged both to continue paying the company’s fees *and* to pay financial damages caused by the *vis major* event, if that event was uninsurable. This means the municipality would be liable for all damages for uninsurable events such as war, commotion, nuclear fall out and so on, as well as those “relief” events which cannot be insured.

However, what is truly striking about these two contracts when it comes to *vis major* is that the municipality is specifically obliged to include consequential

²⁹¹ Contract G is also different in that (unlike many of the other contracts) the service provider acknowledges that, having assumed the operational risk in the contract; it will be responsible for getting bulk water. Many of the other contracts place the risk of securing bulk water supply and the risk of changes in bulk water quality on the municipality.

²⁹² For example, 120 days in Contract C and 90 days in Contract D.

²⁹³ See Contract C.

damages in the financial compensation it pays the company. The potential difference between “direct” and “indirect” (or “consequential”) damages can be immense and potentially financially crippling to the party who has to pay. It is therefore common for contracting parties to specifically exclude consequential damages from their potential liability. To find a contract specifically including indirect damages is very unusual indeed²⁹⁴.

6.6.9 Material Adverse Governmental Action

Most of the sample contracts contain provisions regarding the risk of “material adverse governmental action”, or similar wording. This is the risk of, for example, a change in legislation which negatively and materially impacts on the contract. The contracts generally protect the service provider against this risk but the Standardised Provisions take a slightly different approach, again placing more risk on the service provider than appears to be the case currently. The Standardised Provisions recommend that the cost of complying with current and foreseeable law should be built into the service provider’s price²⁹⁵. But who should bear the risk of unforeseen government conduct? The Standardised Provisions reason that there is no reason why a service provider in a public-private partnership should be placed in a better position than its counterparts in non-PPP business. The exception to this approach is if the adverse government conduct is not of general application and is instead specific to PPPs.

The Standardised Provisions suggest that the risk of government conduct, which is of general application and which was not foreseen, should be borne by the service provider. Government conduct which specifically discriminates against the service provider or public private partnerships should be borne by the municipality. The Standardised Provisions, by extension, go so far as to suggest that if government (i.e. in this case the municipality) makes a by-law of general

²⁹⁴ For example, in Contract G the service provider acknowledges that it performs the services entirely at its own technical and operational risk but it is specifically recorded that neither party will be liable for the other’s consequential damages.

²⁹⁵ National Treasury (2004), pg 205.

application and that law adversely affects the service provider, then the service provider must still bear that risk.

6.6.9.1 Different Categories of Governmental Conduct

Almost none of the contracts make the distinction between laws of general application and those that discriminate specifically against the service provider or outsourcing contracts. For example, in Contract A, a long term water contract with a private company, if bylaws are amended and the result has “financial consequences” for the company (i.e. a form of “adverse governmental action”) then this will be dealt with by a “variation order”. In other words the contract will automatically be amended to accommodate the service provider²⁹⁶. Contract D, a concession contract, is one of the exceptions to the general rule that municipal outsourcing contracts do not exclude laws of general application. In this contract any law of general application is specifically excluded from the definition of material adverse governmental action but, rather confusingly, the contract then goes on to deem “anything” the municipality does which adversely affects the company’s rights, interests, costs or general economic position as “material adverse governmental action”. The municipality also bears all risk (and more) for this aspect of the contract in that it is under a duty to put the company in the same position it was before the material adverse governmental action occurred and, if it does not, the company has a right to cancel the contract.

Contract F, a long term electricity provision contract with a municipal entity, is effectively silent on material adverse government action with the exception of only two particular events. The two events are, first; changes imposed by the national electricity regulator (the NER) – in which case the parties must negotiate in good faith to amend the agreement and, second; if the national minister for local government issues regulations which clash with aspects of the agreement, then as far as possible, the contract is deemed to be amended. If this is not possible, then the parties agree to renegotiate in good faith. This contract

²⁹⁶ A similar provision is found in Contract E, which allows for an adjustment to the price formula to accommodate the costs associated with governmental conduct.

therefore does not automatically compensate the service provider if this risk arises²⁹⁷. Also, the fact that the service provider in this contract is a municipal entity should lessen the risk of the municipality being bullied in any negotiations which occur as a result of this risk.

But it is Contract G, the long term water services contract with a municipal entity, which goes further than any of the others on this aspect of risk allocation. This is the only contract in the sample study which makes a clear distinction between different classes of material adverse governmental action. This risk is divided into three categories- material adverse councillor action; material adverse municipal action, and; material adverse regulator action (i.e. national or provincial sphere of government). It appears that the definition of adverse action does not exclude laws of general application²⁹⁸.

The service provider enjoys quite vigorous protection from the risk of adverse councillor action (for example a councillor attempting to obstruct the implementation of a municipal decision or encouraging conduct which would lead to maladministration). If the service provider believes such conduct has taken place, this is ultimately reported to the municipal council and an investigation has to take place. If the investigation finds that the conduct does fall within the definition of adverse action, then the municipality must pay the company a penalty fee. As far as adverse municipal action is concerned, the service provider is unable to rely on the protection of this clause if the adverse action is contained in a municipal by-law and the service provider failed to comment on the proposed by-law. In all other cases, if this risk occurs then the municipality is obliged to remedy the situation and indemnify the service provider for actual losses. The existence or otherwise of material adverse municipal action is determined by an

²⁹⁷ Contract H, Contract K, Contract E and Contract I also allow for a form of negotiation process followed by dispute resolution if negotiation fails.

²⁹⁸ The draft agreement under the definition of adverse “Regulator” action describes actions which apply “to the Service Provider in its capacity as a service provider...” This possibly means that actions applying generally to all commercial entities would not be included in this definition, but this is not clear.

expert according to procedures set out in the contract. Material adverse regulator action are those actions taken by the national or provincial spheres of government and which have a material and adverse effect on the rights or obligations of the service provider. If this occurs the municipality is contractually obliged to use its “best endeavours” to prevent, mitigate or reverse this action.

This raises questions as to a municipality’s duties if the action of the national or provincial sphere is for a public good or a means to realize socio-economic rights. For example, if the contract had been entered into before the imposition of a policy of free basic services, would the introduction of such a policy have qualified as material adverse action? It may have if the application of such a policy tipped the balance on the service provider’s financial sustainability. However, under this contract the municipality would technically have been obliged to try and “reverse” or prevent the imposition of this policy.

Apart from being obliged to attempt to prevent the conduct, if material adverse regulator action has occurred the service provider will be entitled to amend its water services delivery plan to take into account the regulatory changes. Alternatively it may inform the municipality it is unable to continue with the service delivery plan and if the municipality does not agree, then the matter goes through dispute resolution procedures. If the municipality does agree then the event is treated as one of *vis major*. This means that the service provider is effectively relieved of its performance obligations.

In summary then, in this contract adverse councillor action obliges the municipality to pay a penalty fee, adverse municipal action obliges the municipality to cover the service provider’s actual losses and adverse regulator action obliges the municipality relieve the service provider of its performance obligations (to the extent it is unable to perform). Adverse regulator action therefore does not entitle the service provider to have its actual losses covered by the municipality. This makes sense as the “regulator” action is invariably beyond the municipality’s control (unlike adverse municipal or councillor action).

6.6.9.2 *Prospective Loss*

Many of the contracts also define adverse action as conduct which may cause prospective future financial loss. In this way, the service provider enjoys the benefit of protection from this risk arising before they have suffered the loss. By way of illustration, the definition of material adverse governmental action in Contract C, a concession contract, includes any law or regulation (i.e. of general application or not) which has an adverse effect on the private company's rights, interests and obligations and/or results in actual or prospective change in the company's costs or revenues.

6.6.9.3 *Mitigating the Risk*

But, the Standardised Provisions go further and suggest that even if the municipality bears the risk of adverse governmental action, the service provider should still be duty bound to mitigate the effect of the government conduct as far as it is able²⁹⁹. This concept has generally not found its way into the sample contracts.



6.6.9.4 *Beneficial Governmental Conduct*

Of significance (and again, certainly nowhere to be seen in the sample contracts) is the suggestion that unforeseeable government conduct which economically *benefits* the service provider should oblige the service provider to pay the value of that benefit to the municipality.

6.6.10 *Contracts with CBOs*

The sample CBO contracts are all in the refuse collection and disposal sector. None of the contracts specifically state that the contractor supplies the service at its own risk, but this is implicit in the contract terms. All the contracts contain the usual "indemnity" provisions in terms of which the contractor indemnifies the council against all claims for injuries and damage to property. This is coupled

²⁹⁹ National Treasury (2004), pg 207.

with the contractor's obligation to take out insurance, to the satisfaction of the council, to cover these risks.

In Contract L, a five year refuse collection contract, the contractor is also obliged to provide a "surety" but this is only to a nominal value. This contract also recognizes two "special" risks, namely "unrest" and "state of emergency", in terms of which options for termination are built in where appropriate. The contract is silent on risks such as *vis major* and material adverse governmental action.

In the other CBO contracts *vis major* and risks such as fire, riots, theft and the like are mentioned, but only in the context of the provision that the contractor has no right to claim damages from the council as a result of these events. The contracts are silent on the rights and obligations of the parties generally in *vis major* and similar circumstances.

6.6.11 Conclusion



Risk transfer in the initial study of contracts appears on the face of it to protect the service provider from risk to an extent that the service provider would probably never enjoy in a normal commercial environment. For those terms which should be most capable of generic treatment, namely *vis major* and adverse governmental action, the contracts differ from the Standardised Provisions recommendations, all to the detriment of the municipality. This raises questions as to whether generic risks are being allocated appropriately.

The service provider appears to be protected from risk in a variety of different ways, namely by allowing the service provider to amend its business plan, amend its charge or to force a tariff review. The service provider's right to constantly adjust and review its income stream, contract obligations or contract charge is generally triggered by events or factors which are so widely or vaguely worded that they could apply to almost any event which arises during the contract period. This means that the risk the service provider actually takes on is only that which is specifically identified in the contract. It is ironic that in the CBO contracts (where the service provider would be least able to take on risk) the opposite is true and only a few restricted risks are taken on by the municipality.

As a result, the service provider is the one operating in a “certain” environment and not the municipality. This goes against one of the “drivers” of outsourcing, which is the ability of the municipality to plan and budget more effectively because of the “certainty” created by appropriate risk transfer.

The potential of risk events leading to tariff amendments or higher contract charges could also threaten the affordability and value for money objectives of the outsourcing project. Particular risks are also often transferred wholly to the service provider only to be transferred back again in a slightly different form later in the contract. The risk provisions are thus often not all that clear.

The risk allocation structure of these contracts could be greatly improved by the use of a risk matrix, setting out all those risk events which could reasonably occur, such as consumer non-payment, vis major, environmental risk, utility supply risk, adverse governmental action risk, service demand risk and so on. The risk matrix could then clearly set out which party will take on which risk and thus enable the parties to better understand the risk allocation and take the necessary steps to limit or mitigate those risks.



6.7 Accountability

6.7.1 Suggested Contract Requirements

The danger of a municipality losing accountability to its community as a result of an outsourcing contract, especially a basic service, is a real one. The risk is possibly higher in the case of a municipality deciding to outsource, inter alia, because of a skills shortage. The very lack of capacity to perform the service effectively may lead to the municipality passively allowing the external entity to get on with the job without further interference.

The service delivery contract is unlikely to contain a section headed “Accountability”, as accountability cannot be tied down in one clause alone. It is more a function of the wider “effect” of the contract and includes the impact the contract has on the ability of the municipality to function independently and in the best interests of the community it serves. Put simply, the municipality needs to ensure it continues to hold itself accountable and responsible for the service

provided. With this in mind, it is clear that one of the primary duties a municipality needs to perform to ensure accountability is the monitoring function. Monitoring is also a crucial pre-requisite for determining whether value for money and efficiency are being achieved.

Monitoring can only be effective if the contract provides for comprehensive record keeping, regular reporting and clear and measurable outputs. This is also crucial to enable the municipality to impose penalties for poor performance (or to reward excellent performance). Although the Systems Act contains detailed provisions on this issue, these provisions relate primarily to the obligations of the municipality once it has the performance information and thus would not need to be included in the service delivery agreement.

Accountability could also come under threat if the service provider is able to exercise undue influence over the municipality's legislative, strategy and policy making powers. The risk to accountability will vary depending on the nature of the entity. For example it is most dangerous when contracting with a private company and least so with a municipal entity³⁰⁰. The contract, especially a contract with a private entity, should therefore provide for a clear boundary between the "authority" and "provider" roles and should ensure that the municipality can perform its legislative functions unfettered and in the best interests of its community.

Finally, another factor which arises from provisions in a few contracts and which potentially threatens the principle of accountability is that of the municipality divesting itself of responsibility for making future decisions on issues relating to the contract. This will be discussed separately below.

6.7.2 Contracts and Monitoring

The Standardised Provisions recommend that the contract contain detailed provisions regarding reporting on monitoring, with clear identification of what

³⁰⁰ In fact, it could be argued that it is *beneficial* for a municipal entity to participate in strategy and planning sessions.

reports are necessary, to whom they must be sent, by when and in what format. They also recommend clarification regarding how often meetings are needed for monitoring and who should attend³⁰¹ and recommend that each party appoint a liaison officer for this purpose³⁰². Finally, they recommend that the service provider be responsible for the costs of monitoring³⁰³.

As will be seen below, none of the contracts comply with all these recommendations and the contents vary quite widely from treating monitoring seriously to merely paying it lip-service. Effective “monitoring” is such a crucial aspect of a service delivery agreement, having the potential to have a direct impact on other important factors (such as value for money and efficiency) that it is worthwhile briefly summarizing what each contract has to say under this heading.

6.7.2.1 Contract A – long term water services contract with private company

No monitoring structures are set up nor are liaison people identified. The company is required to prepare monthly reports on raw water extraction, potable water produced and consumption to assess the volumes of unaccounted for water. The municipality and company are also required to meet “on a regular basis” to review the previous month’s operations (the implication being that a meeting should be held at least monthly) but no detail is given as to who should attend the meetings, where they should meet, what precisely should be discussed and what the outcome of the meeting should be (e.g. a report compiled or just minutes kept?).

6.7.2.2 Contract B – long term water services contract with private company

No monitoring structures are set up nor are liaison people identified. The company is required to keep comprehensive records regarding service provision and must send annual reports containing “relevant” information. The precise

³⁰¹ National Treasury (2004), pg 132.

³⁰² National Treasury (2004), pg 157.

³⁰³ National Treasury (2004), pg 130.

contents of the annual report, its format and to whom it must be sent are not stipulated.

No regular meeting structure is set up (not even “on a regular basis” as in Contract A) and, apart from providing that the company will keep the minutes of any meetings with the municipality, no other provisions regarding meetings between the parties are to be found. On the subject of performance, the company is liable to pay penalties by way of a reduction of the contract fee, if it fails to deliver drinking water in accordance with the quality criteria stipulated in the contract.

6.7.2.3 Contract C – water concession contract with private company

Despite the large scale and long term nature of this contract, no liaison person is appointed, no monitoring office is set up, no obligations are set on reporting requirements (apart from an annual report) and no detail is given as to precisely what is to be contained in the annual report. An annual report is required on service levels, but is very vague on what it should contain, and an annual finance report containing the usual information (audited statements, income statements, audit report etc) is required. The service provider is obliged to keep “complete information” on the works and the services on a continuous basis. The municipality’s role is a passive one; it being entitled to inspect that information when it wants.

The contract does state that the municipality will monitor the service provider’s performance, but does not say how often this will occur, by whom, in what format and to whom the information is reported. The contract does however contain performance targets, which would make the job of monitoring performance easier. The performance targets are accompanied by a system of penalties for non-performance with different categories of seriousness depending on the nature of the non- or poor-performance.

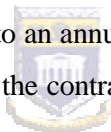
6.7.2.4 Contract D – water concession contract with private company

No monitoring office is set up, no liaison person identified and no co-ordinating committee is established. A schedule of performance levels is attached to the contract. The contract does contain a long list of items the municipality is

required to monitor and contains provisions relating to the collection of information and inspection of works. The service provider is obliged to co-operate in this process.

The contract elsewhere contains provisions requiring the service provider to report on certain aspects (such as sewer overflow and monthly water quality tests) but no detail is given regarding to whom this information must be given and in what format. The contract provides for a performance guarantee escalated annually in accordance with the CPI and also contains a schedule of sanctions for non-performance. The service provider pays a fee to the municipality to enable it to fulfil its monitoring functions.

The contract allows for the imposition of monetary sanctions on the company for non-performance but, again, the company is protected in that the sanction penalty will not be enforced if to do so would cause problems with the company's lenders. The sanction remains suspended until the lenders declare that the company can pay. The sanctions are also subject to an annual maximum and are also capped to a maximum total for the duration of the contract.



6.7.2.5 Contract E – solid waste services contract with municipality

This contract contains a more conscientious treatment of monitoring requirements. A contract monitoring unit is set up which the service provider is specifically obliged to co-operate with. The service provider is obliged to provide clearly defined reports, some on a quarterly basis and others on an annual basis. The quarterly reports include those relating to financial performance, achievement of service levels, any special circumstances and measures to be taken by the service provider to improve performance. The annual reports, apart from including financial statements, must compare financial performance with that of the previous year³⁰⁴. The annual report also includes service levels achievement, special circumstances, measures taken to improve performance and a statement of risks (e.g. litigation, environmental risk etc).

³⁰⁴ See section 46 of the Systems Act which makes this obligatory.

At the same time as the annual report, the service provider must also compile an “end user” report, which is then made public. The purpose of this report is to give the public a clear assessment of the service provider’s performance. The contract contains detailed service standards and service levels.

6.7.2.6 Contract F – long term electricity services contract with municipal entity

Instead of setting the necessary service levels in the agreement, the municipal entity is obliged to comply with the service requirements as set by the National Electricity Regulator (“the NER”). Key performance objectives are set in the annual business plan which has to be approved by the municipality. The service provider must prepare a mid-year and annual review as part of its budget process and must also prepare “a performances review” (presumably annually, but this is not clear).

There is no list of penalties for poor performance and, given that the municipality is not paying the municipal entity a fee for the services (instead ceding its right to collect service fees) there is no prospect of the municipality withholding payment as a form of penalty for poor performance.

The contract notes that the NER has a “primary role” in monitoring the agreement but then confirms that the municipality will also play a monitoring role. The parties each have to appoint a “contract manager”. The contract managers are obliged to meet quarterly “to consider the achievement of Service Levels” and will represent the interface between the municipality and municipal entity.

The monitoring and record keeping requirements are kept to a bare minimum and leave much to the future discretion of the parties. For example, the municipality is granted the power (but not the obligation) to conduct interviews with customers, to assess user satisfaction, to conduct performance audits or use any “other monitoring methods” it deems fit. The contract is silent on when these surveys would take place, who would conduct them, who they would be submitted to and in what format and what level of co-operation may be required from the service provider.

The municipality is granted access to all relevant information kept by the service provider regarding the services but the contract does not, apart from an asset, risk and liability register, specifically list the records the service provider is obliged to keep or for how long, leaving this instead to be agreed “from time to time” between the parties.

6.7.2.7 *Contract G – long term water service contract with municipal entity*

A monitoring office is set up with a list of clearly defined functions. The service provider must pay R20 000 per month towards monitoring costs. The contract does not specify who will sit in the monitoring office and what its relationship to, or within, the municipality will be.

A steering committee is created which would operate as a “co-operative forum” and thus share information, attempt to resolve disputes and assist with practical issues arising out of the implementation of the contract. The committee, made up of an equal number of representatives from each party, has to meet monthly and is chaired by an independent person appointed annually by the parties on a rotational basis. The parties share the cost of the independent chair.

As discussed above, this contract contains the novel provision entitling the municipality to conduct a benchmarking study to assess and compare the service provider’s cost structures and tariffs with comparable municipalities. The municipality can ask the service provider to amend its service delivery plan if the benchmarking study reveals the service being provided by the external entity is expensive or inefficient. This has positive implications for accountability, efficiency and value for money objectives.

The contract contains a detailed schedule of key performance indicators separated into key performance areas, key performance indicators and annual performance indicators. The contract also specifically obliges the service provider to devise a water service delivery plan containing “detailed and *measurable*” (emphasis added) performance indicators. This reveals a clear concern to ensure effective monitoring is able to take place.

The service provider must compile an annual report and is specifically obliged to compare its performance during that year with its performance in the previous year.

6.7.2.8 Contracts with Water Boards on monitoring

Most of these contracts set up a monitoring office and provide detailed lists of the aspects the office is responsible for monitoring. The service provider is obliged to co-operate with this office and provide the requisite information. The service provider is typically obliged to provide a host of clearly defined monthly reports (e.g. customer complaints, volume of water sold), quarterly reports (e.g. summary of repairs and maintenance) and annual reports (e.g. business plan, financial statements).

Some of the contracts also establish a co-ordinating committee for the purpose of sharing information and ensuring contract implementation. The committee is made up of representatives from both the municipality and the service provider and it is obliged to meet at defined periods. In one contract (Contract J) the “contract management committee”, made up of representatives from both the municipality and service provider, is given certain decision making powers, including the power to make minor deviations from the budget. The committee is also authorized to use (presumably “external”) experts in the performance of its functions.

Only one contract, Contract H, obliges the service provider to pay a monitoring and compliance fee (R10 000 a month). Of significance is that none of the contracts contain clear and pre-determined levels or standards against which to measure performance and there appears to be no system of penalties for non-performance or poor performance.

Service levels or performance targets would naturally be included in the annual “business” or “operating” plans the service provider is obliged to prepare, but the contracts do not specify at what level of detail these service levels and targets should be set by the service provider. Because of this contract configuration (namely specified service obligations being devised and approved annually as annexures to the contract instead of in the body of the contract) there is a real risk

that the service levels are described in too generalized a manner for effective performance monitoring to take place. This would make it difficult for the municipality to assess efficiency, value for money and for the municipality to punish poor performance (or reward good performance).

It certainly seems highly unlikely that annually devised business or operating plans would contain detailed penalties and sanctions for particular incidences of non-performance. One can therefore probably safely assume that the absence of a sanctions or penalties provision in the body of the contract means that there will be none. Attempting to ensure that a contract achieves the objective of “efficiency” would be greatly helped by the use of penalties and sanctions, although their absence does not automatically mean the contract is at risk of not meeting the efficiency objective.

It is also worth remembering that, as revealed in the risk analysis section above, the business plans can be quite fluid depending on whether certain risk events occur during that particular year. Thus, if one got hold of a business plan for one particular year, this would not necessarily correlate with what the following year’s plan would contain.

6.7.2.9 *CBOs on Monitoring*

The nature of the CBO contracts are quite different to the other service delivery agreement, focused as they are on setting such specific inputs. The municipality retains a tight control on what happens in the contract and leaves little to the contractor’s own entrepreneurial initiative.

This, however, naturally makes it a lot easier for the municipality to monitor performance under the contract. The contracts all allow for monthly payments to be made to the contractor and these payments fluctuate according to the actual work completed. This means that each month the municipality has to satisfy itself that the work has in fact been performed. This is a relatively easier procedure in refuse collection and disposal than it would be in, for example, a water service contract.

Contract L, a five year contract for refuse collection, appoints the “Engineer” as an agent for the municipality to monitor the contract and authorizes the Engineer to appoint representatives to assist in this task. The representatives are specifically appointed to assist with “quality control” and evaluation of the work done by the contractor. The contract also grants the Engineer a high level of control over the contractor, effectively obliging the contractor to comply with “any” instruction given by the Engineer (this even reaches to the rather extreme level that the Engineer is entitled to instruct the contractor to get rid of particular employees). The Engineer is granted powers to carry out inspections and, if the work is not up to standard the contractor faces penalties. In fact, Contract L, unlike the other CBO contracts, contains a list of very specific indicators of poor performance (e.g. spillage from refuse trucks, non-compliant vehicles etc) with each item resulting in a predetermined penalty payable by the contractor.

This contract is unusual in that it actually goes so far as to financially penalize the contractor for failing to attend site meetings. These meetings are to be held on a “regular basis”. This reveals a concern for effective monitoring which goes beyond that found in most of the other service delivery agreements, despite the fact that these other agreements are invariably far more complex and have far more significant financial implications.

6.7.2.10 Conclusions on monitoring

It is clear from the contracts studied thus far that monitoring, despite its fundamental importance in any outsourcing contract, is generally not adequately dealt with. In fact it is ironic that the contracts with public sector providers and municipal entities contain more detailed and onerous monitoring provisions than those contracts of a long-term nature with the private sector. Clearly, if anything, this should be the other way round.

It is rare for contracts to contain detailed penalties or sanctions clauses. This means that, if the municipality through its monitoring mechanisms picks up poor performance, it would be restricted to using the cumbersome breach provisions to try and enforce compliance.

6.7.3 Contracts and Provider Influence over Legislative Functions

Some contracts give some scope for the service provider to involve itself in the policy and strategy deliberations of a municipality. This was seen to some extent under the “risk” section above, which revealed a tendency in certain contracts to grant the service provider an inappropriate influence over the municipality’s tariff setting discretion. Although none of the contracts purport to give the service provider any actual power in this process, the potential of the service provider to wield a persuasive power over the municipality is difficult to deny. It also potentially blurs the role between “service authority” and “service provider”³⁰⁵. This, however, is naturally less of a problem in contracts with a municipal entity because of its special relationship with the municipality. The problem is entirely absent in the contracts with CBOs.

Certain contracts skate very close to attempting to grant legislative power to the service provider. For example, Contracts A and B, water services contracts with private companies, provide that any amendment to by-laws governing the provision of the service will first be negotiated “and agreed” between the municipality and the private company. Contract F, a long term electricity services contract, provides that the municipality will adopt by-laws “in consultation with” the municipal entity service provider.

Of course, this can also be a positive thing in circumstances where the municipality has little capacity or skills in the service area and the service provider can be of practical assistance. It would also be more palatable with a public sector service provider as opposed to a profit driven private company. As a general rule, any infringement of a municipality’s independence and autonomy surely has dangerous implications for accountability.

In one of the contracts (Contract H, a short term water services contract with a water board) the municipality actually gives the service provider the duty of investigating mechanisms for the future provision of the water services, including

³⁰⁵ A requirement of the Water Services Act, see inter alia, section 20.

determining anticipated funding and making suggestions as to appropriate future mechanisms. The fact that the municipality is contracting out such a crucial function, and to the very entity currently providing the outsourced service, has worrying implications for that municipality's accountability to its community.

Finally, in perhaps the most startling example of a municipality divesting itself of accountability, a concession contract includes a provision stating that any reduction in tariffs which may be required in order to support indigent consumers will require the prior written approval of the financiers of the private company.³⁰⁶

6.7.4 Contracts and Loss of Contractual Decision-making Power

Another feature of a few of these contracts is the tendency to divest the municipality of the power to make decisions on important matters in the contracts and to send them to "independent" panels instead. For example, as was seen above under the "Risk Transfer" section above, many important decisions (such as approving significant amendments to a business plan) are not left to the discretion of the municipality and are instead decided by structures with no political accountability through the contract's dispute resolution mechanisms. This represents a serious inroad into a municipality's independence and directly threatens accountability. Contractual decisions and approvals should remain within the municipality's discretion with dispute resolution being reserved only for actual contractual disputes.

6.8 Public buy-in

6.8.1 Suggested contract requirements

Many aspects of public participation take place in the build up to an outsourcing contract being entered into and thus cannot be assessed from looking at the contract provisions alone. It does not however end there. It is equally important to ensure public information dissemination during the course of the contract. This would start with the requirement that the contract be open to the public.

³⁰⁶Contract D.

The contract should therefore contain a confidentiality clause (if at all) which is drafted as restrictively as possible and limits “confidential” matters to only those which, if made public, would lead to real prejudice to either of the parties. The clause should not be vague or ambiguous, so that if a member of the public requests information on the contract the municipal officials will be quite confident what can be handed over. This is aside, of course, from the fact that it is a legislative requirement that the contract terms be made public. The contract should be accessible to the public, both in respect of physical access to the document and in respect of the contract being reader-friendly and straight-forward to understand. Without these qualities a member of the public would find it difficult to take informed decisions on the impact and consequences of the various contract terms.

6.8.2 Contracts and information sharing

Contract G, a long term water contract with a municipal entity, is the only agreement which provides for a contractually binding and relatively detailed ongoing programme of information sharing with all stakeholders. The contract expressly recognizes the importance of ongoing communication with all stakeholders and thus provides for an annual “information sharing indaba” for these stakeholders. The parties share the cost of this indaba. The objective of the indaba is for the stakeholders to, inter alia, consider strategic issues regarding the services and to promote a common understanding of matters relevant to the stakeholders. The contract specifies who will chair the indaba, who will be secretary and who will be invited. Those invited include the mayor, certain councillors, the monitoring office, various government representatives (e.g. from Water Affairs and Forestry, Treasury and so on), certain MEC’s and organized labour. The community is represented at this indaba through their ward councillors.

A contract with a CBO, by its very nature, would be unlikely to face serious problems with public buy-in given that the service provider comes from the

community and, presumably, all the labour used in performing the service will be locally based³⁰⁷.

6.8.3 Contracts and accessibility

On an initial reading, one is struck by the inaccessibility and sheer length of many of these contracts. Some contracts, with annexures, are longer than the average novel and mired in legalese perhaps the only exceptions being the contracts with CBOs which tend to be quite short and relatively easy to read.

The average length of the contracts range from 50 to 100 pages, but with annexures they can reach up to between 400 and 600 pages. In most cases the annexures are not merely made up of “lists” such as schedules of assets, but more often than not contain important and substantive provisions, such as emergency procedures, service levels and standards, lease agreements, contract price adjustment formulae and performance guarantees. The annexures therefore form an integral part of the contract and cannot merely be “skimmed over” by anyone wanting a proper understanding of the nature and effect of the contract.

The language is generally old-fashioned, pompous and wordy. The contracts are peppered with words and phrases such as “forthwith”, “herewith”, “pursuant to” and “notwithstanding”.

The following extracts illustrate some typical examples of the general style of the contract terms:

Pending the rectification and repair of any latent defect and/or state of disrepair in any of the existing assets identified pursuant to 17.1 and notified to the COUNCIL, the CONCESSIONAIRE shall be deemed not to be in breach of any provision of this contract and the COUNCIL undertakes to waive its right to exercise any remedy as a result of such breach (including, but not limited to, its right to levy a penalty in respect of any act and/or omission of the

³⁰⁷ In fact Contract L authorises the municipality to terminate the contract if it is established that the CBO has used labour other than from the local area.

CONCESSIONAIRE attributable thereto), provided that such breach is attributable to the existence of such latent defect and/or state of disrepair”³⁰⁸.

...the expiration or termination of this contract shall not affect such of the provisions of this contract as expressly provide that they will operate after any such expiration or termination or which of necessity must continue to have effect after such expiration or termination, notwithstanding that the clauses themselves do not expressly provide for this³⁰⁹.

The procedures in 15.9 and 15.10 shall apply mutatis mutandi to the COUNCIL in consultation with the CONCESSIONAIRE in respect of the failure or refusal of a Customer to make timeous or full payment in respect of the supply of Water Services prior to the Effective Date to the maximum amount of the deposit (and interest thereon) paid by such Customer³¹⁰.

It is also often necessary to cross reference to other parts of the contract in order to understand the meaning of a particular clause, which can be a frustrating process, especially if there is more than one cross reference. For example, in the clause immediately above, the reader would have to cross reference to the two other clauses mentioned (15.9 and 15.10) and to the definitions clauses for Customer, Water Services and Effective Date to fully understand the effect of the clause.

Another common feature is the use of excessively long sentences, which pack in a whole host of different concepts and provisos instead of separating them out into distinct clauses. This is a sure-fire way to inhibit easy reading and comprehension of a particular clause. Sentences of between 90 to 130 words are a relatively common feature, with one contract containing one 99 word sentence immediately followed by a 94 word one³¹¹.

³⁰⁸ Clause 17.3 Contract D.

³⁰⁹ Clause 1.11 Contract H.

³¹⁰ Clause 15.12 Contract C.

³¹¹ Clause 3 Contract H.

It is useful to illustrate the frustration and difficulty caused by drafting such unnecessarily long sentences by quoting one of the longer ones (about 180 words) from a concession contract. The clause deals with the important issue of the service provider's authority to purchase new assets.

In the event that any of the existing assets reflected in the schedules to the lease agreements cannot be located despite diligent search by the CONCESSIONAIRE or in the event that the CONCESSIONAIRE cannot confirm the existence of any such existing asset in the course and scope of the inventory referred to in 17.1 and the CONCESSIONAIRE notifies the COUNCIL of such fact and that such existing assets are required by the CONCESSIONAIRE to enable it to operate the works and/or fulfil its other obligations under this contract the CONCESSIONAIRE shall be entitled to purchase a similar asset on an arms length basis at its own cost and recover the cost associated with the purchase of the asset from the COUNCIL by off-setting same against and deducting same from the rentals due to the COUNCIL in terms of the lease agreements, provided that, should such cost exceed the amount of the rentals due under the lease agreements, the COUNCIL shall refund such excess to the CONCESSIONAIRE within 30(thirty) days of the date on which the CONCESSIONAIRE purchased such asset³¹².

Also, in many of the contracts it is very difficult, if not impossible, to understand the background context and rationale of the contract. The "Recordal" sections at the beginning of most contracts are usually not helpful as they are often widely worded with lofty ideals and offer little detail as to the true reasons behind the decision to outsource. The problem is exacerbated when the contract involves elaborate financial arrangements between the parties where they pay each other various "fees", "rentals", "charges" and so on, and it is not clear how all the payments ultimately balance out. How one would be able to assess whether value for money, or even mere "financial benefit", is being met in the contract is difficult to see.

³¹² Clause 17.4 Contract D.

The features of these contracts as described above effectively make a farce of meaningful public participation and transparency. If a trained lawyer finds it hard work to unravel and understand the contractual relationship between the parties, what hope is there for the general community to do so? The complexity and length of the contracts also have a potentially adverse affect on the ability of the municipality to effectively monitor contract implementation. Regardless of what structures are set up to monitor the contract, if the people doing the monitoring do not have the essential provisions of the contract at their fingertips, how can they do a proper job?

This has been borne out in a case study which, inter alia, assessed how a municipality was monitoring an outsourcing contract. The study found that; “While city councillors are certainly part of the monitoring process, their own understanding of the detail of the contract remains limited, leading to acquiescence to those who hold technical expertise.”³¹³.

6.8.4 Contracts and Confidentiality



Most of the contracts, with the exception of those with CBOs, contain a confidentiality clause, usually very widely worded and applicable both during the term of the contract and after termination.

The confidentiality clauses do not clearly define what would or would not be confidential and one concession contract goes so far as to say “anything” arising from the contract must be regarded as confidential³¹⁴. The other concession contract deems any information acquired “pursuant to the implementation of this contract” as confidential and prohibits either party from disclosing the contents of the contract without the other’s written consent³¹⁵.

The Standardised Provisions suggest that the test for confidential information should be whether disclosure would cause real prejudice to the legal or

³¹³ Smith & Fakir (2003).

³¹⁴ Contract C.

³¹⁵ Contract D

commercial interests of the party. This common sense and principle-based approach is certainly not followed in the contracts and the issue is left very vague. In fact, some contracts contain circular definitions of confidential information, saying in effect that “confidential information” is information which is by its nature “confidential”. This takes the issue no further. The effect of circular or vague definitions of confidential information would possibly be that municipal officials, if wanting to be risk averse, would be hesitant to release *any* details regarding the contract in case that information fell within the wide definition of “confidential information”.

6.8.5 Conclusion

The contracts appear to rarely provide for continuous or periodic information sharing with the public post contract signature. They are also notoriously lengthy, complex and often worded in inaccessible language. This poses risks to the municipality both in respect of public participation and in respect of contract monitoring, as the people responsible for monitoring and managing the contract should have an understanding of the contract provisions at their fingertips.

6.9 Consumer Protection

6.9.1 Suggested Contract Requirements

“Consumer protection” is concerned with ensuring that the community does not suffer having to pay disproportionately higher tariffs or having to undergo unfairly harsh credit control measures as a result of an outsourcing contract. These would be risks more usually associated with contracts with the private sector as the risk could arise as a result of the service provider being profit driven. “Affordability” here is meant in the context of the affordability of tariffs and not the affordability of the contract as a whole to the municipality. Contract affordability would be closely linked with the risks influencing value for money, namely risk factors which affect the financial balance of the contract and which would thus form part of the factors discussed above.

The contract would have to contain specific provisions ensuring affordability and fair and reasonable credit control and disconnection procedures. Affordability is

closely tied to the power of the municipality to set its own tariffs. The contract should therefore contain provisions which ensure the municipality can exercise its legislative discretion in tariff setting in an unfettered and free way, and naturally in accordance with its tariff policy.

An inappropriate transfer of risk could also naturally have a negative impact on affordability, if that risk results in the municipality incurring extra costs and thus being forced to raise tariffs. The impact of risk transfer and potential extra cost to the municipality is covered under “Risk Transfer” above.

Customer care is also inherently linked with the credit control and disconnection policies of the municipality. The contract should therefore ensure that the procedures are fair and closely monitored by the municipality if those functions are outsourced.

6.9.2 Contracts and Affordability

Many of the issues relating to setting of tariffs has been dealt with under “Risk Transfer” above, which revealed that in some contracts a real attempt is made to fetter the municipality’s ability to set its own tariffs. The fact that it is also relatively common for the municipality to take on a disproportionate amount of risk also has an immediate negative impact on affordability.

In most of the contracts there is some link made between the setting of tariffs and the payment of fees to the contractor. In the CBO contracts however, because they are for refuse collection which is typically rates funded, this issue does not arise.

Contract F, a long term electricity services contract with a municipal entity, contains an entire section dedicated to “socio-economic services” and obliges the municipal entity to develop a socio-economic plan after consultation with the community to address, *inter alia*, affordability issues.

6.9.3 *Contracts and Credit Control*

Most of the contracts allow the service provider (if performing this function) to disconnect the service for non-payment, but make this subject to the municipality's credit control policy or by-law, the contents of which are not reflected in the contract. It is thus not possible to assess the fairness of the procedures, how they may include public participation and whether they comply with the statutory requirements. However, in those contracts which do set out a procedure for disconnection, no provision is made for the consumer to make representations prior to cut-off. This is despite the fact that, in the water sector at least, this is a requirement of the Water Services Act³¹⁶.

Most contracts do acknowledge the need to supply a basic service and provide that, if the service provider is unable to provide a full service, then it must give priority to a basic supply. In two of the contracts with water boards (Contract J and Contract K) the service provider is obliged to implement customer care programmes, including educational and awareness programmes, to ensure that the customers are aware of their rights and obligations with the aim of creating "a positive and reciprocal relationship" between the customers, the municipality and the water services provider. It is worth noting however that these contracts also place similar obligations on the municipalities so that the municipality is not entirely divorced from the community on these issues.

6.9.4 *Conclusion*

The efficacy of outsourcing contract provisions on ensuring the municipality's consumers are not prejudiced by tariff hikes and harsh credit control measures are not that easy to assess in a desk top study of the contract. So much will depend on the external factors, such as the credit control policy of the municipality and how strongly the municipality exercises its rights and duties in setting tariff policy. The fact that municipalities can almost be coerced into amending their tariffs or face contract breach, as outlined under the "risk transfer" heading above, naturally

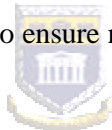
³¹⁶ S 4 Water Services Act.

constitutes a potential negative influence on the achievement of the consumer protection objective.

6.10 Protection of Service Environment

6.10.1 Suggested Contract Requirements

The chief factors under this “danger area” are continuity, asset protection and dispute resolution. Under “continuity” the contract will have to contain clear hand-over provisions dealing with early termination of the contract, whether by breach, insolvency or the like. Likewise, the contract will have to contain a detailed hand-over plan for expiry of the contract. It is suggested that a “step in right” also be created to entitle the municipality to “step in” and take over service provision for a short period of time in defined circumstances (i.e. where the provider for any reason is temporarily unable to perform and neither party wants to invoke termination procedures). Likewise, the contract will have to contain clear and detailed emergency plans to ensure no, or limited, service interruption in the event of an emergency.



Under “asset protection” the contract should oblige the service provider to develop a clear maintenance and repair schedules, asset registers, insurance schedules and, in long term contracts, maintenance bond or the like to ensure the municipality can afford large scale maintenance and repair at the end of the contract if this is necessary.

Finally, the contract should contain practical and workable dispute resolution mechanisms to enable the speedy and fair resolution of any differences which may arise between the parties during the contract.

6.10.2 Contracts on Continuity

The contracts generally have detailed handover provisions to ensure the smooth transition of the service from the municipality to the service provider and back again. The importance of the service and the need to ensure no interruption is emphasized.

Contract G, a long term water contract with a municipal entity, contains a provision where the parties specifically acknowledge that termination of the contract is a “process” and not an “event”. This appears to be a very useful basis on which to approach the issue. In Contract F, a long term electricity services contract with a municipal entity, the service provider is specifically obliged to continue rendering the service despite the termination of the agreement. This is to give the municipality enough time to make suitable arrangements and thus ensure the service is not interrupted on hand over.

Two exceptions, however, are two of the contracts with Water Boards (Contract J and Contract K), which only require a “Transfer Plan” to be drafted by the service provider just before expiry of the contract. In Contract K a plan must be prepared at least four months before expiry and in Contract J, six months before expiry. It is not clear why the plan is not prepared upfront and, given the complexity of these issues, it is significant that the plan need only be drafted so close to the end of the contract. The plan still has to be approved by the municipality and, given that there could well be amendments required before final approval, there appears a real risk of the parties not having an agreed transfer plan by the end of the contract.

Quite a few contracts also oblige the service provider to provide a performance guarantee, inter alia, to ensure a smooth handover either at the end of the contract or earlier if there is a breach, insolvency and so on. These provisions are however, almost entirely absent in the CBO refuse collection contracts.

The Standardised Provisions suggest that a “step in” right be granted to the municipality if there is an urgent need to take over the service (e.g. because of a threat to public health or to exercise a statutory duty)³¹⁷. The municipality may need to do this because of a breach on the part of the service provider, or for reasons outside the control of either party. Typically, a step in right would last between a few hours to several days or possibly up to a few weeks and is appropriate for projects involving essential core rights (as are basic municipal

³¹⁷ National Treasury (2004), pg 307.

services). The step in should always be in the sole discretion of the municipality – it should never be forced to exercise a step in right. None of the sample contracts contain a classic step in right. In some contracts (for refuse collection and disposal) in the case of emergency or failure by the service provider, the municipality is entitled to contract someone else to perform the service in the interim and claim damages from the service provider. The service provider will then take over again when it can.

As far as emergency plans are concerned very few contracts contain details of the emergency plan itself. Most contracts oblige the service provider to draft a plan for council's later approval. Provisions regarding emergency plans tend to be found only in the water sector contracts.

In terms of the Water Services Act, a contract is not allowed to extend for a period longer than thirty years³¹⁸. Both concession contracts do not comply as they allow for indefinite extension after the thirty year period and neither do Contracts A and B, being long term water services contracts with private companies, which likewise contemplate indefinite extension. In theory some of the other contracts, such as Contract J, a two year water services contract with a water board, which although on the face of it for a much shorter term could also fall foul of the thirty year limit as they do allow for indefinite contract extension.

6.10.3 Contracts and Asset Protection

The contracts prohibit the service provider from disposing of the core assets necessary to perform the services and confirm that these assets remain the municipality's. The contracts generally have detailed provisions ensuring the safety of the assets, insurance, proper maintenance and repair and the creation of asset registers. Assets must be handed over in good condition, fair wear and tear excepted.

In the CBO contracts for refuse collection, the major assets (the rubbish trucks) are owned by the contractor and certainly do not revert to the municipality at the

³¹⁸ Regulation 9, Water Services Provider Contract Regulations (August 2001).

end of the contract. Whether these would be deemed “core assets” for provision of the service is debatable, but seems unlikely.

However, only one of the contracts (a long term concession contract³¹⁹) requires the provision of a maintenance bond close to the end of the contract period. This is a recommended provision in the Standardised Provisions, which emphasize the importance of the state of assets at handover in an essential service. Either a maintenance bond is recommended, or a maintenance reserve or the withholding of later payments to the service provider to create some form of protection³²⁰. It is surprising that the contracts do not contain such provisions as there is a possible risk of interrupted service if the assets are not handed over in good order.

Effective monitoring of asset repair and maintenance is naturally of the utmost importance, especially when the contract is nearing its end and thus the conclusions regarding the efficacy of the monitoring provisions found in these contracts is relevant.

6.10.4 Contracts and Dispute Resolution



Almost all the contracts forming part of this study contain detailed dispute resolution procedures and invariably choose an arbitration route (if other options such as mediation have failed) over that of the Courts. The only exception is Contract J, a two year contract with a water board, which allows for a process of mediation and then, if that fails, it is up to the parties to decide where to go next, i.e. whether to follow the court option or arbitration.

It is notable that Contract L with a CBO provides that if a dispute reaches the level of arbitration the parties share the costs of the arbitration equally (the implication being that this applies regardless of the outcome of the arbitration). Given that these contracts are with CBOs who would presumably have very limited resources, and that arbitrations can end up being enormously expensive,

³¹⁹ Contract C.

³²⁰ National Treasury (2004), pg122.

this seems a rather unfair provision. This is especially so if the CBO is in fact successful in its dispute.

The Standardised Provisions in fact suggest that the court route is preferable over that of arbitration. They point out that one often hears the argument that resolving disputes through the courts “is too slow, too expensive and sometimes even ‘unreliable’ as the courts may lack the expertise necessary to adjudicate the technical and financial complexities of PPP agreements”³²¹.

The Standardised Provisions take issue with this attitude and argue that arbitration can be just as slow and expensive as the courts and, if a case is highly technical, the rules of court in any event allow technical experts to be appointed to assist the presiding judge. However, it argues that “the most compelling reason” to prefer the courts over arbitration is:

the need to build up a substantial legal precedent base for the interpretation and enforcement of PPP Agreements, to provide the courts with the opportunity to grow the expertise required to deal with the complexities of PPP Agreements and to promote a measure of transparency regarding the interpretation and enforcement of PPP Agreements³²².

6.11 General features of contracts

6.11.1 Amendments

The issue of contract amendment is of particular importance when it comes to the issue of new developments which need a supply of services. There is always a risk of the incumbent provider being in an unfairly advantageous position to take over the new service area as well. This may have a negative effect on competition (and thus value for money) as well as public participation.

In fact, most of the contracts allow a process of negotiation in respect of an extension of either the service area, or the scope of services. The incumbent

³²¹ National Treasury (2004), par 86.1.2.

³²² National Treasury (2004), par 86.1.3.

service provider is thus given an opportunity to amend the scope of its contract quite significantly, and without a public process. In some contracts the service provider is even given a right of first refusal (Contract J and Contract K and more) but in the others the municipality ultimately decides whether the service provider may extend its scope of services³²³. In another contract, the risk of a change in demarcation is catered for with a cost formula set to take into account either an extension or reduction of the service area, with the proviso that it is still up to the municipality to decide on the service provider.

In Contracts A and B, water services contracts with private companies, the municipality is given a wide scope to increase the scope of the contract simply by agreement with the company. Some significant examples include the parties agreeing that the company will do meter reading, revenue collection, disconnections, fix pipelines or do major repair works. Apart from denying the public any participation in this process, this thwarts the benefits of a competitive procurement process and could thus ultimately negatively affect value for money.

Similarly one of the CBO contracts allows the municipality, entirely at its discretion, to “increase”, “decrease” or “change the method” of the service. The municipality is also allowed to entirely omit any aspect of the service. Unusually, the contract does not require mutual agreement between the parties for this to occur and any additional fees are determined by the municipality “after consultation” with the contractor. This puts the municipality in a markedly more powerful position than the contractor and also allows the municipality to significantly amend the scope of the contract without following a competitive process.

A potential risk in other contracts, however, is an unequal bargaining power between a large company and, for example, a small local municipality. How much scope is there really for the municipality to play hardball when it comes to

³²³ Again it seems less problematic in principle for a municipal entity to be given a right of first refusal for an amendment or extension to the scope of service, contract area or contract term. This is the case with the Contract G, a water services contract with a municipal entity.

proposed amendments to the contract? The new statutory provisions, which oblige the municipality to follow a public participation process before any material contract amendment, will hopefully limit this risk.

6.11.2 Built-in Uncertainty

In many of the contracts, because of open-ended provisions, the future decisions of the parties, and not current contract terms, will determine critical aspects of the service delivery agreement. In this way an element of uncertainty is built in. This makes it difficult to assess the effectiveness of the contract's provisions or to precisely pin down the nature of the parties' future contractual relationship. For example, instead of dealing with the crucial issue of credit control and disconnection procedures, a contract may simply oblige the service provider to comply with a future credit control policy to be drafted either by the service provider or the municipality and adopted at a later date. Whether that credit control policy will be draconian or far-sighted is an unknown.

Alternatively, a party's particular obligation may be so widely worded that it is left with a choice to either pay lip-service to that duty or to conscientiously comply with it. For example, the contract may baldly say that the municipality will "monitor" the service provider's performance. The monitoring may turn out to be really effective, or, as was the case in a large concession agreement, end up being the responsibility of only one individual³²⁴. Again, this adds to the difficulty of accurately assessing whether the contract is meeting the objectives of outsourcing and adequately avoiding its risks.

Of course, these are not issues which affect the legality of the contracts, they instead illustrate the difficulty of making a meaningful assessment of the workability of a contract from looking at its provisions alone.

Also on the subject of "uncertainty", having made the point that the CBO contracts tend to be shorter and easier to follow than the other contracts, they almost all contain an ambiguous reference to other generic conditions of contract

³²⁴ Smith & Fakir (2003), pg 9.

which may or may not apply to the contract in question. For example, some of the contracts define the word “Contract” as including the municipality’s “General Conditions of Contract and/or Conditions of Tender...” The use of “and/or” means that it is entirely unclear whether the General Conditions of Contract actually apply to that particular contract or not. This would naturally add unnecessary legal complications if either of the parties wished to exercise rights in terms of the agreement.

On a slightly different point, as will be seen under the “Accountability” heading below, some contracts grant the municipality a wide scope to amend and increase the extent of the service provider’s duties, sometimes quite significantly so. If the municipality were to act on these powers the contractual relationship would change quite significantly. So, again, an element of unpredictability is built into the parties’ future relationship.

6.11.3 Right to Water

Many of the contracts analysed in the thesis involve the provision of water services. The Constitution, in its Bill of Rights, provides for a constitutional right to water³²⁵. Given that provision of water and sanitation services is a local government function, a municipality not only has a duty to respect, protect and promote the right, but actually has a positive duty to act in order to realize this right. This is the crucial, overarching context within which a municipality must provide water services and is one it cannot simply contract out of. Despite the existence of this constitutional framework, it will be hard work to find any significant reference to it in the contracts. In fact, in many cases, if you were unaware of the existence of this right, reading the contracts would leave you none the wiser.

Although the absence of an emphasis of this fundamental human right is noteworthy, it does not however necessarily affect the legality or constitutionality

³²⁵ S 27 Constitution.

of the contracts. A municipality's constitutional duties exist independently of any service delivery agreement.

6.12 Conclusion

The following conclusions can be drawn from the contract analysis and evaluation on how they typically deal with the identified drivers and dangers:

- The capital investment objective is not a common feature in basic municipal service outsourcing;
- Value for money requirements are put at risk by inappropriate and unclear allocation of risk which could threaten the financial balance of the contract. Insufficient setting of measurable outcomes and monitoring provisions mean that the municipality may find it difficult to periodically assess through the contract period whether it continues to receive value for money out of the contract;
- The contracts rarely deal directly with "efficiency" objectives, but this objective could be negatively impacted on by poor monitoring structures, failure to set performance targets and the rarity in the contracts of detailed sanctions for specific instances of poor performance and detailed methods to reward good performance;
- Skills transfer is not treated seriously in the contracts and, at most, is paid lip-service;
- Appropriate risk transfer is difficult to assess in a desk top study, however, generally speaking, the apparent "cushioning" of the service provider from significant risk, foreseeable or not, could threaten the very objectives of outsourcing; namely appropriate risk transfer and value for money. This has a knock-on effect on accountability and affordability as the risk event may compel a municipality to rethink its tariffs, in the interests of the contract rather than in the interests of the community. Risk is not clearly allocated nor clearly described. Generic risk allocation, such as vis major

and adverse governmental action, appear to be allocated more in favour of the service provider than the municipality;

- The accountability objective is put under threat a number of contracts purported attempts to fetter the municipality’s tariff setting powers. Accountability is also threatened by the tendency to refer important contractual decisions to independent, non-accountable bodies and not to leave it within the municipality’s discretion. Monitoring is one of the key functions a municipality must perform to ensure it remains accountable, yet the monitoring provisions found in these contracts are certainly capable of significant improvement, especially when it comes to setting clear and measurable outputs with appropriate sanctions for poor or non-performance. This would also apply to rewarding good performance. Although some contracts set up a “monitoring office”, it is not clear from the contract terms alone whether this would operate as a separate independent office or merely be an in-house line function of a department;
- Under the “public buy-in” heading, the contracts mostly contain widely worded confidentiality clauses which could raise obstacles in allowing the public access to the contracts. The nature and style of the contracts render them non-reader friendly and generally inaccessible documents. This threatens the efficacy of public participation processes on the draft contracts and could also prejudice satisfactory contract monitoring on the part of the municipality;
- Risks of tariff hikes and harsh credit control measures were difficult to assess from a desk top study as credit control was mostly subject to municipal credit control policies then in existence or yet to be adopted and tariff setting would depend on how stringently the municipality complied with its tariff policy under the Systems Act. However, certain contracts did purport to fetter the municipality’s discretion in this regard; and
- Contracts were generally quite detailed in their provisions for hand over on expiry of the outsourcing contract. There was a general absence of maintenance bonds, or other forms of security, in the longer term

contracts. This could raise the risk of interrupted service delivery if assets are handed back to the municipality in a poor state of repair, alternatively the municipality could risk having to face a significant maintenance bill if the service provider failed to adequately maintain the assets as the contract was drawing to a close.

The conclusions on the contract analysis reached above, clearly indicate that in some key respects the contents of current municipal outsourcing contracts do not adequately translate outsourcing objectives into contract terms. Nor do they adequately provide protection against, or limit the effects of, the many dangers a municipality faces when embarking on an outsourcing project. This leads on to the next stage of the analysis, which is to evaluate the relevance of contract terms and the outsourcing “drivers” and “dangers” during the contract implementation phase.



7 Chapter Seven: Contract implementation

7.1 Introduction

Based on selected case studies and other publicly available information, this chapter investigates how certain of the “drivers” and “dangers” have been dealt with in practice and, in particular, explores the relevance of contract terms in the practical reality of contract implementation. If contract provisions are ignored at the whim of the parties, or are renegotiated when it is unnecessary to do so, then the efforts expended to try and formulate an excellently drafted and structured contract could become wasted.

The idea behind doing this analysis arose out of the fact that, while conducting the desk top study of the contracts it became apparent that in certain instances contracts had been materially amended relatively shortly after signature. Some of the amendments, as will be seen below, went against certain of the stated objectives in the contracts and thus raised the question of how binding the contracts actually are in reality. It also became apparent that in certain cases, although the contract provisions on the face of it appeared adequate, other external factors had a negative impact on the implementation of these provisions and thus threatened the success of the contracts.

It is therefore useful to have a look at whether post “contract –signature” developments in any contracts have threatened any of the chief “objectives” or benefits of outsourcing. Alternatively, have any of these developments increased the risk of the contracts experiencing any of the typical “dangers” associated with outsourcing?

There is naturally no way to guarantee the successful implementation of a contract. If one, or both, of the parties simply have no interest in expending the resources necessary to implement and enforce the agreement conscientiously, then clearly nothing further can be done. In other words, no amount of sophisticated contract terms will be of assistance. But this is an extreme example, and there are surely many ways that contract terms could assist in heading off the risk of the parties’ relationship unravelling after contract signature. Hopefully a look at the

reality of what has happened with some contracts on the ground will assist in finding ways to ensure the successful implementation of these contracts.

This Chapter will consider contract implementation under the headings “risk realisation”, “monitoring”, “capital investment”, “public buy-in”, “political will”, “affordability” and “skills transfer” as the case studies demonstrated that it was under these headings that contract implementation problems arose. The case studies and other source documents used for this Chapter relate only to the contract implementation experiences of the Nelspruit³²⁶, Dolphin Coast³²⁷, Harrismith³²⁸, City Power³²⁹, Amahlati³³⁰ and Lukhanji³³¹ outsourcing projects as these were the contracts that were the subject of detailed and published case studies, containing information relevant to the thesis.

7.2 Risk realisation

7.2.1 Introduction

What have the case studies found in regard to the consequences of changing circumstances during the contract period? In other words, when things start to go wrong, financially or otherwise, during the contract period and for reasons anticipated in the contract, have the contract terms themselves been effective in dealing with these events?

The two most significant examples of contracts falling into serious difficulties as a result of anticipated risk events are South Africa’s first two water concessions, namely Dolphin Coast and Nelspruit. Much has been written about these two concession contracts but, for the purpose of the thesis, it is the effectiveness (or

³²⁶ A long term water concession with a private party. The concession is, for ease of reading, referred to as “Nelspruit”.

³²⁷ A long term water concession with a private party.

³²⁸ A three year (with an option to renew) water services contract with a water board.

³²⁹ An electricity provision contract with a municipal entity.

³³⁰ A long term water and sanitation management and service contract with a private company.

³³¹ A long term water and sanitation management and service contract with a private company.

otherwise) of contract terms in assisting to meet outsourcing objectives that will be explored

As discussed more fully below, both contracts were renegotiated or amended as a result of serious difficulties experienced by the service providers during contract implementation. Were these contracts lacking in some way, or was it actually a case of the contracts becoming subordinate to other factors relevant to the power relationship between the parties? In other words, were the actual contract terms ultimately irrelevant? As will be seen below in the brief summary of each of the contracts, the question of risk allocation is central to the problems that arose in each case. Did the contracts make it sufficiently clear who bore the particular risks in each case and, if so, who in fact ultimately bore the risk?

7.2.2 Nelspruit

The water concession launched in Nelspruit in 1999 was the first and largest privatization initiative in the country³³². It is approximately five times the scale of the Dolphin Coast contract³³³.



Nelspruit municipality had previously serviced a small and affluent white town. After the amalgamation of local authorities in the local government transformation process, Nelspruit's population leapt from about 24 000 to 230 000, as it then included the former homeland of KaNgwane. Although the municipality's population increased ten-fold, its income only grew by 38%, with 52% of its population living in poverty³³⁴. The massive service backlog and need for infrastructure is well illustrated by the fact that, after amalgamation, the number of residents per sewer length went from 96 to 830³³⁵. It was apparent that the resources necessary to meet the community's needs could not be met from the existing tariff income and the municipality thus approached the private sector to assist in bringing in the capital to meet the service and infrastructure backlog.

³³² Smith, Mottiar & White (2003) pg 7.

³³³ MIIU & NBI (October 1999).

³³⁴ Smith, Mottiar & White (2003) pg 8.

³³⁵ Smith, Mottiar & White (2003) pg 8.

A private company, BiWater, was ultimately appointed as concessionaire and, shortly after signature of the agreement, the concession area was dramatically increased as a result of redemarcation of municipal boundaries. The concession ran into serious problems shortly after the contract was entered into as a result of significant and concerted community resistance to the concession and “privatization” of the water services. It appears that this was in part as a result of the almost total non-performance of the BEE partner to BiWater who were in theory responsible for communication with the community³³⁶. However other factors, such as the perceived harsh credit control measures imposed by the concessionaire and the perceived higher costs of water were also crucial factors in the community resistance. The community subsequently launched payment boycotts, BiWater employees were subjected to intimidation and vandalism became a common feature. The community resistance threatened to bring the concession to a premature close.

What did the contract have to say about this? The contract obliged the concessionaire to perform its service obligations to particular levels but “subject to” certain factors, including “consumers paying tariffs in accordance with prescribed tariffs”³³⁷. It is not clear whether this condition is focused primarily on the need for the existence of “tariffs” or whether it is intended to cover consumer non-payment of service fees. Either way, it seems that consumer non-payment of the tariffs (as, for example in a payment boycott) would quite arguably fall within the parameters of this clause. If this is so, then the effect appears to be that the contract allows the company to adjust its service levels to take into account low payment levels.

However, the issue is dealt with quite explicitly in the contract provision which prohibits the company from claiming an increase in their contract charge as a result of “low payment levels”³³⁸. Although the company cannot claim more money as a result of low payment levels, the contract does grant it financial

³³⁶ Smith, Mottiar & White (2003) pg 12.

³³⁷ Par 30.

³³⁸ Par 45.6

compensation for this risk by allowing it to reduce its capital expenditure programme. This is found in two provisions. In one, the contract records that if the level of consumer payments differs from those projected by the company then the company can adjust its capital expenditure programme³³⁹. The second provision states that the capital works programme “will” be adjusted to take cognizance of “actual payment levels” achieved by the company³⁴⁰. The contract therefore recognised the risk and allowed the concessionaire indirect compensation in the form of reduced capital investment while denying actual monetary compensation.

But what actually happened when this risk became a reality? Not only did the low payment levels effectively bring the entire capital works programme to a halt but proposed relief measures involved a R109m bail-out from government, including an R18m reduction in loan repayments, scrapping lease repayments of R4m per annum, reducing electricity charges and so on³⁴¹. In other words, despite the explicit contract terms on this issue, the reality was that the municipality went far beyond its contractual obligations to save the contract.



7.2.3 *Dolphin Coast*

The Dolphin Coast concession was entered into in 1999, at almost the same time as the Nelspruit concession. After amalgamation of various local authorities, the Borough of Dolphin Coast (“BODC”) came into being in 1995. The areas taken over by BODC suffered a serious infrastructure backlog, with about 50% of the population living in informal settlements. The capital investment needs to meet this backlog were estimated at R230m. At the time a rapid population growth was also estimated in the area, which would only heighten the need for substantial

³³⁹ Par 32.2.2.

³⁴⁰ Par 32.1.

³⁴¹ Yende et al (2003).

capital investment³⁴². Estimates in 1997 were that the municipality's population would expand nine times by 2020³⁴³.

Because of municipal budgetary restrictions, lack of municipal creditworthiness and a dearth of technical and management expertise, the municipality decided that a concession was the most viable alternative to meet its needs³⁴⁴. In 1999, after a protracted pre-qualification and tender process, Siza Water, a local company formed by Societe d'Aménagement Urbain et Rural (SAUR), was appointed as concessionaire. After only two years the concession ran into serious financial problems and the concessionaire failed to make a scheduled payment, in effect breaching the agreement. The primary reason for the company's financial difficulties could be traced back to incorrect growth projections³⁴⁵. Growth simply did not increase as predicted. Other factors raised as contributing to the financial difficulties were the increase of bulk water costs and the poor state of the infrastructure.

Who bore the risk for these factors? The contract specifically allowed for an automatic proportionate increase of the tariff in accordance with any increase in bulk water costs. The concessionaire was therefore automatically protected from this risk and no change in contract terms would be necessary³⁴⁶.

As far as the state of infrastructure was concerned, the contract quite clearly placed this risk with the concessionaire company. The contract stated explicitly that the existing works were taken "voetstoots" (i.e. "as is")³⁴⁷. Furthermore, under "Warranties", the contract recorded that instead of the council giving full commercial warranties, a due diligence investigation would be completed by the concessionaire³⁴⁸. The concessionaire was also "deemed to have fully inspected

³⁴² WZC (2003), Introduction.

³⁴³ MIIU & NBI (July 1999).

³⁴⁴ WZC (2003), Introduction.

³⁴⁵ WZC (2003), Executive summary.

³⁴⁶ Annexure E2.

³⁴⁷ Par 19.2.

³⁴⁸ Par 19.1.

and acquainted itself with all the circumstances connected to or associated with the supply of water services...”³⁴⁹ Finally, the contract specifically prohibited the concessionaire from being entitled to an extraordinary review of tariffs on the grounds of the poor state of infrastructure.³⁵⁰ The concessionaire could therefore expect no contractual relief based on the poor state of infrastructure.

What about risk allocation regarding incorrect growth projections? Certain provisions contained in the body of the contract are consistent in placing the responsibility for incorrect growth projections with the concessionaire. However, a provision in one of the annexures appears to contradict this, making the contract less than clear.

The contract places an obligation on the company to make total population projections for each part of the concession area based on the latest existing national population census³⁵¹. The contract then goes on to say that the council will be entitled to refuse an “extraordinary” review of tariffs based in whole or in part on the “difference between the actual pattern of demand for the supply of Water Services and the projection made by the concessionaire in the prevailing Five Year Plan”³⁵². More generally, the contract also prohibits tariff modifications used to offset “deficits incurred arising from entrepreneurial risk”.³⁵³

Despite these provisions, in an annexure to the contract setting out the process to be followed when applying for an extraordinary review of tariffs, the contract lists “significant unforeseen change in the population growth or settlement patterns” as one of the grounds to justify an extraordinary review of tariffs³⁵⁴. Although this does not really dovetail with the previous provision on “pattern of demand”, it should be noted that this provision does not *compel* the council to agree to an

³⁴⁹ Par 18.1.

³⁵⁰ Par 43.6.3.2.

³⁵¹ Par 58.6.

³⁵² Par 43.6.3.2.

³⁵³ Par 43.2.

³⁵⁴ Annexure E2 par 4.2.

extraordinary modification of the tariff. The council will still be entitled to refuse the request for tariff modification.

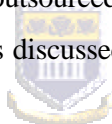
From the above it is clear that, at most, the concessionaire could argue for an extraordinary review of tariffs if its growth projections proved incorrect. It would appear that it would remain within the council's discretion whether to agree to this or not and so the risk should ultimately rest with the concessionaire. If the concessionaire could not afford to bear this risk and continued to be in default, the council could call on the R5m performance guarantee established specifically for this purpose. The reality, however, was that as a result of the company entering into financial difficulties, a commercial risk it was contractually bound to bear, the agreement was instead materially altered in a manner which is difficult to argue was in the benefit of the community.

From tariffs supposedly being set for five years (subject to an annual escalation according to a set formula) the community instead experienced a significant and unexpected tariff hike shortly into the contract (15% increase from July 2001 and a further 12% from July 2002). This occurred because the council agreed to an extraordinary review of the tariffs. The company was also given substantial financial relief in the form of a "supplementary agreement" entered into between the parties. This included a 50% reduction in the compliance monitoring fee payable to the municipality and a 7% reduction in the electricity tariff charged to the company. Monitoring obligations were thus regarded as subservient to protecting the company from commercial risk and perhaps makes it less surprising, as will be seen below, that the contract monitoring later came to an almost total standstill.

The supplementary agreement had the effect of reducing the capital investment programme by just over half. Originally capital expenditure for the first five years of the contract was set at R21,6m but was then reduced to R10m. This fundamentally weakened one of the main objectives of this particular outsourcing project, namely access to capital (this was also one of the consequences of the problems faced in the Nelspruit contract). For its part, the company halved its monthly management fee paid to the major shareholder for five years.

What is significant is that the contract clearly and specifically catered for the scenarios which occurred in this contract. At worst, the municipality could call on the performance guarantee in the case of the company breaching the agreement. Why were the contractual remedies not called on?

In an interview in 2001, Dr Jim Leigland of the MIIU explained that the municipality could indeed have cancelled the contract and held the company to the performance guarantee, but was not willing to do so as they believed the company had done “ a good technical job” and because in any event, the municipality “realized that they would not be able to run the system as efficiently as Siza, because they had never actually run the system by themselves and did not have the necessary technical expertise or experience”³⁵⁵. If this is correct, then the municipality appeared to be making the contract allowances and modifications from a position of weakness (inability to do otherwise) rather than a position of strength. This illustrates the well identified danger of the municipality becoming increasingly unable to take over an outsourced service the longer it is separated from actual service delivery. This is discussed in more detail below.



7.2.4 Conclusion

A recent IMF report made a point quite pertinent to the developments which occurred in the Nelspruit and Dolphin Coast concessions. It stated that:

...the PPP contract may not tell the whole story, since it is only relevant to ex ante risk transfer. Political pressure for the government to bail out large projects (that are too big to fail), and providers of essential services, may mean that the government in fact bears more risk than the contract suggests³⁵⁶.

This illustrates the limitations of relying on contract terms alone to give a complete and accurate representation of the parties’ relationship. On a similar point, as a spokesperson at the MIIU put it at the time of the amendments to the

³⁵⁵ MIIU & NBI (July 2001).

³⁵⁶ IMF (2004), par 39.

Dolphin Coast contract: "...long term concessions are not written in stone"³⁵⁷. If this is indeed so, then one must question the purported centrality of a carefully balanced and structured contract in an outsourcing project. If the contract is susceptible to amendment to take into account changing circumstances, then surely it comes down to who wields the real power in the relationship which determines to whose benefit the contract is amended. Or are the parties necessarily interdependent?

The point is well made in one of the case studies, that:

.. local authorities are drawn to the conceptual idea of concessions because of the promise that the private sector will take the commercial risk through its financial investment. In practice, however, the local authority is not immune from bearing the financial burden of these commercial risks should the conditions of the service delivery agreement no longer be favourable to the concessionaire³⁵⁸.

From the two case studies above, it appears that one can indeed make the observation that long-term concessions are not written in stone. One can naturally expect some contract adjustment over time to cater for particular circumstances, but the amendments revealed in these two cases do not fall into a "minor adjustment" category. These were significant and material changes to the contract, amendments which had immediate consequences to the community and which were made without community participation.

The problems experienced in these two contracts arose out of an apparent over-compensation (from a strictly contractual perspective) for risk events which occurred during the contract term. The parties chose alternative methods to deal with the financial consequences of the risk events rather than the methods set in the contracts.

³⁵⁷ MIIU & NBI (July 2001).

³⁵⁸ Smith, Mottiar & White (2003) pg 26.

7.3 Monitoring

How effective have contract terms been when it comes to monitoring the service provider's performance during contract implementation? This is important to assess as monitoring is one of the most important prerequisites for a successful outsourcing contract and is the chief method at the municipality's disposal to ensure it does not suffer a loss of accountability.

Of the contracts analysed in this section, almost all reveal a tendency on the part of the municipalities to not take their monitoring duties seriously. This is despite what actual terms may be found in the respective contracts on the subject of monitoring. For example, in both the Harrismith contract and that of Nelspruit, case studies identified monitoring and regulation as weak points in the contracts.

Harrismith's performance on this score was described as "mediocre" and in the Nelspruit contract it was noted that the municipality had not made monitoring a priority and that this constituted a "significant weakness"³⁵⁹ of the contract. From the municipality's side in each of these contracts, monitoring ultimately became the responsibility of only one individual; in both cases a senior engineer³⁶⁰. This is clearly unsustainable - no matter how efficient and conscientious that official may be. This is particularly so in the case of a contract the size of Nelspruit. It was however apparent from the case study that plans were in the pipeline to address this problem in Nelspruit, in part by the creation of a Water Forum made up of members of the community, ward councillors and the company³⁶¹.

In Harrismith, although effective monitoring mechanisms were indeed set up as per the contract, effective monitoring was hampered by councillors playing a passive role. This appeared to be in part as a result of their lack of understanding of the contract. They would then tend to acquiesce to those with technical knowledge³⁶². The mechanism was also problematic in that, although the

³⁵⁹ Smith, Mottiar and White (2003) pg 11.

³⁶⁰ Smith & Fakir (2003) pg 9.

³⁶¹ Smith, Mottiar and White (2003) pg 15.

³⁶² Smith & Fakir (2003) executive summary.

independent monitoring unit worked very well, it relied almost entirely on the skills of an outside expert. The case study quite correctly raises the question of what happens when that consultant's contract comes to an end³⁶³. The case study summaries the municipality's monitoring generally as "mediocre" and notes that the municipality simply did not have sufficient staff capacity to adequately fulfil the role of a water services authority³⁶⁴.

Although the monitoring experiences in Harrismith and Nelspruit are very far from the ideal, they still do not come close to the almost total failure of monitoring experienced in Dolphin Coast. In this case, a study revealed that monitoring became so bad that it effectively came to a total standstill in mid-2002. This was identified in a recent study of the contract, as the single most important problem facing the concession³⁶⁵ (ignoring of course the circumstances behind the need for the "supplementary agreement" referred to above). The company, to its credit, continued submitting the various reports it was contractually obliged to furnish to the municipality, but to cover itself set up a system whereby it had written proof that it had complied with its reporting obligations. After that, the reports appeared to go into a black hole. The company would receive no response from the municipality and the reports would not appear on any agenda.

The weakness of the monitoring system was revealed even before it came to a standstill, when the existing financial compliance monitoring mechanisms failed to pick up the impending financial problems facing the company and thus its failure to make a scheduled contract payment came as a total surprise to the municipality. The mechanisms were inadequate in that they failed to give a "comprehensive" picture of what was happening in the contract and did not look at financial viability. It was also significant that, despite the contract attempting to ensure proper monitoring by obliging the company to contribute to monitoring costs, the municipality instead chose to use a large part of these monitoring fees to

³⁶³ Smith & Fakir (2003) pg 9.

³⁶⁴ Smith & Fakir (2003) pg 17.

³⁶⁵ WZC (2003) Executive Summary.

cover operating costs³⁶⁶. This is a further example of contract terms simply being ignored during contract implementation.

As will be seen under “Political Will” below, Dolphin Coast had performed its monitoring duties relatively adequately (“fair to good”)³⁶⁷ prior to the new municipal demarcation boundaries which were effected at the local government elections in 2000. This was when the KwaDukuza municipality effectively took over from the Borough of Dolphin Coast and the lack of monitoring can be traced back to this time. The evaluation report on Dolphin Coast notes that attempts were then (in 2003) in the pipeline to address the problem of compliance monitoring.

The experiences of the electricity provision contract with a municipal entity, City Power, and those of Lukhanji and Amahlati appear to have been a lot better when it comes to monitoring, but are again not ideal.

On the positive side, a case study on the City Power contract notes that the business plans, service delivery agreement and monthly and quarterly reports that the company is obliged to furnish are indeed effective tools to ensure contract compliance³⁶⁸. Certain important issues have been made standing items on the agenda at the regular meetings between the municipality and the company. These include income and expenditure details, service delivery progress reports, capital expenditure, extension of services to under-serviced areas, social responsibility projects and so on³⁶⁹. This all assists the municipality in performing its monitoring functions.

The only weakness identified in the case study of this contract is that there is a lack of clarity regarding the roles councillors are expected to play in the monitoring process and this affects their ability to monitor. It became apparent from the study that the bulk of councillors play a peripheral role in the monitoring

³⁶⁶ WZC (2003) pg 52.

³⁶⁷ WZC (2003) pg 43.

³⁶⁸ Khumalo et al (2003) pg18.

³⁶⁹ Khumalo et al (2003) pg 33.

process. The chief players in the monitoring arena are the mayoral committee, the portfolio committee on municipal service entities, the contract management unit and the council's administration³⁷⁰. Some councillors had never seen the regular progress reports the company sends to the municipality. The study accordingly recommends that councillors need to increase their involvement in the monitoring, reporting and oversight processes and certainly need access to the reports generated by the service provider³⁷¹.

Although the case study on the Lukhanji and Amahlati contracts does not go into great detail on monitoring compliance, the study reveals that the parties appear to enjoy a close and cordial relationship with a lot of communication. In the case of Luhanji, the parties meet each month when the company reports to the municipality in detail³⁷² and in Amahlati there are daily reporting sessions between the town engineer and the company plant manager. There are also monthly reports to the municipality and bi-monthly management meetings between the company and the municipality³⁷³. However, the Amahlati and Lukhanji case study also made the point that a cash crisis Lukhanji was experiencing was "possibly" attributable to the fact that the municipality was paying too much to the private service provider under their service delivery contract. But there did not appear to be any way to check whether the municipality could in fact provide the service more cheaply. This is a direct illustration of poorly devised and implemented monitoring provisions leading to a potential threat to the value for money objective³⁷⁴.

From the above examples it is clear that it is always of course preferable for a contract to set up detailed monitoring mechanisms with clear roles and reporting lines. However, it is also clear that this is not the answer to all the municipality's problems and it would be dangerous for the municipality to sit back and passively

³⁷⁰ Khumalo et al (2003) pg 33.

³⁷¹ Khumalo et al (2003) pg 36.

³⁷² Booysen (2004) pg 33.

³⁷³ Booysen (2004) pg 33.

³⁷⁴ Booysen (2004) pg 75.

rely on these mechanisms and structures to get the job done. Monitoring structures are vulnerable to being all about form and not substance and it would pay for the municipality to keep this in mind constantly. Effective monitoring clearly requires ongoing assessment and a strong political will on the part of the municipality to be successful. Mere contract terms will not always suffice.

7.4 Capital investment

As I have noted before in the thesis, probably the primary rationale for a municipality entering into a long-term concession agreement is the need to access capital. Concession agreements are about building infrastructure to meet the significant backlog which needs to be met. It is therefore ironic that both water concession contracts entered into in South Africa, quite shortly after contract signature, ended up either totally stalling, or significantly reducing, their projected capital expenditure programmes. This illustrates how the handling of risk transfer and risk allocation can directly negatively impact on the very reason why the contract was entered into in the first place. The contract terms regarding risk allocation were ignored and the result was prejudice to the “capital investment” outsourcing objective.

As discussed above, in the Dolphin Coast example capital investment for the first five year term was reduced by half. In Nelspruit infrastructure development, envisioned as the centerpiece of the deal, also ground to a halt one year later in July 2001 and BiWater’s local partners, the Greater Nelspruit Utility Company (GNUC), officially suspended infrastructure projects in August³⁷⁵. All capital expenditure was therefore stalled, with the service provider concentrating instead only on operations and maintenance³⁷⁶.

The concessionaire stated that it would only commence with capital investments when payment levels reached 50%. At the time payment levels in one of the

³⁷⁵ Yende et al (2003).

³⁷⁶ Smith, Mottiar and White (2003) pg 13.

concession areas (KaNyamanzane) were at 35% and in another (Matsulu) at 8%³⁷⁷.

Another aspect to consider in the “capital investment” objective and actual contract implementation is the actual source of capital funds and whether the municipality itself would have been able to access the capital. If so, then one of the prime reasons for considering concessions (i.e. the perceived inability of the municipality to access sufficient funds) falls away.

In the Nelspruit case the promise of private sector funding was one of the key motivations behind the decision to enter into a concession. However, it ultimately transpired that the chief source of funding (R150 million) in fact came from the Development Bank of South Africa³⁷⁸. And in the case of Dolphin Coast, a media report noted that questions had arisen regarding the amount of foreign capital committed to the project. It noted that “...it seems the overwhelming sum invested was raised in SA. Much of the capital, it seems, has been raised from public funds that the municipality itself could have accessed”³⁷⁹.

The Municipal Infrastructure Investment Unit has identified one of its most pressing challenges as the attempt to find public-private partnership financing alternatives which are attractive to the private sector. The experience of the two concessions appear to have scared off investors somewhat and the MIIU is investigating partnerships that “create financial instruments that enhance the creditworthiness of projects, thereby improving their attractiveness to the market while simultaneously addressing political risk factors that impact on demand for such solutions at the municipal level”³⁸⁰.

³⁷⁷ Smith, Mottiar and White (2003) pg 14.

³⁷⁸ Bell, T. (2000).

³⁷⁹ Hemson, D. (2001).

³⁸⁰ MIIU & NBI (March 2003).

7.5 Public buy-in

The Nelspruit concession contract serves as an important illustration of the importance of ensuring public buy-in for a long term outsourcing project. It is clearly crucial for both the municipality and the service provider to take this issue seriously. In Nelspruit, the public unhappiness with the concession was naturally a combination of complex factors, but was certainly not helped by the almost total lack of performance by the business appointed to handle marketing and communications for the concessionaire. The contractual roles and responsibilities of the communications company were simply not implemented as envisaged by the contract.

A study of this concession noted that the concessionaire's harsh cost recovery methods resulted in high levels of illegal connections and community intimidation of workers³⁸¹. This community unhappiness also meant that unaccounted for water (UAW), which is usually an indicator of illegal connections, leapt from 59% to 76% in KaNyamanzane and from 68% to 88% in Matsulu³⁸². Overall, a newspaper report put the cost of consumer boycotts to the concessionaire at R13 million per annum³⁸³.

Although Nelspruit is clearly an extreme example, other case studies also noted problems with public support of outsourcing projects during contract implementation. These seem to be directly impacted upon by the efficacy of communication both pre and post-outsourcing and by the perceived fairness of credit control measures. For example, the Dolphin Coast evaluation report found that, despite the existence of a full-time Public Relations Officer, the level of communication with the community was "poor" and the parties actually ended up communicating with each other primarily through the media³⁸⁴. Community workshops on this issue revealed a unanimous desire for the establishment of a

³⁸¹ Smith, Mottiar and White (2003) pg 12.

³⁸² Smith, Mottiar and White (2003) pg 20.

³⁸³ Yende et al (2003).

³⁸⁴ WZC (2003) pg 41.

Water Forum to provide a communication vehicle for the parties. The Forum would also be used as a monitoring device³⁸⁵.

The case study of Amahlati and Lukhanji noted that when there was an attempt to install water trickle supply devices as a credit control mechanism, this had to be put on hold as a result of community intimidation of staff³⁸⁶. One of the municipalities also used a private company to provide cost recovery services from 1997 to 2000, but the number of complaints and adverse community reaction brought this to a close and the municipality again assumed responsibility for cost recovery³⁸⁷.

In the case of the municipal entity created for electricity services in Johannesburg (“City Power”), poor customer care and communication appeared to a common complaint, with specific focus on the poor performance of the call centre³⁸⁸.

Under this service delivery agreement, the municipal entity took over responsibility for the municipality’s top 10 000 customer accounts (based on electricity sales), with the municipality being responsible for cost recovery and communication with all the rest. Of the 10 000 consumers City power was responsible for, they picked the few biggest consumers in this group and identified them as “key” accounts. The “key” users enjoyed far more communication, including one-on-one meetings, than the rest of the 10 000 users; a strategy which built up resentment among the non-key users. However, this resentment does not appear to have translated into any behaviour which would represent a danger of any kind to the outsourcing contract³⁸⁹.

In the City Power contract, a User Forum was supposed to be created within twelve months of the contract being entered into³⁹⁰. The User Forum would be the communication channel between consumers, stakeholders and City Power’s

³⁸⁵ WZC (2003) pg 41.

³⁸⁶ Booysen (2004) pg 22.

³⁸⁷ Booysen (2004) pg 52.

³⁸⁸ Khumalo et al (2003) pg 25.

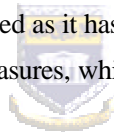
³⁸⁹ Khumalo et al (2003) pg 29.

³⁹⁰ Khumalo et al (2003) pg 29.

board of directors (i.e. similar to the “Water Forum” identified as highly desirable in the Dolphin Coast case). The company was also obliged to produce a “customer charter” before December 2001. At the time of the case study (2003) it appeared that neither had been done. This again shows the danger of contract terms becoming meaningless if the parties are not conscientious in abiding by them. It does not matter how effective and sophisticated the provisions of a contract are, if the parties exhibit no will in enforcing them, then the outcome and success of a contract will depend less on its terms and more on the attitude of its signatories.

The Harrismith case reveals a far more conscientious treatment of public participation and community buy-in. A case study of this public-public partnership (the first of its kind in South Africa) revealed that:

With regard to labour and service users, extensive consultation throughout the negotiation process led to a general support for the partnership. The value of this support cannot be underestimated as it has contributed to residents generally complying to credit control measures, which is illustrated through very low illegal connection rates³⁹¹.



It is useful to compare this positive result with the rocketing illegal connection rate which was experienced in Nelspruit (as outlined above). The study noted that consultation had been particularly good with labour and that the parties had been effective in including labour in negotiations not only restricted to “labour” issues, but on all aspects of the partnership³⁹².

On the cost recovery side, the strategy focused on distinguishing between who could afford to pay and who not. Those who were seen as being able to pay then faced strict cost recovery measures³⁹³. Perhaps another reason for the success of this partnership is the evidence the case study found of a “sympathetic orientation” towards those living poor socio-economic circumstances. The study

³⁹¹ Smith & Fakir (2003) Executive Summary.

³⁹² Smith & Fakir (2003) pg 7.

³⁹³ Smith & Fakir (2003) pg 11.

cited the following case as an example of the municipality displaying this “sympathetic” attitude. After the municipality was advised of a death in the family of a home which had been reduced to a trickle supply, the municipality agreed to resume a normal supply for the mourning period (in fact the supply was ultimately left reconnected) ³⁹⁴.

Again, this is an “attitude” issue which is difficult, if not impossible, to pin down contractually. In the same way as the attitude of the parties may be to simply ignore, or just pay lip-service to, certain contractual obligations (as is appears to be the case with “monitoring” and “communication” in certain contracts) the parties can likewise choose to act beyond their strict contractual obligations in order to make the contract a success ³⁹⁵.

7.6 Political Will

It is not surprising that the success of an outsourcing project will depend in a large part on the political will of a municipality to promote it and support it through all its phases. A lack of political will or political appetite for the outsourcing project can operate as a significant impeding influence on the contract regardless of the actual provisions of the contract. From reading the various case studies it became apparent that the role of politicians, and the wider “political will” of the municipality, can indeed be a significant factor in the success, or otherwise, of an outsourcing project. As one of the case studies put it:

³⁹⁴ Smith & Fakir (2003) pg 14.

³⁹⁵ It must be said that there have recently (in 2004) been violent community protests in this area regarding the issue of municipal services. However, it appears that this community unrest stems, in part, from the local authority amalgamation and re-demarcation process which has ultimately resulted in one community believing (rightly or wrongly) that another is receiving preferential treatment when it comes to the allocation of housing and municipal services. However, from a study of various media reports regarding this issue, it does not appear that water services, and particularly this public-public partnership, are the source of unhappiness. Media reports on the unrest do not mention the partnership nor are water services specifically mentioned. See Tabane, R. (2004) reporting in the Mail & Guardian.

...essentially in the developing world, the lack of political support is a major risk factor that a concessionaire has to deal with. As such it has a negative impact on the financial modelling of a concession contract since all risk factors have to be quantified by the concessionaire³⁹⁶.

A long term outsourcing contract represents a significant commitment on the part of the private sector and if there is a lack of political commitment this gives rise to a political risk which does not promote the making of long term business decisions³⁹⁷. In other words, this could discourage even the entering into of an outsourcing contract, let alone negatively impact on financial modelling.

In the Dolphin Coast, Nelspruit and Harrismith cases the fact that many, if not most, of the councillors involved in the planning and negotiation of the outsourcing contract were not there at the time of implementation was cited as a significant impediment to the success of the contract. In fact, the turnover of city council politicians during municipal restructuring is seen as being at the root of regulatory problems facing municipalities countrywide³⁹⁸. One of the obvious consequences of new councillors taking over a municipality is that these councillors will be ignorant both about the history leading to the contract and the terms of the contract itself. This will naturally impact on the ability of the councillors to perform their monitoring obligations³⁹⁹. The case study noted that the fact that the Water Committee was not meeting was because of “political sidelining”⁴⁰⁰.

In the Harrismith case the study noted a “lukewarm” attitude on the part of the municipality to the contract arising from the fact that the original councillors involved in the project had subsequently moved on and the new administration did

³⁹⁶ WZC (2003) pg 55.

³⁹⁷ IMF (2004), par 28.

³⁹⁸ Smith & Fakir (2003) Executive Summary.

³⁹⁹ This was seen in part in the “Monitoring” section above where, for example, monitoring in the Dolphin Coast contract effectively came to a standstill.

⁴⁰⁰ WZC (2003) pg 51.

not want to be bound by the contract⁴⁰¹. This is despite the fact that the same political party remained in control of the municipality. One has to wonder what the consequences would have been for the contract if a *different* political party had won that election.

The councillors in the Harrismith case study expressed their need for a formal introduction process to the contract as a result of their missing the two year negotiation period leading up to the contract⁴⁰². The Dolphin Coast case identified a similar need for councillor education regarding that partnership. But in that case an information workshop was specifically organised to meet this need but was so poorly attended by the councillors, that the report concluded that “...the lack of knowledge still evident amongst councillors while being given the opportunity to gain insight into the concession, is politically irresponsible”⁴⁰³.

The other case studies all reveal instances of councillors failing to take their duties seriously when it comes to the successful implementation of the outsourcing contract. For example, in Harrismith, disconnection procedures included the mechanism that before a disconnection would take place the company’s customer care manager and the relevant ward councillor would accompany the company to ensure that services to the indigent were not cut off. The policy could at times not be implemented properly because of councillors not pitching up⁴⁰⁴.

In Nelspruit, when the policy of free basic water was to be implemented, the politicians failed to clarify to the community that free water would be restricted to only the first six kilolitres. This miscommunication unravelled any progress the company had made up till then in communicating with the community⁴⁰⁵. The Nelspruit study also revealed that politicians representing townships with high

⁴⁰¹ Smith & Fakir (2003) pg 17.

⁴⁰² Smith & Fakir (2003) pg 9.

⁴⁰³ WZC (2003) pg 55.

⁴⁰⁴ Smith & Fakir (2003) pg 13.

⁴⁰⁵ Smith, Mottiar and White (2003) pg 13.

non-payment levels had not been actively involved in trying to bridge the communication gap between the community and the company⁴⁰⁶.

The City Power contract does not seem to suffer from a problem of lack of political will because of councillor turnover. In fact, the study on this contract noted almost the opposite problem. It found that all parties are so keen to see the municipal entity succeed that it has become a double-edged sword in that the municipality may be less likely to invoke penalties if the company does not abide by the contract provisions⁴⁰⁷. Again one sees the evidence of extraneous factors rendering contract terms and conditions meaningless. Another aspect raised in this study is the suggestion that one of the reasons the City has not transferred the bulk of domestic users to City Power is because the politicians only later realised the loss of political control inherent in the outsourcing of a service to a municipal entity⁴⁰⁸.

Finally, the City Power study suggested that the reason why some councillors are uncertain regarding their role in the provision of electricity services (and are thus not effective) is because the contract has not adequately clarified their role. This is clearly an aspect which could be remedied by appropriate contract provisions. As a whole, the contracts forming part of this study do not attempt to carve out a clear role for councillors. In fact this aspect is hardly mentioned. This could raise risks regarding the accountability of the elected office bearers and councillors to the municipality's community and could have a negative impact on a municipality's monitoring functions. A contract would benefit from a clear delineation of roles and responsibilities for councillors and officials in respect of monitoring and overseeing contract performance.

⁴⁰⁶ Smith, Mottiar and White (2003) pg 14.

⁴⁰⁷ Khumalo et al (2003) pg 33.

⁴⁰⁸ Khumalo et al (2003) pg 19.

7.7 Affordability

One of the common “dangers” associated with outsourcing, is the risk of tariff hikes which potentially render the services unaffordable to poorer members of the community. What do the case studies have to say on this aspect of outsourcing in contract implementation?

As was seen earlier in this Chapter under “Risk realisation”, although the Dolphin Coast contract specifically set the tariff for a number of years, this contract provision was superseded by a subsequent council resolution substantially increasing the tariffs. In Nelspruit, although the concessionaire explained that water prices had increased only 10% on contract implementation, an analysis of the different tariff bands revealed that the overall effect on the domestic user was far higher. The second band of tariffs, the level of use most applicable to township users, in fact experienced the highest price increase (69%)⁴⁰⁹.

Contrary to the above, in Harrismith the contract reversed the previous cross subsidy arrangement with the result that the poor no longer subsidised industry. The highest price increase was instead in the 30kl to 50kl block, the level of use usually applicable to higher income users.⁴¹⁰ Is this an indication of the benefits of a public-public partnership? The case study suggested that:

If we examine the spectrum of service delivery options, a full-blown concession tips the balance towards prioritizing cost-recovery principles while a public/public partnership puts greater emphasis on equity issues with the recognition of the public benefits that come with access to essential services regardless of ability to pay⁴¹¹.

However, blame cannot always be placed solely at the door of the private operator. In the Dolphin Coast contract, the Auditor General severely criticised the municipality for failing to use the equitable share for the indigent and for

⁴⁰⁹ Smith, Mottiar and White (2003) p g 22.

⁴¹⁰ Smith and Fakir (2003) p g 10.

⁴¹¹ Smith and Fakir (2003) p g 11.

instead using it to cover normal operating expenditure⁴¹². Of course, these merely serve as some examples of the effects of outsourcing on tariffs in particular contracts and, with such a small sample, cannot justify reaching any general conclusions on this issue.

7.8 Skills Transfer

Skills transfer should be a key objective for a municipality contracting with a skilled provider. This is especially relevant given the severe skills shortage suffered by many municipalities. This is relevant too to the risk of a municipality becoming increasingly unable to provide a service itself and thus becoming entirely reliant on external service providers. Effective skills transfer should enable a municipality to ensure continuity at contract expiry. However, it has been seen in Chapter Six that few contracts even mention skills transfer. How has this objective been translated in the contract implementation phase?

It is perhaps not surprising that none of the case studies described a strong desire, or ability, on the part of the municipality to take over service delivery at expiry of the contract. Those case studies that did deal with this issue, instead painted a picture of the municipality being unable (generally as a perception on the part of the municipality) or unwilling to take over service delivery.

The Harrismith case study puts it well when it says:

The challenge of service delivery alternatives is to ensure that the local authority capacity to govern is built up in the process of partnering. This can then put the local authority in a position of choice regarding whether it runs the sector itself or can at least be in a stronger position to provide oversight should it choose to enter into a partnership⁴¹³.

However, it was apparent in the Harrismith case that, although the parties were aware of the importance of skills transfer and capacity building, the :

⁴¹² WZC (2003) pg 53.

⁴¹³ Smith and Fakir (2003) Executive summary.

...knowledge acquired through Rand Water's managerial and administrative achievements has not been sufficiently transferred to the city council in order to strengthen its own capacity in managing the sector or to better monitor a new service delivery agreement⁴¹⁴.

The Nelspruit case study revealed that the Compliance Monitoring Unit failed to monitor the skills transfer that was promised as part of the negotiations⁴¹⁵. The study also noted that the municipality had decided, if the concession were to fail, it would hand service provision over to another external service provider as they preferred not to take the service back. Their view was also that it was too expensive to reintegrate labour. Given that almost all long term service delivery contracts involve the transfer of staff, this would presumably be an issue in those contracts was well. In fact, the Nelspruit case study made the point that: "There are few international examples of local authorities that have successfully reintegrated water sectors after failed concessions"⁴¹⁶. If this is true, then again the relevance of sophisticated contract provisions on service hand over procedures comes into question.

In an interview in the Amahlati case study, the municipal manager of this municipality stated that, in respect of what impact the outsourcing contract had on capacity building: "We have to ask the question: has it built capacity? I would argue that it has not done it." He went on to say that capacity building would therefore "be a serious emphasis" in any new contract the municipality may enter into with an external provider⁴¹⁷. It is therefore suggested in this case study that in both the Amahlati and Lukhanji contracts the municipality feels it cannot match the private provider's level of service⁴¹⁸. This is evidenced by the fact that, even a

⁴¹⁴ Smith and Fakir (2003) Executive summary.

⁴¹⁵ Smith, Mottiar and White (2003) pg 17.

⁴¹⁶ Smith, Mottiar and White (2003) pg 27.

⁴¹⁷ Booysen (2004) pg 35.

⁴¹⁸ Booysen (2004) pg 34.

year after expiry of the ten year contract in Amahlati, the private company continues to perform ad hoc services for the municipality⁴¹⁹.

In contrast, the Dolphin Coast contract, according to the 2003 MIU evaluation report, appears to be on track with its skills training objectives, with a strong focus on training ranging from literacy to specialised skills⁴²⁰.

7.9 Conclusion

The conclusion that can be reached from the analysis of case studies is that under certain circumstance contract provisions can risk becoming irrelevant or being sidelined during contract implementation. This can prejudice certain outsourcing objectives. Some instances include :

- Even if contracts correctly anticipate potential risk events and put in place binding provisions to deal with these events, the contract terms still risk being overridden by the contracting parties acting on other external pressures. This has a potential knock on effect for affordability and value for money.
- Long term contracts, such as concession contracts, are more vulnerable to material contract amendment or renegotiation. The results can lead to the watering down of outsourcing objectives, such as the provision of capital for infrastructure projects.
- Monitoring duties specifically provided for in contracts are not being conscientiously implemented by certain municipalities, rendering the monitoring provisions meaningless.
- Contract provisions attempting to ensure public buy-in, such as the establishment of a User Forum in one case, have been effectively ignored with no visible contractual consequences.

⁴¹⁹Booyesen (2004) pg 19.

⁴²⁰WZC (2003) pg 45.

- A lack of political will can render contract provisions meaningless if the municipality chooses not to promote or implement the contract provisions.

Having considered policy, legislation, contract terms and contract implementation in South Africa, it is necessary to explore whether international trends or experiences can offer any insights into the conclusions reached thus far.



8 Chapter Eight: International Trends

8.1 Background

What are the trends for private sector involvement in essential services worldwide, and particularly for developing countries? There has been a clear international trend for significant increased private sector involvement by way of PPPs in a range of historically public sector services. The PPP projects range from transport projects, schools, electricity and telecommunications to (less commonly) water and sanitation. This trend has had quite a defined starting point, with the use of PPPs taking off around the world from the early 1990s. What is the background to this development?

The 1980s and early 1990s saw widespread privatization of those sectors most suited to competition; such as trading establishments, local transportation and small and medium enterprises. However, privatisation of the large public sector services such as water and electricity, which are generally more in the nature of monopolies and have significant “strategic” value, was far less common⁴²¹. In developing countries, the involvement of the private sector in water and sanitation services is a relatively new occurrence⁴²². Certainly pre-1990, the public sector in developing countries was almost invariably the provider of these services and, more importantly, water and sanitation services were generally regarded as a “social good” which meant there was inherent opposition to the “commodification” of these services. Also, historically water and sanitation services were commonly provided below cost, which almost guaranteed political and community resistance to raising tariffs to cost recovery levels⁴²³.

The strategic value of these services, the fact that they can also be seen as a “social good”, meant that any attempt at outright privatisation was liable to meet

⁴²¹ IMF (2004) Par 2.

⁴²² Silva et al (August 1998).

⁴²³ Silva et al (August 1998).

with resistance from labour unions⁴²⁴. This would naturally also have an influence on the low incidence of privatization in these areas. Finally, another factor behind the low incidence of private sector involvement in water and sanitation services is the fact that at the time there was a global move to “decentralize” water and sanitation services to the realm of provinces or municipalities. These government structures did not have experience in contracting with the private sector and were thus less likely, initially at least, to seek private sector participation⁴²⁵.

The global privatization drive started to lose steam by the late 1990s, but the problem of infrastructure backlog in many countries remained a problem, and this is when the concept of PPPs really started to come to the fore⁴²⁶. As a recent IMF report noted, “After a modest start, a wave of PPPs is now beginning to sweep the world”⁴²⁷. The basic rationale behind the drive to use PPPs is to enable the public sector to benefit from private sector capital and management expertise.

However, in developing countries, the trend in the use of PPPs experienced its biggest acceleration between 1990 and 1997. From 1998 to 2003 private investment in developing countries fell, with the biggest declines (in 1998 at least) being experienced in the electricity and telecommunications sectors. Although investment in water and sanitation projects also fell in this period, the decline was not as steep⁴²⁸. However, by 2003 a significant decline in investment in the water and sanitation sector was recorded⁴²⁹. In fact, in 2003, when activity was down by a further 13%, the only real progress was being experienced in China. A World Bank report on the levels of activity in this field noted that as at 2003 “Activity in all other countries has come to a virtual standstill”⁴³⁰.

⁴²⁴ IMF (2004) footnote 2.

⁴²⁵ Silva et al (August 1998).

⁴²⁶ IMF (2004) Par 3.

⁴²⁷ IMF (2004) Par 3.

⁴²⁸ Izaguirre, A. K. (October 2002).

⁴²⁹ Izaguirre, A. K. (September 2004).

⁴³⁰ Izaguirre, A. K. (September 2004).

Factors behind this decline are explained as including the impact of the macroeconomic crisis on developing countries, a failure to implement reforms to place infrastructure business on a commercial footing and underdeveloped local capital markets⁴³¹.

8.2 International Trends

An IMF report on PPPs notes the following developments in the prevalence of PPPs across the world. A number of countries have very advanced PPP programmes, most notably the United Kingdom, but also Australia, Ireland and the United States. Continental EU countries which have more modest PPP programmes include Finland, Germany, Greece, Italy, the Netherlands, Portugal and Spain. Central and Eastern European countries (such as Czech Republic, Hungary and Poland) have embarked on PPP programmes, with Canada and Japan having fledgling PPP plans⁴³². However, it is worth noting that the majority of the PPP projects in these countries are dominated by the transport sector, namely roads projects⁴³³.



In the rest of the world, PPP projects are not as common, although some countries are mentioned as showing growing interest in this field. These include Chile, Mexico, Brazil, Korea and Singapore. The IMF report also includes South Africa in this category⁴³⁴. The IMF report goes on to outline the experiences in a selection of countries, namely Chile, Ireland, Mexico and the United Kingdom. It is useful to summarise the findings of this report for each country and compare their experiences with that of South Africa.

8.2.1 Chile

Chile has been relatively successful in taking steps to meet its infrastructure backlog through the use of PPPs. However, for the purposes of the thesis, it must

⁴³¹ Izaguirre, A. K. (September 2004).

⁴³² IMF (2004) Par 5.

⁴³³ IMF (2004) Par 5.

⁴³⁴ IMF (2004) Par 6.

be noted that none of these big projects involve the provision of essential services. Their projects have involved primarily the transport sector, followed by airports, prisons and so on. Since 1994 the country has engaged in 36 PPP projects with a total value 5.5 billion dollars.

The success of the PPPs has been helped by the existence of sophisticated tender procedures, good dispute resolution procedures and a credible regulatory and legal framework. On the issue of risk transfer, the private entity and government generally share the foreign exchange risk while construction and performance risk is borne solely by the private entity. The government covers demand risk by guaranteeing a minimum revenue to the private entity but then, in an innovative arrangement, if revenue exceeds a certain specified sum, the parties share this extra revenue.

Of interest, especially in light of the experiences in South Africa's two big water concessions, is that a relatively high number of PPP contracts have had to be renegotiated. The IMF paper suggests that the reasons behind these contract renegotiations arise either as a result of the government wanting to expand the contract to include additional work or because the private entity starts experiencing financial difficulties. However the IMF report records that the renegotiations in contracts where the private entity was suffering financial difficulties were apparently to solve "liquidity" and not "solvency" problems. The report notes that in contract renegotiations, project budgets have on average increased by 15%.

As will be seen below, contract renegotiations appear to be a common feature of PPPs across the world. If the effect is for the project budget to commonly increase by such a large proportion, this brings the validity and credibility of "value for money" and "affordability" assessments as at the time of entering into the contract into serious question. In the South African context one could question the need and relevance of the plethora of "feasibility" and cost/benefit analyses the government is required to conduct before outsourcing, if all those figures are liable to be thrown into disarray a few years later.

In the Chilean context there is an attempt to mitigate the risk of contract renegotiations by a statutory prohibition on renegotiations altering the “financial balance” of the contract. However the IMF report notes that this is naturally very difficult to enforce. The Chilean authorities clearly recognize that contract renegotiations are not ideal and are attempting to reduce the risk of this occurring by improving project specifications and tender procedures.

Finally, as in South Africa, contracts are treated as public information in Chile. But, as was seen in the analysis of the “readability” and accessibility of these contracts in South Africa, the IMF report notes that the complexity of the Chilean PPP contracts makes it difficult to fully understand the financial implications of the contract.

8.2.2 Ireland

Ireland embarked on a PPP programme in 1998 in response to the recognition that it faced an infrastructure backlog. There was strong political commitment behind the programme and the favourable reception the PPPs generally received was helped in part by the fact that government made a commitment that stakeholders, particularly employees and trade unions, would be consulted on the approach taken in selecting PPP projects.

The PPP programme started off with eight pilot projects (for schools, transport/roads and waste management). By mid 2003 however, it had implemented 36 big PPP projects (i.e. with a value in excess of 6.4 million Euros) chiefly in the transport/roads sector, but also many “smaller” projects. Of the smaller projects, most are water projects. The report unfortunately does not record the success or otherwise of these smaller water projects or the nature of the PPPs used (i.e. concession or just management contracts).

8.2.3 Mexico

Mexico has been involved in PPPs since the mid 1990’s and although water and sanitation are candidate sectors for private sector involvement, there has been little private investment in this area. The PPP projects have been primarily in the oil and electricity sectors but there have also been some developments in

telecommunications, ports and airports. However, in the latter three areas private involvement has mostly taken the form of privatization.

8.2.4 *United Kingdom*

The United Kingdom has an advanced and sophisticated PPP programme which is regarded by government as well designed and well managed. The UK approach to PPPs is relevant to South Africa as the approach South Africa has taken, at least at a national and provincial level, in the contractual treatment of PPPs has been strongly influenced by the UK experience.

The PPP programme in the UK dates back earlier than most other countries, to the early 1980s. In 1992 the Private Finance Initiative (“PFI”) was launched. The objective of this initiative was to encourage private investment in PPP projects primarily involved with the provision of services. Under this initiative the private sector would make a long term commitment to provide a particular service and maintain the assets associated with that service, while at the same time taking on a significant proportion of the risk. Before determining whether to embark on a PPP, a “rigorous” value for money test is applied. Value for money considerations as well as risk transfer play an important part in the UK PPP programme. The value for money tests that government must apply are being refined and the IMF report also notes that generally risk transfer is effective in these projects.

Although PFI projects are varied, as with many other countries, transportation projects are the largest of the PPP projects. The PFI also includes other “traditional” projects such as schools and hospitals. The IMF report states that, “Independent studies confirm that PFI projects offer significant cost savings over publicly financed alternatives.” According to one report, savings are estimated at an average of 17%⁴³⁵.

⁴³⁵ IMF (2004), pg 39, fn 65.

8.3 PPP prevalence in the developing world

The global use of PPPs really took off from the 1990s. This is well illustrated by the fact that between 1984 and 1990 developing countries awarded only eight water and sanitation contracts to the private sector. Between 1990 and 1997 this figure leapt to 97⁴³⁶. But, despite the rapid increase in private sector participation, the proportion of private sector involvement in water and sanitation services in developing countries is still very low compared to public sector provision⁴³⁷. In fact, “Private water and sanitation projects have been rare in low-income countries”⁴³⁸. Furthermore, of the private sector involvement that does exist in this area, much is focused on water rather than sanitation⁴³⁹.

As further illustration of the sudden increased inclination to use PPPs, an October 2000 report on trends in low-income countries found that between 1990 and 1999 the proportion of low income countries with at least one private infrastructure project grew from about 20% to 80%⁴⁴⁰.

The characteristics of water and sanitation PPPs in the developing world (as at 1998) found that concession contracts tended to dominate over other service delivery mechanisms (such as divestitures and management and lease contracts)⁴⁴¹. Furthermore, the private sector was represented by only a handful of international companies⁴⁴². However, a recent report noted an emerging trend where there appears to be an increase in participation by regional and local

⁴³⁶ Silva et al (Aug 1998).

⁴³⁷ Silva et al (Aug 1998).

⁴³⁸ Houskamp et al (October 2000).

⁴³⁹ Silva et al (August 1998).

⁴⁴⁰ Houskamp et al (October 2000). Most of these projects were “greenfield” projects, i.e. building new infrastructure, particularly telecommunications and energy. Very few involved operations and management contracts with large capital investment.

⁴⁴¹ Silva et al (August 1998).

⁴⁴² The primary companies involved were (in order of their market dominance); Suez Lyonnaise des Eaux, Vivendi, Aguas de Barcelona, Thames Water and SAUR International.

sponsors⁴⁴³. There also appears to be a trend developing for some private sponsors to use local capital markets to finance projects. The example is given of Chile where not insignificant sums have been raised through the issue of local currency bonds and bank debt. The report notes that, “As domestic capital markets continue to develop, regional and local investors are more likely to increase participation in infrastructure projects”⁴⁴⁴. Which developing countries were primarily involved in the trend to encourage PPPs in traditional public sector projects?

Of the 97 water and sanitation projects in place in the developing world as at the end of 1997, most of the activity (73%) took place in Latin America (including the Caribbean) and the East Asia and Pacific area.⁴⁴⁵ Europe and Central Asia accounted for a further 15% with Africa showing the lowest proportion of the project share. Central, East and North Africa accounted for 4% and sub-Saharan Africa for 8%⁴⁴⁶. However, the picture looks slightly different if one assesses these projects by actual investment value. Of the total investment value of these projects Central, East and North Africa account for 13% and sub-Saharan Africa for 0%.



This shows that sub-Saharan Africa has experienced very little actual investment and private sector participation has been more in the form of management contracts. It has been suggested that this is possibly as a result of inadequate regulatory provisions and a lack of strong commitment on tariffs⁴⁴⁷. Management and lease contracts are inherently less risky and usually involve significantly less risk transfer to the private sector participant. There is also a potentially political side to the use of management contracts. It has been noted that, “(t)he strategy is less visible, avoids suspicion often associated with foreign ownership of African

⁴⁴³ Izaguirre, A. K. (September 2004).

⁴⁴⁴ Izaguirre, A. K. (September 2004).

⁴⁴⁵ Silva et al (August 1998). Latin America and the Caribbean were responsible for 42% of the projects and East Asia and the Pacific for 31%.

⁴⁴⁶ Silva et al (August 1998).

⁴⁴⁷ Silva et al (August 1998).

assets and diffuses the re-colonization issues”⁴⁴⁸. There is also an apparent awakening of interest in PPPs across the world – one of the main objectives of these partnerships being “capacity building, with the intent of keeping the service in public hands in the long run”⁴⁴⁹. However there appears to be little literature on the success and prevalence of these contracts in the developing world.

8.4 Renegotiations and Cancellations

PPPs in the developing world have not been without controversy. Chief among the bad press these projects attract is for cancelled or renegotiated projects. A World Bank report notes that “For a variety of reasons the renegotiation of projects is not an unusual occurrence.” For example, as at 2003, an estimated 74% of transport concessions and 55% of water concessions in Latin America were renegotiated⁴⁵⁰.

If the figures estimated above of renegotiations on average leading to a 15% increase in project cost are correct, then the impact of contract renegotiations may have far-reaching implications for the public sector, particularly in terms of value for money. This is apart from any other impacts or consequences renegotiations may commonly have. In fact, in terms of potential prejudice to the community concerned, it seems quite possible that a very unbalanced or unfair contract renegotiation could in fact lead to a worse scenario than a total cancellation of a project. Another potentially dangerous consequence of allowing a culture of “renegotiation” is what another World Bank paper identifies as “strategic bidding” on the part of the private sector⁴⁵¹. Quite simply, if a bidder is confident that the contract can be renegotiated at a later stage, the bidder has scope to alter the bid to make it more attractive at the tendering stage. The bidder can then rely on later contract amendments to make up any ground it may have lost.

⁴⁴⁸ Uzochukwu (2003), pg 57.

⁴⁴⁹ Equinet (2004).

⁴⁵⁰ Harris et al (January 2003).

⁴⁵¹ Clarke et al (2004) pg 6.

This also raises the issue of the respective skills and expertise the parties may have around the negotiating table. If, as is the case in the water and sanitation sector at least, the market is dominated by a few “big” players, then the municipality is facing a negotiator who can draw on a wealth of international experience and leverage when hammering out a renegotiation. A big metropolitan municipality may have the resources to be an equal partner in the process, but a smaller municipality could well be out of its depth. This could be especially so if the very rationale for embarking on a PPP is because a municipality lacks the skills and expertise to perform the service. The World Bank report also makes the point that only a very small percentage of the then existing PPP projects were in fact cancelled⁴⁵². Of those cancelled, most cancellations occurred relatively early on in the contracts – on average four and a half years after contract commencement. What is the reason behind these contract renegotiations and cancellations?

According to the 2003 World Bank report, it appears that most water and sanitation projects fell into difficulties because of widespread dissatisfaction with price increases and problems with collecting service fees from consumers. The echoes with the South African experience, particularly with the Nelspruit water concession, go without saying. The report notes that in many developing countries, the public sector has historically provided water and sanitation below cost and has had a low collection rate. For this *status quo* to change with the introduction of private sector participation not surprisingly leads to strong community opposition⁴⁵³.

The example of the Cochabamba water concession in Bolivia is given (which again shares many similarities with the Nelspruit concession) where, because a high-cost bulk water source was selected, tariffs had to be increased to meet the increased expenses. Tariffs increased by about 35% with the result that there was

⁴⁵² For the eleven year period 1990 to 2001, only 48 of a total of 2500 projects were cancelled. However one can compare a follow-on report, Izaguirre, A. K. (February 2004) which recorded a total of ten cancellations in only *one* year – 2002.

⁴⁵³ Harris et al (January 2003).

widespread opposition and civil disturbances⁴⁵⁴. The report also notes that in the electricity sector, contract cancellations likewise result from difficulties in collection service fees from consumers.

It has been submitted that where there is a Regulator for a particular sector, it is less likely that there will be contract renegotiations in that sector. This points to the importance of a sophisticated regulatory environment in ensuring the successful implementation of PPPs⁴⁵⁵. As a spokesperson on water concessions in Santiago, Chile put it, “An uncontrolled private monopoly will probably lead to high prices, whereas an uncontrolled public monopoly will lead to a lack of service. So, monopoly services are an issue of regulation and control, *not* of ownership”⁴⁵⁶. It has been suggested that Regulators play a vital role in promoting competition and public policy objectives through pricing, licencing, performance monitoring and ensuring contract compliance⁴⁵⁷. On the issue of regulatory bodies, it appears that the international norm appears to be that countries start off with individual contracts and only when there are many contracts in that sector do they form a regulatory institution for that sector⁴⁵⁸.

The 2003 report argues that, because of the high percentage of contract renegotiations (and despite the high profile contract cancellations) governments in the developing world continue to support the concept of private participation in the public sector. The very fact that contracts are renegotiated (as opposed to being cancelled) and the fact that governments in countries which have experienced cancellations have continued with their PPP programmes indicate general support for the concept of private participation. This is further backed up by evidence of governments attempting to again involve the private sector in the very contracts which had previously been cancelled⁴⁵⁹. However only a year later,

⁴⁵⁴ Harris et al (January 2003).

⁴⁵⁵ Clarke et al (2004) pg 6.

⁴⁵⁶ MIIU & NBI (September 2000).

⁴⁵⁷ NBI (November 2000).

⁴⁵⁸ NBI (March 2000).

⁴⁵⁹ Harris et al (January 2003).

a further report on developments in this field noted that in a growing number of projects governments were not renegotiating when the project experienced difficulties, leading instead to contract cancellations or contracts in “distress”⁴⁶⁰. By the end of 2003 it was estimated that a total of 140 projects were in “distress”. For the purposes of this report a contract in “distress” is one in which either cancellation has been requested or where the project is under international arbitration. These are quite narrow criteria, a fact which the report acknowledges. It notes that the figure of 140 may well be underestimated because most arbitration bodies do not disclose information regarding their cases.

Despite these narrow criteria, this report found that in the water and sanitation sector, projects accounting for an amazing 40% of the total investment slated for PPPs between 1990 and 2003 were either cancelled or under international arbitration by December 2003. Although water and sanitation clearly suffered most, energy projects were also in trouble, with contracts representing 11.2% of investment, cancelled or under arbitration⁴⁶¹.

8.5 Impact of Water and Sanitation PPPs in Developing World

A World Bank policy research working paper on the impact of water and sanitation PPPs in the developing world has recently been published⁴⁶². One of the defining characteristics of this study is that, unlike many other studies on the impact of specific PPPs, it uses control regions in the study in addition to the regions where PPPs are in force. This gives the study both a more scientific flavour and an interesting counterpoint to the findings on the areas where PPPs are used. The study was conducted by way of household surveys over a number of years in Argentina, Bolivia and Brazil and was conducted both before and after the implementation of PPPs and of course in the control areas. The authors used this approach in part because, they argue, empirical studies on the effects of PPPs

⁴⁶⁰ Izaguirre, A. K. (September 2004).

⁴⁶¹ Projects cancelled or under distress in the transport sector were at 12.6% and in telecommunications at 4.1%.

⁴⁶² Clarke et al (2004).

are generally inconclusive and, although case studies do tend to find that PPPs lead to improvements, one cannot discount selection bias in these studies. It is also difficult to generalize their results⁴⁶³. In fact they go so far to say that, “There is little existing rigorous evidence on the effects of introducing [PPP s] into water and sewage”⁴⁶⁴. They further argue that in both developing and industrial countries there is no real consensus on the relative performance of private and public providers⁴⁶⁵. If there is indeed no convincing empirical evidence showing the benefits of PPPs, nor agreement on the respective performance of public versus private providers, does it instead come down to mere philosophical preference or “faith” that the benefits do in fact exist? Or is it that in certain countries with a lack of financial resources, there is simply no other choice? Either way, in this context any new studies on the issue will have added significance as they help build up the body of evidence on the effect of PPPs.

The results of this recent study, in very summarized form, are that there was (in terms of connections) hardly any difference between those areas which used PPPs and those that did not (The proviso to this is that the study did not cover a wide range of aspects of PPPs). The PPP areas showed improved connection rates for water and sanitation, but so did the control regions. The study also found that, for the poorest households, connection rates were the same in the PPP areas as they were in the control regions. This led the authors to the conclusion that, in terms of *connections* at least, the evidence suggests that PPPs “do not harm the poor”⁴⁶⁶. On the assessment of case study evidence this Working Paper found that most PPPs appeared to improve performance in coverage, water quality, new connections and productivity, but that generally this was accompanied by price increases⁴⁶⁷.

⁴⁶³ Clarke et al (2004) Abstract.

⁴⁶⁴ Clarke et al (2004) Introduction.

⁴⁶⁵ Clarke et al (2004) pg 3.

⁴⁶⁶ Clarke et al (2004) Abstract.

⁴⁶⁷ Clarke et al (2004) pg 7.

Finally, another point this Working Paper makes is that in the water and sanitation sector there is an apparent “...lack of consensus about how best to organize the sector”⁴⁶⁸. Private sector participation in the water and sanitation sector is still relatively rare and is often fraught with difficulty and controversy. In the United States, a country where there has long been widespread participation of the private sector in almost all areas, the water and sanitation sector is the exception, with municipalities owning and operating most of the systems. In France, on the other hand, there has been a long history of private provision of water. Why is this sector so different to the others?

Some reasons posited in the Working Paper include the fact that the potential for competition is far more limited in the water and sanitation sector than, for example, the electricity sector. It is expensive to transport water over long distances and much of the expense associated with the service is tied up in the distribution network. This is an area with a limited potential for competition. Also, the significant assets attached to the services are fixed, underground pipes with no alternative use and which do not need regular replacing. Finally, the service is also controversial for socio-economic or philosophical reasons – water is essential for life and literally “falls from the sky”. It is a public good. This raises the possibility of political and/or community resistance to the very concept of private participation in the sector.

8.6 Conclusion

A quote from a recent IMF report perhaps puts it best when it says “While a number of countries have developed PPP programs, it is too early to draw meaningful lessons from their experiences” and “...there are as yet few general lessons that can be drawn, especially from the experiences of emerging market economies and developing countries”⁴⁶⁹. And when can one expect to learn the lessons? This will only happen if there is an effective evaluation of the effects and impact of PPPs on service delivery. In Nigeria for example, fifteen years

⁴⁶⁸ Clarke et al (2004) Introduction.

⁴⁶⁹ IMF (2004) p ar 7.

after the implementation of their privatisation programme, they have yet to implement an assessment programme to evaluate the success of service provision pre- and post-privatisation⁴⁷⁰. If other countries act in a similar way it may be many decades before the true impact of implementing PPPs will be understood in the developing world.

What should sound a warning, however, is the apparent ease with which large PPP contracts are renegotiated. These contracts are notoriously complex and, unless there is total transparency, it will not always be possible to accurately assess the impact and consequences of these renegotiations on the various role-players and stakeholders. It is difficult enough to do so even before contract amendment. In particular, how does one accurately ensure that value for money continues to be met after a significant contract renegotiation? Are the drivers behind the decision to outsource, still in place?

One will have to see, in the South African context, what impact the provision in the Systems Act requiring public participation before material contract amendment will have. This could well be an important safeguard against opportunistic private businesses wanting to protect themselves from risks they should be paying for.

⁴⁷⁰ Igbuzor (2003), pg 42.

9 Chapter Nine: Conclusions

9.1 Introduction

A feature of the analysis of municipal outsourcing, from policy development, to legislation, to contract formation and finally to contract implementation, is that at each transition from one phase to the next there is disjuncture. Policy is not adequately translated into legislation, legislation and policy are not adequately reflected in contracts and the implementation of contracts tends to treat contract provisions as malleable and open to negotiation or, even worse, capable of being ignored if circumstances so dictate.

The aim should be to limit disjuncture and to create a seamless, logical and simple regulatory environment to ensure that municipalities are indeed encouraged to explore outsourcing and that the contracts that arise out of that process make sense, reflect policy objectives, are legally compliant and are diligently managed and implemented.



The key conclusions under each major heading are set out below and are followed by recommendations intended to meet the objective of developing a sensible, practical and effective outsourcing regime for municipalities.

9.2 Policy

In South Africa, government policy favours and encourages consideration of municipal outsourcing. Apart from any other benefits outsourcing may possess, at a policy level it is regarded as a desirable option as it offers a possible solution to the massive infrastructure backlogs which are a feature of the municipal sphere. The infrastructure deficit will not simply disappear of its own accord but will require the employment of innovative solutions, specifically the use of alternative service delivery mechanisms.

Government policy is not entirely harmonious on this issue as water and sanitation policy explicitly favours a municipality as provider of first choice. However, the potential positive role external service providers can offer, specifically to meet

infrastructure backlogs, is acknowledged in the water and sanitation sector and thus there is no inherent contradiction in the various policies. Is policy's positive attitude to outsourcing reflected in the relevant legislative framework?

9.3 Legislative framework

Although current policy encourages municipalities to consider outsourcing, the legislative framework does not entirely reflect this and instead places quite significant hurdles in the way of municipalities wanting to explore this option.

The legislation is strongly “process” driven and the procedures highly regulated and time-consuming to complete. The assessment process is also artificial in its separation into two stages, which effectively prohibits an upfront comparative analysis of in-house versus external service provision. The municipal outsourcing process has been seriously complicated by the promulgation of the Finance Management Act, which adds a further burden on an already complex assessment process. The unfortunate result of all this is that the cost of complying with the various pieces of legislation has become prohibitively expensive. This could act as a further discouragement to cash-strapped municipalities when weighing up their options for service delivery mechanisms⁴⁷¹.

9.4 Drivers and dangers

The policy and legislative analysis revealed shared perceptions as to the typical benefits and risks associated with outsourcing and in this respect policy and legislation are complementary. Some of the key drivers include capital investment, skills transfer, value for money and potential greater efficiency while on the “danger” side inappropriate risk allocation, loss of accountability and lack of public buy-in represent some of the common risks associated with this form of

⁴⁷¹ The MIU has estimated the average cost of a normal outsourcing transaction to be R1 million. This was before promulgation of the Finance Management Act, which will certainly add to the transaction cost.

service mechanism. How successfully have current outsourcing contracts translated these drivers and dangers into reality?

9.5 Contracts and drivers and dangers

The provisions found in current South African outsourcing contracts do not, in certain key respects, adequately translate the “drivers” and “dangers” into effective contract terms. Overall, the chief problem areas identified in the assessment process included:

- inadequate, vague and at times, inappropriate, allocation of risk potentially threatening value for money and affordability objectives;
- inadequate, or entirely non-existent, provisions on skills transfer;
- inadequate provisions on monitoring directly threatening the “accountability” objective, with long-term contracts with the private sector being the least satisfactory of the sample contracts on monitoring provisions;
- provisions threatening the “accountability” objective by purporting to fetter the municipality’s discretion on tariff setting and, in respect of important contractual matters requiring the municipality’s decision, removing that decision from the municipality and placing it in the hands of a “panel” or similar body with no political accountability;
- non reader-friendly, excessively long, inaccessible and complex contract provisions which threaten the relevance and efficacy of public participation and the ability of the municipality to monitor contract performance; and
- insufficient “context” given in contracts’ introductory sections so that it is difficult for an outside reader to understand the rationale for entering into the contract and precisely what each party expects to achieve out of the project.

The provisions on risk transfer and monitoring appeared to be poorest for those contracts entered into the 1990s with private sector entities. More recent contracts entered into post 1999 and within the context of the current regulatory environment appear to treat, especially monitoring, more conscientiously.

Although the most recent contracts forming part of the study did not treat skills transfer with any rigour, they did at least mention this aspect of outsourcing when others did not provide for it contractually at all.

However, on the issue of “older” versus “more recent” contracts, one should be wary of translating these observations into general statements. Although the contract sample size was sufficient in giving a taste of what current municipal outsourcing contracts look like, in order to make a meaningful comparison of contracts entered into prior to and post the regulatory regime one should preferably have access to a larger contract sample size for each period.

9.6 Contract implementation



The assessment of outsourcing case studies evaluated both how the “drivers” and “dangers” were treated, or impacted on, in the contract implementation phase and how relevant particular contract provisions were to the practical problems arising in the various contract scenarios. The conclusion reached was that in many instances contract provisions were rendered irrelevant and meaningless as the parties chose to override or ignore them in particular circumstances.

The findings in this part of the study included the following:

- contract provisions on risk allocation, procedures and protections against certain identified risk events were effectively overridden by the contracting parties on the occurrence of the risk events, rendering the contract provisions essentially irrelevant;
- contracts themselves, particularly the financial balance of the contracts, were subject to material renegotiation as evidenced in the case of the two water concessions contracts. This included the significant reduction of initial capital projections; and

- despite monitoring provisions in contracts, the actual practical implementation of monitoring obligations appears not to be taken too seriously in some cases. Certain contract provisions were entirely ignored, such as the provision in Dolphin Coast requiring the payment of monitoring fees but part of the fees were used for operating expenses instead.

The overview of international trends revealed that contract cancellation and renegotiation are common features for long term agreements, specifically concession contracts, worldwide. The experiences of the Dolphin Coast and Nelspruit water concessions were therefore not unusual when seen in this context. Contract renegotiation raises certain risks, including bidders submitting low bids in the confidence that they will be able to increase their bid in the subsequent contract renegotiations and a general risk that contract renegotiation will commonly increase the project cost by a significant percentage. This is further indication that contract provisions are not regarded by contracting parties as being cast in stone.



If contract renegotiations are indeed a reality for the bigger, long term contracts, this surely brings the validity and credibility of “value for money” and “affordability” assessments as at the time of entering into the contract into serious question. The approach government takes to outsourcing in South Africa is a process focussed one. It appears to work on the false assumption that if the preparatory studies are sufficiently rigorous and comprehensive then the risks of outsourcing are avoided, or at least mitigated. But what is the purpose of the plethora of pre-contract “feasibility” and cost/benefit analyses, if all the carefully balanced figures and value for money considerations are liable to be rendered meaningless a few years later?

9.7 New legislation

Subsequent to this research being conducted, new regulations were promulgated under the Finance Management Act, which have had some impact on the

outsourcing process. The “Municipal Public-Private Partnership Regulations”⁴⁷² apply only to the “public-private partnership” category of outsourcing and not to outsourcing as a whole. In other words the new regulations will not cover contracts with municipal entities or organs of state. These regulations do however make it more difficult for PPP contracts to be materially amended. Not only do municipalities have to call for public comment on proposed amendments but they must now also solicit the views and recommendations of National and Provincial Treasuries on the reasons for the amendment⁴⁷³. The municipality must also ensure that the amendment is consistent with the basic essentials of public-private partnerships⁴⁷⁴.

Unfortunately, the new regulations do not repeal any of the conflicting and overlapping provisions contained in the Systems Act, Finance Management Act and Water Services Act. However, at least some concession is made to the problem of duplicated feasibility studies. When setting out the various matters to be covered in the PPP feasibility study the regulations specifically allow the municipality to ignore those matters already covered under the Systems Act feasibility study⁴⁷⁵. Although a step in the right direction, this provision is of no help in clarifying the confusing provisions regarding the timing of the various feasibility studies. The municipality will also be required to analyse the Systems Act and Finance Management Act feasibility studies and make a call on whether the one study has sufficiently covered an issue to warrant the relief granted in the regulations. This is merely one more aspect a municipality has to consider in an already burdensome process.

The regulations take the welcome step of defining the term public-private partnership⁴⁷⁶. As the Systems Act nowhere mentions the term PPP and instead

⁴⁷² Local Government: Municipal Finance Management Act, 2003, Municipal Public-Private Partnership Regulations, 1 April 2005, Government Gazette No. 27431, No. R 309.

⁴⁷³ Regulation 9(2), municipal public-private partnership regulations.

⁴⁷⁴ Regulation 9(1), municipal public-private partnership regulations.

⁴⁷⁵ Regulation 3(3).

⁴⁷⁶ Regulation 1.

treats all outsourcing with the same brush, the addition of a definition of a PPP will assist in determining when the Finance Management provisions on PPPs are in fact triggered. The definition places emphasis on the need for significant transfer of financial, technical and operational risk to the private party in order for a contract to qualify as a PPP.

Finally, the regulations contain provisions which build in extra protection mechanisms during the procurement phase. This includes the obligation on a municipality to formally notify National Treasury if it intends initiating a feasibility study for a PPP⁴⁷⁷ and to solicit the views of National and Provincial Treasury at various stages of the procurement process. These provisions reflect an intention on the part of national government to take a close interest in the initiation and management of PPP projects. The regulations also set out certain “basic requirements” of a PPP agreement. These are widely worded and in many ways merely duplicate provisions contained in existing legislation and so add to the legislative duplication problem rather than easing it⁴⁷⁸.



9.8 Recommendations

The conclusions reached in the thesis reveal that outsourcing in the municipal sphere is a complex, complicated and often contradictory area. But, if government is indeed committed to making the process work, an intention which seems quite apparent in the promulgation of the new PPP regulations, then a focussed attempt needs to be made to find solutions to the existing problem areas. It is in this light that the following recommendations are made.

9.8.1 *Align legislative framework with policy*

If government is serious about wanting to encourage outsourcing at the municipal level, then the evidence of bias toward internal service delivery options contained in the Systems Act section 78 process should be eliminated. The assessment

⁴⁷⁷ Regulation 2.

⁴⁷⁸ Regulation 5.

process a municipality must follow when considering outsourcing should preferably be a single, comparative assessment. This will be a more logical approach and will also benefit from being quicker and more cost-effective.

The provision in the Finance Management Act which requires a three year (or more) contract to show “significant” financial benefit to the municipality should be reconsidered to allow value for money factors and not just pure financial benefit to guide a municipality on whether the contract is worth entering into.

9.8.2 Streamline outsourcing process

It is strongly recommended that the outsourcing regulatory provisions be contained in a single piece of legislation. The municipal outsourcing process would also benefit by the compilation of a single “outsourcing manual” similar to that applicable to national and provincial PPP projects. At the very least, a concerted effort needs to be made to do away with current overlaps and duplications in the legislative framework. The Systems Act and the Finance Management Act need to be dovetailed in a comprehensible manner and steps must be taken to reduce the cost of the assessment procedure. The recently promulgated municipal PPP regulations simply do not go far enough in attempting to bring sense to the regulatory regime and constitute only a minor improvement in a process still swamped in complexity.

9.8.3 Improve contract provisions

It is recommended that standardised contract provisions, similar to National Treasury’s Standardised PPP Provisions, be compiled for municipal outsourcing contracts. The standardised provisions could deal with the problems identified in the thesis; namely to guide municipalities on the optimal contract provisions for matters such as risk allocation, skills transfer, performance measurement and contract enforcement.

Municipalities should also be obliged to draft a reader-friendly and accessible summary to accompany each outsourcing contract, including draft contracts advertised for public comment and the final signed contract. The summary should follow a set format, dealing systematically with a list of required information,

with the objective of giving the reader a clear idea of the essential elements of the contract, including what each party expects to get out of the contract.

9.8.4 Focus on implementation

The current government emphasis on “process” as opposed to implementation and management of outsourcing needs to be shifted. Here the drafting of guidelines or policy on contract implementation would be a welcome addition to the regulatory regime. The guidelines should go beyond a mere wish list and should instead contain practical advice for real implementation issues to be expected in a typical municipal outsourcing project. The outsourcing experiences of particular municipalities, as evidenced and described in case studies, would be invaluable to this process.

It is submitted that the implementation of these recommendations would go some way in doing away with the difficulties and anomalies which have become such a feature of municipal outsourcing in South Africa.



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12 Appendix

12.1 Table of Contracts

REFERENCE	COUNCIL	SERVICE PROVIDER	SECTOR	TYPE	DATE	DURATION
Contract A	Rural, local municipality	Private Company	Water	A contract to manage, operate and maintain the water and sewerage system - and does not involve capital expenditure. The company hires the municipality's assets at a nominal rental. The company pays all costs incidental to the service (including raw water, chemicals, manpower, repairs etc) and the municipality pays the company a monthly fee, which is subject to a contract price adjustment formula. The company is excused from paying any fees for the disposal of sludge. The municipality remains responsible for customer management, including meter reading, billing and credit control (although the contract does allow the municipality to agree that the company perform these functions at a later stage).	Early 1990's	10 years, parties can agree to extend indefinitely and Council has option to cancel after first ½ of contract complete

REFERENCE	COUNCIL	SERVICE PROVIDER	SECTOR	TYPE	DATE	DURATION
Contract B	Rural, local municipality	Private Company	Water	<p>A contract for the management, operation and maintenance of the municipality's water and sewage systems. The municipality's assets are leased for a nominal annual amount. The municipality remains responsible for all customer management, including meter reading, billing and credit control.</p> <p>The company pays all costs incidental to the service (including raw water, chemicals, manpower and repairs) and the municipality pays the company a monthly fee which is subject to a contract price adjustment formula and comprises fixed costs (e.g. operational costs) and variable costs (e.g. metered water consumed).</p>	Early 1990's	25 years, parties can agree to extend indefinitely and Council has option to cancel after first ½ of contract complete
Contract C	Rural, local municipality	Private Company	Water	<p>A concession contract for the construction, financing, design and expansion of the water system and for the operation, maintenance and management of the water services and system. The company is responsible for cash collection, customer relationships and disconnections.</p> <p>The company pays the municipality rental for the works, the rental representing the debt owing on these assets, and also pays an annual "concession fee" as a contribution to the municipality's regulatory costs. All money due and payable from consumers for water services accrues to the company.</p>	Late 1990's	30 years with indefinitely long renewal

REFERENCE	COUNCIL	SERVICE PROVIDER	SECTOR	TYPE	DATE	DURATION
Contract D	Local municipality including a provincial capital	Private Company	Water	This contract is a contract to provide water services and improve and expand the concession assets. Its duties include that of customer management and disconnections. The company pays the municipality an annual fee for its monitoring and regulatory functions and all consumer payments for water services accrue to the company.	Late 1990's	30 years with indefinitely long renewal
Contract E	Metropolitan municipality	Municipal Entity	Solid Waste	Contract for the collection and disposal of solid waste on an exclusive basis in the municipal area. The municipality pays the entity a monthly service fee in accordance with a formula, which is based in part on the service levels the municipality has set for the service.	Post 2000	6 year guarantee then indefinite with council option to terminate on notice

REFERENCE	COUNCIL	SERVICE PROVIDER	SECTOR	TYPE	DATE	DURATION
Contract F	City/urban, local municipality	Municipal Entity	Electricity	Operations & management contract for the provision of all electricity services, including customer management and collection of service fees. As compensation for the municipal entity performing these services, the municipality cedes all rights to recover charges. The municipal entity will be responsible for any capital expenditure projects, but the municipality will act as banker and will annually provide capital funding requirements in accordance with an internal interest rate. A separate "Sale of Business" agreement deals with the transfer of assets from the municipality to the municipal entity.	Post 2000	Indefinite
Contract G	Urban, local municipality	Municipal Entity	Water	The local municipality has contracted with a municipal entity owned jointly by the local municipality, the district municipality and a Water Board. ⁴⁷⁹ The services include the full water services function and revenue collection.	Post 2000	20 years

⁴⁷⁹ This contract has, for complex reasons, not been entered into yet and is thus still a "draft". It is uncertain at this stage whether it will ultimately be finalised, however it remains an interesting example of what provisions are to be found in current service delivery agreements. For ease of reading the analysis of this contract assumes that it is in force.

REFERENCE	COUNCIL	SERVICE PROVIDER	SECTOR	TYPE	DATE	DURATION
Contract H	Rural, local municipality	Water Board	Water	<p>The contract is for the full water services and revenue services function, including cost recovery in accordance with the municipality's credit control policy and by-laws. The company recovers its costs from water revenue.</p> <p>The municipality pays the Water Board a portion of the equitable share (to be used for the supply of basic services) and also pays a "management" charge for professional management services provided by the Water Board, which is capped at one twelfth of 5% of budgeted cash income for that year. The Water Board in turn pays the municipality a monitoring fee and a contract fee to enable the municipality to balance its books. The contract fee reduces annually at a predetermined rate. The idea is for the Water Board to be in a break even position at the end of the contract period.</p>	Post 2000	3 years with option to renew for maximum of 3 years
Contract I	Rural, local municipality	Water Board	Water	<p>The contract is for the provision of water and sanitation services with some customer care and optional revenue services obligations. The service provider is paid the DWAF subsidy, grant funding and a portion of the equitable share. It is also entitled to all deposits and contributions in respect of developments and can raise a "charge" against water revenue for its "head office" costs. The municipality is guaranteed 10% of the actual water revenue collected.</p>	Post 2000	3 years with option to renew for maximum of 3 years

REFERENCE	COUNCIL	SERVICE PROVIDER	SECTOR	TYPE	DATE	DURATION
Contract J	Metropolitan municipality	Water Board	Water	The contract covers water operating and management services, including revenue collection. The idea is for the service provider to be in a breakeven position at the end of the contract.	Post 2000	2 years with Council option to extend for 5 years. However, the parties can “by agreement” extend the contract for any other period. This makes the contract of potentially indefinite duration.
Contract K	Rural, local municipality	Water Board	Water	The contract is a short term water services management and operations agreement which includes revenue collection and customer care. Financially, the stated objective of the contract is for the Water Board to be in a “break even” position at the end of the contract period.	Post 2000	1 year with Council option to extend for up to 3 years
Contract L	Metropolitan municipality	CBO	Refuse collection	Service Agreement	Post 2000	5 years with Council option to extend for 2 years
Contract M	Metropolitan municipality	CBO	Refuse collection	Service Agreement	Post 2000	2 years with Council option to extend indefinitely

REFERENCE	COUNCIL	SERVICE PROVIDER	SECTOR	TYPE	DATE	DURATION
Contract N	Metropolitan municipality	CBO	Refuse Collection	Service Agreement	Post 2000	3 years
Contract O	Metropolitan municipality	CBO	Street Sweeping and Litter Picking	Service Agreement	Post 2000	1 year with “no extensions”

