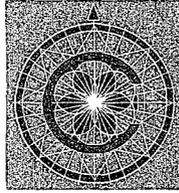


PN - ACB-806
96215



CHEMONICS INTERNATIONAL INC.



DIAGNOSTIC MISSION TO DETERMINE:
A STRATEGIC APPROACH TO ESTABLISH A REGULATORY FRAMEWORK FOR
PUBLIC-PRIVATE PARTNERSHIPS IN MUNICIPAL INFRASTRUCTURE

Final Report

Delivery Order No. 802
Contract No. PCE-1008-I-00-6006-00
Environmental and Urban Programs IQC

Submitted to:
U.S. Agency for International Development
Pretoria, South Africa

Submitted by:
Chemonics International Inc.
and the Institute for Public-Private Partnerships, Inc.

May 1997

TABLE OF CONTENTS

	<u>Page</u>
ACRONYMS	i
EXECUTIVE SUMMARY	iii
SECTION I	1
CONCERNS OF KEY STAKEHOLDERS	
A. Local Governments	1
B. National Government Departments	2
C. Provincial Governments	3
D. Development Finance Institutions	5
E. Private Developers and Investors in Municipal Infrastructure	5
F. Private Lenders and Financial Institutions	6
G. Labor	7
H. Consumers	7
SECTION II	9
LABOR ISSUES	
A. Overview	9
B. Labor Opposition to PPPs	9
C. The Main Elements of a Labor Strategy	11
D. Strategy Options to Deal with Labor	13
E. Conclusion	13
SECTION III	15
KEY CONSTRAINTS TO MUNICIPAL PUBLIC-PRIVATE PARTNERSHIPS	
A. Legislative Constraints	15
B. Capacity and Informational Constraints	16
C. Institutional Constraints	18
D. Financial and Structural Constraints	19
SECTION IV	21
MARKET STRUCTURE FOR THE PRIVATE PROVISION OF MUNICIPAL SERVICES	
A. Why Public Sector Provision of Municipal Services Is Often Suboptimal	21
B. Empirical Evidence on the Benefits of PPPs	21
C. Competition and Unbundling	22
D. Competition for and in the Market	22
SECTION V	25
INSTITUTIONAL ARRANGEMENTS FOR A MUNICIPAL INFRASTRUCTURE INVESTMENT UNIT	
A. International Best Practices for PPP Technical Units	26
B. Establishing a Municipal Infrastructure Investment Unit	26
C. Principles, Objectives, and Activities of the MIU	28

D.	Identifying and Processing PPP Projects in Municipal Services	29
E.	Developing Professional Capacity	32
F.	Financing Mechanisms	33

SECTION VI **ELEMENTS OF A STRATEGIC APPROACH TO REGULATE PRIVATE PROVIDERS OF MUNICIPAL SERVICES IN SOUTH AFRICA** **35**

A.	Regulatory Gaps Exist	35
B.	Regulatory Best Practices	39
C.	Creating a Better Framework Using the Existing Foundation	42
D.	Regulatory Imperatives in South Africa	45
E.	Decentralization of Regulatory Responsibilities	47
F.	Five Particularly Relevant Regulatory Models	48
G.	Next Steps	62
H.	Conclusion	65

ACRONYMS

ABSA	Association of Banks of South Africa
BOOT	Build-own-operate-transfer
BOT	Build-operate-transfer
BTO	Build-transfer-operate
CCD	Contract Compliance Department
CCO	Contract compliance officer
CE	Credit enhancement
DBSA	Development Bank of Southern Africa
DCD	Department of Constitutional Development
DOF	Department of Finance
DPE	Department of Public Enterprises
DWAF	Department of Water Affairs and Forestry
FNB	First National Bank
GNP	Gross national product
LOI	Letter of intent
MIIU	Municipal Infrastructure Investment Unit
MOU	Memorandum of understanding
NGO	Nongovernmental organization
PPP	Public-private partnership
PPU	Project Preparation Unit
RFP	Request for proposal
RDQ	Request for qualification
RPI-X	Rate of price inflation minus X
SAAMUR	South African Association of Municipal and Utility Regulators
SANCA	South African National Civic Association
SAMRI	South African Municipal Regulatory Institute
SAMU	South African Municipal Union
SCMB	Standard Chartered Merchant Bank
TOR	Terms of reference
WSSA	Water and Sanitation Services of South Africa

EXECUTIVE SUMMARY

This report presents the findings and analysis of the diagnostic mission for the establishment of a regulatory framework for municipal public-private partnerships (PPPs) in South Africa. The legacy of apartheid has left South Africa with an economy marked by great disparities between blacks and whites in access to public services in water supply, sanitation, solid waste collection, urban transportation, electricity, telephone service, and other key areas. Currently, many municipalities are managing deteriorating infrastructure systems and are unable to find the capital to expand service networks. Additionally, many local governments are unable to collect rate payments from many users for water, sanitation, and electricity services. For many local authorities, problems such as technical losses in water reticulation systems make continuing to provide services at the current level even more difficult.

The only way forward for many local authorities appears to be partnership arrangements with private sector firms that have either the capital, technology, or management experience to help local governments fulfill their goal of providing access to public services to all South Africans at affordable rates. What type of partnerships are most appropriate to the goals and conditions in South Africa? This question needs to be answered individually for each project. International experience has provided many models of PPP techniques and many "best practices" that can be applied to the individual conditions of each project. The more important question is: What kind of overall regulatory framework should South Africa adopt to best support and facilitate the process of determining the most appropriate types of partnerships? This is the objective of this diagnostic mission report.

The mission organized this diagnosis to analyze the following:

- Objectives and concerns of the most important stakeholder groups.
- Concerns of labor.
- Key constraints to implementing and regulating PPPs in South Africa.
- Potential for introducing market-based competition into provision of municipal services.
- How to design South Africa's institutional arrangements for providing technical assistance to local governments preparing PPPs.
- Strategic options available to South Africa in designing and establishing a framework for regulating municipal PPPs during their operational phase.

A. Concerns of Key Stakeholders

The team first assessed the types and level of concern held by principal stakeholders—local, national, and provincial governments; financial institutions; and developers and investors—in undertaking municipal PPP projects. The concerns described by each group are as follows:

Local governments

- Readily available technical assistance needs to be provided as part of any new national regulatory framework.
- Local governments need authority to make their own decisions about PPPs and should not need to obtain a series of approvals from various national government departments to implement and regulate projects.
- The framework must include clear legislation that allows local authorities to engage in PPPs. Neither existing legislation nor the Constitution currently does so.
- National government departments need to provide local governments with clear political support for adopting PPPs.

National government departments

- Many local authorities lack the capacity to implement and monitor many PPPs.
- Local governments and private operators perceive that political support for PPPs by the national government is synonymous with guarantees by the national government.
- There is concern about the nature of approvals required from national government departments.
- Municipal PPPs need to be monitored by the national government to help prevent failed projects.
- Current tendering regulations and procedures are not appropriate for PPPs.
- Different local governments may choose different financial regulatory models, making monitoring by the national government a complex task.

Provincial governments

- A clear national-level policy on municipal PPPs needs to be communicated to provincial government officials.
- There is a lack of capacity within local governments to implement and monitor PPPs.
- Any new regulatory framework should not be too centralized or bureaucratic.
- The new regulatory framework needs to address the problem of over-centralization of authority within metropolitan local councils.
- Responsibility for monitoring and enforcing PPPs must be clearly defined.

Development finance institutions

- There is a lack of capacity within local authorities to develop and monitor PPPs.
- The regulatory framework should be flexible and responsive to local authorities' needs.
- There is concern about the lack of economies of scale in monitoring municipal PPPs.

Private developers and investors in municipal infrastructure

- The regulatory framework should allow for periodic review and revision of long-term contracts.
- Appropriate procurement regulations for long-term concession contracts are needed.
- The new framework should promote the specification of performance standards rather than give instructions on how to do the job.

Private lenders and financial institutions

- The new framework should prevent crowding out private capacities to advise on and finance projects.
- Development finance institutions need to avoid conflict-of-interest situations.
- Risk allocation techniques and the use of guarantees should be decided on a case-by-case basis.
- Many local authorities lack creditworthiness.

Consumers. While they were not among the groups contacted for this diagnostic mission, consumers are the stakeholders that should benefit most from PPPs. Any further diagnosis of municipal PPPs in South Africa should assess their' concerns.

B. Labor Issues

Various stakeholders, including unions, strongly oppose involving the private sector in municipal service delivery. The issues and concerns are wide ranging:

General issues and concerns

- General public suspicion of or a hostile attitude toward PPPs.
- Political opposition from unions.
- Fear of opposition by leaders of nongovernmental organizations.
- Possible tariff increases because of the involvement of the "profit-driven" private partnership.

- Fear that local government will be alienated in its role of direct accountability for the privatized service.
- Inherent corrupt practices by some private companies.
- The absence of regulatory regimes to monitor PPPs.

Unions' Concerns

- Labor force reductions.
- Disparities in the conditions of service of public and private sectors.
- Loss of union membership.
- Division of union membership brought about by PPPs.
- Salary disparities between municipal and private sector staff.

Strategy Options to Deal with Labor

Options	Advantages	Disadvantages
Restructure first	<ul style="list-style-type: none"> • Advances settlement of labor disputes • Allows for the development of safety nets 	<ul style="list-style-type: none"> • Delays PPP processes • Serious implications if the process is mismanaged
Identify and include terms and conditions of public-private sector arrangement	<ul style="list-style-type: none"> • Pragmatic • Joint public-private decision-making and cost-sharing 	<ul style="list-style-type: none"> • Lengthens transaction process
Leave to private sector	<ul style="list-style-type: none"> • Market-based approach • Process may be slow 	<ul style="list-style-type: none"> • Political difficulties • Less attention to social safety nets • Lower-scale value • Shifting of responsibilities

Absolute care should be taken to ensure that union membership and service condition issues and possible implications of the new arrangements are investigated holistically with labor involved before decisions are finalized.

Training and public education on PPPs will become an important function of the Department of Constitutional Development (DCD). This will facilitate greater insight and understanding of the impact of new arrangements on labor. Stakeholder workshops will be ongoing to:

- Continue the participatory approach.
- Inform and communicate the objectives of reform.
- Review conclusions of the fact-finding mission.
- Deliberate on broad options for reform.

C. Market Structure for the Private Provision of Municipal Services

The key issue facing PPPs in South Africa is how such projects should be structured to ensure as much competition as possible before and after project award so that consumers have affordable, accessible services.

Since private sector involvement in integrated monopolies such as piped water and sanitation networks alone will not automatically increase competition in these sectors, South Africa's local governments must consider "unbundling" parts of the monopoly public enterprise. That is, they must identify the segments of the monopoly that are potentially competitive (such as water treatment for a water company) and promote private sector entry and competition in these segments.

Competition for the market. Municipalities that award PPP concessions to the private sector should generate as many competitive bids as possible, so that the municipality may choose the firm (or firms) that best meets its needs. Bid evaluation criteria should include technical capability, track record, quality of service and cost, as well as factors of local importance and sensitivity, such as how labor will be treated in the transition to private sector provision of services.

Competition in the market. It is often thought that once a PPP concession is granted, it is difficult to generate competitive forces to reduce costs and keep services at a high level. However, local governments can often structure a market for these services to ensure that competitive forces remain strong during the concession period. For example, dividing a city into different service areas creates indirect or "proxy" competition, whereby the provider has an on-going competitive environment to keep costs low and standards high. For instance, a municipality such as Johannesburg could choose to divide itself into several service zones for solid waste collection and have each zone served by different private contractors.

D. Institutional Arrangements for a Municipal Infrastructure Investment Unit

D1. Establishing the Unit

In reviewing international best practices, DCD has, in collaboration with other key groups, proposed that a Municipal Infrastructure Investment Unit (MIIU) be established to assist local governments implement municipal PPPs.

Based on international best practices, the institutional framework for an MIIU should be structured to:

- Clarify the responsibilities and authority between and within national and local government agencies governing the process of preparing and granting PPPs.
- Streamline, through effective procedures, the process of selecting, approving, and monitoring projects.
- Develop institutional and regulatory capacity within a PPP technical unit with authority to facilitate transparent treatment of investment proposals, both solicited and unsolicited.
- Build on the lessons of experience to standardize project preparation requirements for use in other projects such as model requests for proposals (RFPs) and other project documentation.

It is envisioned that the MIU will have three components:

- Board of trustees with a broad oversight and policy role.
- Grant fund, seed-funded by government.
- Project Preparation Unit (PPU) to serve as the operational core of the MIU. This unit will process applications and manage the fund.

D2. Operations of the MIU

Unsolicited proposals. DCD believes, in accordance with international best practices, that to ensure identifying the maximum number of quality municipal infrastructure projects, private firms should be invited to identify projects and present them to the MIU and relevant municipal authorities. Procedures should be in place that lay out the terms of both parties should a project not advance to a letter of exclusivity.

Project screening and analysis. The two most important elements of the project evaluation process are: 1) screening out projects that are not economically important or environmentally feasible, and 2) structuring projects to become more financially attractive to the private sector. South Africa must select projects that are already developmentally important for municipalities.

Preparing tendering and bid packages. Once projects have met or exceeded the Technical Unit's "litmus test" of project candidacy, the PPU will work with municipalities and outside technical assistance providers to design, draft, structure, and package tender documents for competitive bidding.

Bid evaluations. After bids have been received, the municipalities, and the PPU on an as-needed basis, will evaluate eligible bids. The Technical Unit will need to develop the bid evaluation criteria and standards in compliance with PPP program guidelines.

Negotiations. Negotiations will include not only project award terms but conditions but, in some cases, will result in granting agreements such as letters of intent to the successful proponent to either commence construction or conduct full feasibility analysis.

Public awareness. This effort should result in a greater awareness for consumers and the general public of the requirements and benefits of private infrastructure in South Africa. The substance of the public awareness should be determined by the MIU.

Marketing. The objective of this activity for the technical unit is to generate the highest number of competitive bids from the broadest possible community of bidders, including local and foreign investors and operators. The MIU will need to develop capacity in private infrastructure promotion and marketing.

E. Financing Mechanisms

Financial needs for municipal PPP projects center on two issues:

- Will there be sufficient financing for municipalities to receive assistance from the MIU to implement projects?

- Will financing be available, either from foreign or domestic sources or both, to support a wide range of municipal PPPs in South Africa?

The MIIU has been structured to provide financing for pilot PPP projects whose lessons and techniques can be transferred to municipalities. DCD is optimistic about the prospects for financing municipal infrastructure projects in South Africa (although this will obviously depend on the particular project and its terms and conditions). Ongoing dialogue with the banking, business, legal, and international sectors indicates that finance is not a constraint per se to South Africa's program of municipal PPPs.

F. Strategic Approach to Regulate Private Providers of Municipal Services

DCD is aware that international best practices must be followed for the South African PPP program to succeed. In addition, conditions and circumstances unique to South Africa must be acknowledged in design of a regulatory strategy and framework. However, a framework to support developing, structuring, financing, and tendering viable municipal PPP projects as described in the above MIIU approach is not sufficient by itself. In addition, a sound, flexible regulatory framework and set of clear procedures for oversight of the market post-award must be put in place as soon as possible.

Design and implementation of the post-award regulatory framework entail critical decisions in South Africa and will require consensus and capacity building initiatives immediately. Key factors in developing a regulatory framework are discussed below.

F1. Regulatory Gaps

To develop a more coherent regulatory regime, the following gaps need to be addressed.

- Currently, no structured or transparent set of regulatory procedures is in place to govern municipal PPPs in South Africa.
- The current procurement law is insufficient and not in accordance with international best practices. So far, the submission of unsolicited proposals has been used to form the basis for a competition.
- Both a policy gap and a regulatory gap exist in the commitment to provide fiscal incentives to facilitate projects at the municipal level.
- Without regulatory guidance on the scope and scale of performance and financial guarantees provided by local and national governments, project transaction costs will be higher than necessary.
- Without an organized approach to credit enhancement strategies, the regulatory burden for the public sector will increase as highly leveraged projects are undertaken.
- A critical objective is to minimize regulatory overlap regarding financial regulation, safety and health regulation, and quality/performance regulation within the three spheres of government.

- While the PPU represents a form of project coordination, it will be important to have a coordinated “regulatory” focal point similar to the PPU to provide investors and consumers confidence in the long term.

F2. Regulatory Best Practices

Most countries in developed and emerging markets that have successfully unbundled municipal service delivery have: 1) developed independent regulatory models before or as a result of significant transactions, and 2) passed a regulatory act on PPPs or other relevant legislation to clarify and authorize policy, procedures, and regulations. DCD believes that South Africa is in a unique position to learn from the last 10 years of other countries’ experiences. Lessons learned are as follows:

- Competition is the best form of regulation.
- Efficiency in design of the regulatory framework is critical to avoid de-regulation trauma.
- Developing viable projects and effective contracts minimizes regulation.
- Consumers must be heard in the regulatory process.
- Investors require certainty and credibility if bids are to be affordable.
- All parties seek real transparency and a level playing field.
- Independence is desirable, but accountability is equally important.
- Effective, efficient dispute resolution is critical.

F3. The Existing Regulatory Foundation in South Africa

While DCD believes more comprehensive regulations and guidelines should be initiated, we also believe that the basic foundation for a regulatory framework exists and should not be reinvented. The following table illustrates where the current regulatory responsibilities rest in South Africa.

Regulatory Activity	Regulatory Responsibility
Project identification	Municipality, province, DCD, private sector
Project tendering	Municipality (with support from MIIU)
Project award	Municipality (with support from MIIU)
Financial guarantees	?
Fiscal incentives	?
Price regulation (form, monitoring, etc.)	?
Environmental regulation	Sectoral Ministry and Department of Environment
Health and safety standards	Department of Health
Dispute settlement	?
Note: “?” indicates a regulatory gap.	

A useful way to gauge these gaps is to review South Africa's two experiences with municipal PPPs in the water sector to date, in Queenstown and Nelspruit.

Queenstown water and sewerage contract. In 1990, Queenstown concluded a 25-year rehabilitation, operation, and maintenance contract with Water and Sanitation Services of South Africa to run its entire water and sanitation system. A number of regulatory pluses and minuses can be cited to assist DCD in strengthening the regulation of future transactions:

Regulatory accomplishments

- The planning, standards, and water policy issues complied with Department of Water Affairs requirements and those of the municipality.
- The concession received approval from the Department of Water Affairs and the Department of Health for environmental and health standards.
- The municipality negotiated acceptable arrangements with labor and complied with labor regulatory matters. For dispute resolution, the contract explicitly used mediation and arbitration as the agreed-to form of dispute resolution and provided a mechanism to fairly regulate changes in the contract.

Regulatory imperfections

- The operator was not asked to provide large amounts of capital expenditure. In other transactions involving significant investment capital, regulatory details and rate-of-return issues will have to be more extensively examined in the contracts.
- The project was developed in the absence of true competition and without a detailed RFP. Through open competition, the municipality may have been able to attract a higher number of competitive bidders offering different terms.
- Despite the success of the project to date, no formal regulatory mechanism spelled out the basis for price review and renegotiation. In larger transactions, reopening price and investment issues would be much more problematic.
- The contract does not spell out the monitoring responsibilities that enable the municipality to ensure it is being well served. From an institutional standpoint, the municipality should be developing long-term capacity to monitor the project independently.

Nelspruit request for proposals for water concession. This RFP represents an improvement in the regulatory sphere by combining what already works in South Africa with some of the lessons learned from the Queenstown project. Although it is too early to tell if the approach is successful, many of the regulatory imperfections were addressed.

With the support of DCD, the effort featured competitive procurement, a bidders conference, risk allocation strategies outlined in the RFP, and stipulation of financial regulation and renegotiation issues. Contract monitoring was explicitly spelled out as well as dispute resolution arrangements. While both Queenstown and Nelspruit are projects in progress, they

provide DCD a basis from which to evaluate functioning and yet-to-exist elements for regulatory oversight.

F4. Regulatory Options for Municipal PPPs in South Africa

DCD believes that regulatory responsibilities should be decentralized as much as possible. In contemplating regulatory design, DCD believes that two issues must be considered: 1) the appropriate regulatory instruments to be used, and 2) the appropriate institutional model to be adopted.

A number of regulatory models around the world are useful examples for South Africa. The five models discussed below are particularly relevant.

National public utilities commission. In many countries, regulation of municipal services is brought into a single, multisectoral, national commission. For reasons of efficiency, often the commission is empowered to oversee the economic, financial, performance, and quality regulatory requirements of sectors involving monopoly characteristics. The commissions operate under a legal framework and regulate by statute and license. Examples of independent, multisectoral regulatory commissions are found in small countries where pooling expertise and functions make sense: such as in Albania, Jamaica, Chile, Trinidad, Panama, and the 50 states of the United States, which all have their own independent regulatory commission. In this approach, the control structure allays concerns about the capacity of local governments, and the pooling of resources allows for greater efficiency between sectors. However, disadvantages include the fact that the Commission may be an intrusive, bureaucratic, and non-local approach not congruent with decentralization objectives.

The national, multisectoral model is not appropriate for South Africa. One could argue that national utilities such as energy, telecommunications, and transport may make sense under this scenario for capacity and scale reasons, but for municipal PPPs, this would likely be more of a bureaucracy than facilitator of competition.

Regulation by contract. This is used increasingly in countries that are "deregulating" through contracts. In this model, the regulatory regime is built into the contract itself and each municipality is responsible for establishing a capacity to monitor the price, quality, and performance of the concessionaire. The costs of regulation and monitoring are covered out of a percentage surcharge on sales by the concessionaire, and penalties or fines are sometimes rebated directly to consumers as a deduction in their monthly bill. Practiced widely in the United States, Mexico, the Philippines, and Canada, regulation by contract requires a capable, vigilant team, acting under some regulatory supervision to ensure that performance is being measured.

Regulation by contract can be extremely local and personal in nature as well as efficient and self-financing. Through daily monitoring, disputes are minimized, and outside experts can be called in on an as-needed basis to assist the contract compliance officer or monitor, avoiding the high cost of expertise 365 days a year. However, today South Africa has inconsistent capacity among municipalities to monitor contracts and the national government is effectively left out.

The regulate by contract model alone, while ideal, is perhaps slightly premature in South Africa. There are few examples in developing countries where scores of contracts between municipalities and private providers exist without some modicum of institutional guidance and support from national government.

Single regulator model or czar. In this model, each sector has its own regulatory body (or Department) and accompanying legislation and guidelines. The director (or czar) of regulation of the given sector is empowered to make decisions. The director or commissioners are appointed for five-year terms and cannot be removed for political reasons. Essentially, the body is a non-ministerial government department with an independent director subject to only limited controls from national government.

The advantages of the single regulator model include the benefits of single sector economies of scale. Also, the single department establishes a clear point-of-contact responsibility for the private sector. The disadvantages of this approach include the risks that it is overly centralized and authoritative, and it can lead to overreliance on an individual.

This model would be difficult to establish and inefficient, since each sector would require its own regulatory design and approach. This approach may be appropriate for South Africa's Telecommunications and Energy sectors due to their "national" characteristics.

Transaction/ad hoc regulation model. Under ad hoc regulation, the establishment of a regulatory body, procedures, and capacity are a result of a transaction design. Used mostly in the last few years in large urban projects in countries lacking a competent or qualified regulatory presence, the transaction drives the regulatory design, including the establishment of a standing regulatory commission, its powers, authority, and instruments.

This model could be appropriate for a few of South Africa's larger municipal transactions in the absence of existing regulatory bodies. However, this model does not contribute well to regulatory economies of scale, because every municipality that creates a concession would establish its own body. While this model has some attraction, it does not serve South Africa's needs for speed, standardization, efficiency, multisectoral approach, and decentralization.

Locally driven, nationally supported hybrid. As one can see from the previous models, elements of each could be applied in South Africa, but each lacks the integration of central and local interests to be truly useful. Rather, a South African model needs to be developed based on the unique constraints, opportunities, precedents, and long-term goals of the country. *It is proposed that a hybrid be developed.* The hybrid would:

- Build on the lessons of Queenstown and Nelspruit.
- Give local governments autonomy and capacity.
- Reduce regulatory uncertainty.
- Allay central government concerns about capacity.
- Provide consumers with confidence.

The responsibility for ensuring and enforcing compliance is vested in the contract compliance officers or department. The consumer will be able to bring complaints directly to the company, and such consumer contact will be reported to the officer. Dispute resolution will be identified and specified in the contract and will rely on efficient and cost-effective methods including consultation, negotiation, mediation, and arbitration.

As stated previously, central government still requires some information and control to serve its own needs. Moreover, some municipalities require more assistance than others. Information dissemination, training, and research should be spearheaded at the national level to develop a regulatory and monitoring industry of practitioners. Therefore, the hybrid model

proposes the creation of a South African Municipal Regulatory Institute (SAMRI). SAMRI will be established not as a bureaucracy, but as a center of technical support, training, and research to do the following:

- Support the efforts of municipalities and the PPU as they negotiate contracts.
- Provide technical support to municipalities on monitoring and regulatory analysis.
- When disputes arise, provide regulatory, financial, and economic analysis to assist the contract compliance officers to develop evidence to submit during dispute resolution.
- Conduct training and workshops on all aspects of regulation and monitoring.
- Provide certificate-based training to municipal contract monitoring officers and sanction a South African Association of Municipal and Utility Regulators (SAAMUR) and its research and training arm.

The success of the hybrid approach, as with any regulatory approach, relies on the quality of the contracts and concessions themselves. Through a Regulatory Act, guidelines, and support from the PPU to eligible municipalities, high-quality, “win-win” concessions can be drafted that are simple to monitor. The pros and cons of the hybrid are summarized below.

Pros of the hybrid model

- Is sensitive to local needs and concerns.
- Combines local and national resources to achieve results.
- Supports contract monitoring through outside experts and self-financing.
- Overcomes initial capacity constraints within local governments.
- Provides consumers with multiple avenues for feedback and accountability.
- Holds contract compliance officers accountable for performance.
- Develops national regulatory resources to “farm-out” to other municipalities.
- Coordinates with national and local agencies to ensure regulatory fit and compliance.
- Can be efficiently expanded as municipalities enter into more transactions.
- Incorporates international as well as domestic best practices.

Cons of the hybrid model

- Role for provincial governments is ambiguous.
- SAMRI must be established early to have an impact on future projects.
- Most municipalities lack capacity to perform or even manage contracts.
- Coordination with PPU is needed, but absolutely must be separate from PPU. Contract monitoring and regulation is a full-time job. Conflict of interest or capture must be avoided.
- Smaller municipalities must be addressed to be equitable and effective.

F5. Next Steps

The proposed hybrid regulatory framework seems to meet most of the needs of the South African environment. While elements of the strategy will change over time, its core thrust must begin immediately: training to provide technical support on some of the upcoming pilots to

ensure compliance with the proposed regulatory structure, policy design, draft regulations, and model contracts. Work should also be performed on detailed design of the regulatory structure including draft legislation on procurement, government support, solicited and unsolicited proposals, fiscal incentives, and linkages between SAMRI and DCD.

SAMRI. The institute should be established as a non-profit, independent unit, sponsored initially by DCD with funding by the donor community. It should be governed initially under a contractual arrangement with DCD and have a board of directors made up of representatives from DCD, the Department of Finance, the Development Bank of Southern Africa, the donor community, and the private sector. It should have a work program aimed at assisting municipalities in developing regulatory capacity, especially for the initial pilot projects, and national capacity on regulation and monitoring.

Funding the regulatory framework. While DCD, through a grants program, is sponsoring the PPU and the assistance to municipalities, the regulatory framework will be funded through different sources. Contract compliance departments are self-financed. However, the preparation of a Regulatory Act and guidelines and capacity building for municipalities will be funded by a combination of DCD resources, USAID, World Bank, and other donor assistance. While the costs of regulation under this structure are lower than usual, the development of a regulatory body at the local and national level is an expense that adds value to the economy and protects the rights of consumers.

Conclusion. The regulatory framework must be consistent with the vision for PPPs in South Africa. Depending on its design, regulation can be a barrier or a complement to economic growth and efficiency. The PPU must coordinate and complement the regulatory structure and unit. Lessons from other countries are highly instructive about the poor results when project preparation and market oversight are not coordinated. The regulatory act and concomitant guidelines must begin as soon as possible. No regulatory model is perfect or complete. The Philippines, which is often cited as a useful example for economies in transition, has gone through several iterations of laws and procedures, with private sector and consumer confidence growing at each phase. DCD believes that a modern regulatory framework is consistent with the goals of the new South Africa. The country has several advantages that augur well for successful planning and implementation of PPPs at the municipal level.

SECTION I CONCERNS OF KEY STAKEHOLDERS

The diagnostic mission first consulted a wide range of stakeholders to determine their principal concerns about establishment of a regulatory framework for municipal public-private partnerships (PPPs) in South Africa. The stakeholder groups consulted included:

- Local governments
- National government departments
- Provincial governments
- Development finance institutions
- Private developers and investors in municipal infrastructure
- Private lenders and financial institutions
- Labor groups
- Consumers

This section describes and assesses the concerns of each group. The concerns covered a broad range, from the clarity of current legislation on allowing municipal PPPs to the ability and willingness of residents to pay commercial rates for services. With this information, the mission can appropriately evaluate the strategic options for a regulatory framework and structure an approach that best meets the unique mix of concerns in South Africa.

A. Local Governments

The mission interviewed local authorities that are currently identifying municipal infrastructure projects for future implementation as PPPs, as well as local authorities already evaluating bids from private investors for the first pilot municipal projects under the new political dispensation.

Financial support from the national government. Compared with other stakeholder groups interviewed, local governments were far less likely to express a pressing need to establish a regulatory framework. While agencies of the national government as a group see a clear need for some type of framework, for the most part local governments do not believe that a framework is urgently needed. This is because local governments feel that management and control of municipal PPP projects should be a local affair. However, local governments report that financial support from the national government is important. This priority is made clear in the local authorities' strong interest in having their projects added to the Department of Constitutional Development's (DCD's) list of pilot projects in municipal PPPs.

Local authority to make decisions. Local government officials were quite concerned that the regulatory framework would become overly centralized and bureaucratic. Overall, local governments believe it is important that they retain their ability to select, structure, and implement municipal PPP projects rather than having to obtain permission or approvals from the national government.

Technical support. While local authorities also believe that municipal PPP projects must be initiated and driven by local forces, almost all will need technical assistance to properly analyze, negotiate, and monitor partnership contracts. A Technical Assistance Unit must be available to answer their general and specific questions about implementing partnerships. Local

governments do not believe that such a unit should be the only source of advice and assistance on these projects; rather, the unit should help local authorities ensure they get the right kind of advisory services. For example, several pilot projects will require some form of cross-subsidization in tariffs. However, several local authorities do not know what level of cross-subsidization is feasible within their communities and what degree is required to make the project financially viable. This is the type of issue that a Technical Support Unit must be able to help address.

Clear legislation to allow municipal PPPs. Local authorities report that the most important role of the national government is to clarify the legality of them entering into partnerships with the private sector to provide local public services. Currently, in South Africa, there is no legislation to allow or forbid local authorities to engage in PPPs. Local authorities currently developing pilot PPP projects are doing so under the rationale that current legislation does not forbid PPP projects at the local level. Local officials have said that this issue leaves them open to criticism from stakeholders, such as unions, who challenge the legality of municipal PPPs.

National government political support and public awareness. Several stakeholders noted that while certain departments in the national government were already supporting municipal PPPs, a clear national policy is missing. Significantly, several local governments believe that local government councillors and provincial government officials are reluctant to endorse locally driven municipal PPP pilot projects because they are awaiting a clear policy from the national government to provide political and technical assistance on this issue. In addition, local authorities believe that a framework must include a strong public awareness and education component to inform groups such as local government councillors, labor unions, and consumers about municipal PPP projects.

B. National Government Departments

While the concerns of local authorities regarding a regulatory framework are generally uniform across a range of issue areas, the concerns of national government departments are not so homogeneous. The principal departments consulted were DCD, the Department of Finance (DOF), the Department of Water Affairs and Forestry (DWAF), and the Department of Public Enterprises. The key issues raised by these stakeholders are described below.

Differing capacities among local governments. All of the national government departments share a strong concern that many local authorities lack the capacity to develop, negotiate, and monitor PPP projects. Therefore, they believe that any new regulatory framework must help local authorities to bridge this critical capacity gap. Additionally, while some local authorities lack capacity, others do not. Any new regulatory framework must be flexible enough to help build capacity where it is lacking and not to duplicate or crowd out capacity where it already exists.

Perceived guarantees by national government. In many countries that have developed policy and regulatory frameworks for municipal PPPs, such as Mexico and the Philippines, the framework has included mechanisms for national governments to provide partial credit guarantees and financial performance guarantees for municipal PPPs. In South Africa, the Department of Finance in particular is against including national government guarantees of contracts entered into by local authorities in the new regulatory framework. It will be important that the new regulatory

framework make this policy clear to avoid any perceived or assumed guarantees by national governments in local projects.

Level of national government approval required. The departments of national government do *not* seem to agree on the appropriate level of approval to be required from the national government for municipal PPP projects. DWAF is in favor of a centralized approach, in which local authorities would be required to secure approval from DWAF before entering into PPPs. DWAF would also help monitor and administer water and sanitation PPPs. However, other departments including DCD and DOF do not favor this more intrusive and centralized approach to regulation and are more inclined to favor a decentralized approach. This issue lies at the foundation of a regulatory framework.

Monitoring projects and preventing failures. Several departments, including DCD and DOF, stress that municipal PPP projects must be monitored at the national level, especially to provide technical assistance to prevent project failures. These departments assume that this monitoring function, rather than being a controlling or directing activity, would serve as a mechanism to collect information from municipalities and disseminate information. Therefore, they believe that the new regulatory framework should specify what types of information and documentation should be collected from local authorities. For example, the departments' information needs might include the request for qualification document, the request for proposal document, and the PPP contract.

Tendering and procurement regulations. All of the departments of national government consulted for this mission agree that current regulations on government tendering procedures are inadequate for the tasks of selecting and negotiating private sector service providers for PPP projects. Many of the guidelines for tendering in South Africa are based upon materials procurement and thus are not appropriate for long-term concessions tendering. The Department of Public Enterprises has found that it cannot use the tendering guidelines issued by the State Tender Board in its privatization projects. The new regulatory framework will need to address this serious concern about appropriate tendering procedures for municipal PPPs.

Financial regulatory models and techniques. National government departments, particularly the DOF, are also concerned about the techniques or criteria to be used to monitor and regulate the financial performance of PPPs. They are concerned that differing criteria could result in difficulties for the overall market for municipal PPPs in South Africa—for example, if some local authorities choose to regulate financial performance based upon a price cap on per-unit tariffs, while other local authorities select a rate-of-return based regulation.

C. Provincial Governments

The provincial governments in South Africa occupy a unique position vis-à-vis the regulatory framework for municipal PPPs. In some respects, provincial governments fill a role somewhere between those of the national and local governments. At present, provincial governments are searching for a policy role in the implementation and regulation of local PPPs. They have expressed a number of concerns regarding the regulatory framework for such partnerships.

A clear national-level policy on municipal PPPs. According to provincial governments contacted for this mission, the lack of clear policy at the national government level to promote PPPs constrains the development of municipal PPPs. Provincial governments feel that a national

policy should clarify their role in developing these projects. While important policy guidance would come from the national government, and implementation of projects will occur at the local authority level, the exact role of the provincial government is unclear to many provincial government officials.

Lack of capacity within local governments. Like other stakeholder groups in South Africa, provincial governments are concerned that local authorities lack the capacity to select, analyze, structure, negotiate, and monitor municipal PPPs. In addition, provincial governments are concerned that they themselves lack the experience and capacity to participate in the PPP process. (Some provinces, such as Gauteng, seem to have a greater potential than other provinces to actively participate in the process.)

An overly centralized regulatory framework. Like the local authorities interviewed, provincial governments tend to agree that any proposed regulatory framework for PPPs should not be an overly centralized framework. They believe that a centralized framework would not be efficient or effective if local or provincial governments were forced to seek and obtain approvals from national government departments before proceeding with each step of the project tendering, monitoring, or renegotiation.

Some provincial governments, like Gauteng, believe that certain provincial governments have the requisite capacity, as well as greater flexibility than many national government departments, to respond to requests from local authorities for technical assistance on municipal PPPs. One idea is that some provincial governments could sponsor their own Technical Assistance Units that member local authorities could access for advisory services.

Devolution of power within metropolitan local councils. The metropolitan local council structures in several of the large urban centers of South Africa have centralized much of the decision-making authority on local government issues. According to some officials at the provincial government level, this centralization impedes the local authorities' ability in metropolitan areas to make their own decisions on selecting, structuring, and implementing PPPs. For example, in Johannesburg, centralization of decision-making is reported to be greater than in Pretoria. According to the Gauteng Provincial Government, the more decentralized structure in Pretoria is providing area local authorities greater flexibility and autonomy in identifying and selecting potential projects.

Lack of clarity within local governments over monitoring responsibility. Provincial governments are also concerned about exactly who within the local authorities will be responsible for monitoring and regulating contracts. Monitoring and regulation could be the responsibility of the chief executive or the town engineer, or possibly of some new unit formed to monitor and administer PPP contracts. If responsibility for monitoring and regulating contracts is different for each local authority, sharing the lessons of experience among local authorities could become difficult. In addition, provincial and national governments would find it more cumbersome to monitor the status of municipal PPPs in South Africa.

D. Development Finance Institutions

Internationally, development finance has been important in the development and funding of municipal PPP pilot projects. In South Africa, the role of development finance is filled principally by the Development Bank of Southern Africa (DBSA), with an emerging presence

from the World Bank. To date, the DBSA has been both developer and advisor to public authorities on PPPs, as well as potential lender to private operators and project companies.

Lack of capacity within local authorities to develop and monitor PPPs. A principal concern of the development finance institutions is the lack of capacity within local authorities to prepare, analyze, negotiate, and monitor PPPs. As a result, the DBSA has been actively advising several local authorities on some of the first pilot projects in municipal services. These include advising Nelspruit on the development of its RFP for water and sanitation services, advising Dolphin Coast on its water and sanitation sector, and advising Stanger and Richard's Bay on solid waste projects.

A regulatory framework responsive to local authorities' needs. Another concern of development finance institutions is that the development of a regulatory framework not hinder the progress of those projects currently being prepared for PPPs. More specifically, the institutions do not want the regulatory framework to be overly burdensome or bureaucratic for local authorities; any approval or monitoring activity by national or provincial governments should be minimal. Development finance institutions prefer that technical units be similarly minimalist in approach. A technical unit should have the flexibility and autonomy to respond quickly to requests for assistance from local authorities. This includes the ability of a technical unit to decide on its own which projects are appropriate for its assistance. But any oversight by the technical unit should be limited to broad strategic issues, and should not include operational decisions.

Lack of economies of scale in monitoring municipal PPPs. Development finance institutions also believe that a regulatory framework for municipal PPPs must promote the efficiency gains of economies of scale in monitoring and contract oversight activities. For example, if one local authority enters into a private contract for the management of its solid waste services and a neighboring local authority decides to award its solid waste services to the same contractor, should each authority have its own contract compliance officer or share one? To protect and promote the efficiency gains of PPPs, development finance institutions believe the regulatory framework should permit and encourage several local authorities to appoint a single contract compliance officer for multi-jurisdictional projects.

E. Private Developers and Investors in Municipal Infrastructure

In general, private sector developers, investors, and operators of municipal infrastructure facilities in South Africa believe they could continue to operate in South Africa, whether or not a new regulatory framework were set up in the future. Currently in South Africa PPP contracts are structured and monitored on the basis of a standard of "performance control" unique to each contract. Relatively vague standards of "prudent operation" and "general performance" are included in each contract, and any issues, complaints, or disputes are addressed through periodic review of each contract, usually every five years, rather than through a national regulatory framework.

However, these developers and investors had several concerns about the exact shape that a future regulatory framework would take in South Africa.

Ability to periodically revise long-term contracts. International experience in sectors such as municipal water and sanitation has shown that long-term concession contracts usually require some form of mutual review and revision by both the public and private sectors. Private

operators and investors interviewed believe that a similar requirement should be adopted in South Africa. The regulatory framework should permit and facilitate the process of periodic contract revisions. This process should include a comprehensive analysis of the contract's record of performance and the renegotiation of several important contract regulation and monitoring issues.

Appropriate procurement regulations for long-term concession projects. Private developers and investors also believe that a new regulatory framework ought to include tendering rules and regulations appropriate for long-term concession contracts. The current tendering regulations in South Africa focus on construction contracting activities that are much shorter and structured aggressively. In some cases, reportedly, construction contracts have been used for service operators.

A related issue is the structure of RFP documents. According to experienced private investors, effective RFPs include full drafts of proposed concession contracts. When an RFP includes only a legal term sheet instead of a full concession contract, bidders will provide a range of bids based upon various interpretations they have assumed for each key term. As a result, the job of evaluating bids becomes very difficult and time-consuming for local authorities, because they are required to issue numerous clarification questions to bidders before they can finally compare bids. A new regulatory framework for South Africa should include revised tendering and procurement regulations appropriate for long-term concession contracts.

Specifying performance standards. One concern that private operators and investors expressed is that a regulatory framework should ensure that concessions are structured based upon specific performance standards and penalties, rather than on specific instructions on how to perform a service. The private sector can work very well when it is simply given a specific target level of service to meet and is left to decide for itself the most efficient way of achieving that goal. These performance targets should include specific information on penalties that will be applied to private operators who do not meet prescribed standards. Therefore, the regulatory framework ought to focus on assisting local authorities with setting specific performance standards and providing information on the added costs of specifying how operators should meet those standards.

F. Private Lenders and Financial Institutions

South Africa's private lending market is dominated by a relatively small number of large domestic banks, with an increasing presence of new international financial institutions. Unlike those of many other countries, South Africa's private banks have become involved in a wide range of services for PPPs, including identifying and selecting projects, and financing and developing partnerships at their own risk.

Prevent crowding out of private capacities to finance projects. Some financial institutions, such as the First National Bank, have been actively involved at their own risk in identifying PPP projects. Examples include the privatization and expansion of Benoni Fire and Ambulance Service and development of private solid waste collection by local black disadvantaged entrepreneurs in Tekoza and Rustenburg. Beyond these examples, however, private banks remain concerned that just as there should be a market for the private provision of municipal services, there should also be markets for advisory services and financing projects. These concerns stem from the DBSA's role as both an advisor and a potential financier of these partnerships. Banks would like the regulatory framework to promote markets for both PPP advisory services and project financing.

Avoiding conflict of interest for development finance institutions. South Africa's private lenders are also concerned that the DBSA risks being in a conflict of interest by providing both advisory and financing services for the same project. Lenders and financial investors would like the new regulatory framework to prevent such situations of conflict of interest for DBSA.

Risk allocation and the use of guarantees. In the recent Telkom SA transaction, the national government took the aggressive measure of guaranteeing current employees their jobs to make the project go forward. While this worked for the high-profile, national-level case, it would not be appropriate for all municipal-level PPPs. Private financial institutions expressed concern that generalized guarantees should not be included in a new regulatory framework, but rather decided on a case-by-case basis.

Creditworthiness of many local authorities. One important impediment to successful municipal PPPs is the lack of creditworthiness of many local authorities. In projects where the local authority itself is responsible for paying private operators or concessionaires, private lenders will require that a credit analysis be performed of the local government. Many local authorities in South Africa have unsatisfactory credit ratings; other local authorities have no credit rating at all. As a result, it is likely that good projects do not get funded and do not become operational because they are situated in credit-poor areas. One approach suggested by South African financial institutions, which has worked in the Philippines and Mexico, is that the regulatory framework establish a mechanism whereby institutions such as the National Reserve Bank or the National Public Works Bank can provide financial performance guarantees to back local authorities. These guarantees improve the creditworthiness of numerous pilot projects.

G. Labor

The concerns of labor are in many respects the most important of stakeholder concerns in South Africa. The difference between union support and opposition for a project can easily become the difference between success and failure. The concerns of labor are presented in Section II of this report.

H. Consumers

While consumers were not among the groups contacted directly for this diagnostic mission, it is nonetheless important to understand the importance of their role as a stakeholder. Consumers are the ones who should benefit most from PPPs, either through improved access to services resulting from new capital investment in infrastructure systems, or through better service levels and lower tariffs through new system efficiencies.

In the Nelspruit project, for example, many employees said they had an interest in finally having their own households in the peri-urban areas connected with the piped water and sanitation network. In general, from our discussions with various groups representing the public, concerns include access to services, service rates, and affordability. Any further analysis of municipal PPPs in South Africa should focus on assessing consumers' concerns.

SECTION II

LABOR ISSUES

SECTION II LABOR ISSUES

A. Overview

The majority of South Africans have inadequate access to housing and limited access to basic services such as water, sanitation, electricity, and solid waste collection. These services are mainly provided by municipalities.

Hitherto, the quality of services provided by White Local Authorities differed dramatically from those provided by the Black Local Authorities established by the defunct apartheid government. Since the new democratic government took over, municipalities have been merging to address these inequalities. Much time and effort has been devoted to initiatives aimed at creating a common vision and culture within the merged municipalities. This has been a daunting exercise.

The Department of Constitutional Development (DCD) is committed to ensuring efficient service delivery, effective municipal management, and use of appropriate options to facilitate the provision of finance for municipal infrastructure development and upgrading. The need to involve the private sector in the delivery of municipal services and the development of infrastructure is thus receiving serious consideration.

Infrastructure delivery that is efficient and cost-effective requires institutions that have the capacity to identify demands from all user groups and provide services for which these users are willing and able to pay. To achieve these goals, a management capacity and level of investment that will support and complement government's resources are required. Public-private partnerships are effective in closing this gap.

Several initiatives to facilitate the process of PPPs are in place. These include several pilot projects, launched by DCD and the Development Bank of Southern Africa (DBSA). In these projects, the private sector will play significant financing and management roles.

The private sector has responded positively to these initiatives. Seven companies were prequalified in the Nelspruit water and wastewater concession bid. These companies have taken the high risk and costly step of bid preparation. In addition, financial institutions such as DBSA, Standard Chartered Merchant Bank, First National Bank, and Association of Banks of South Africa have also shown their commitment to financing municipal infrastructure projects.

B. Labor Opposition to PPPs

Various stakeholders, including unions, strongly oppose involving the private sector in municipal service delivery. Key issues include:

General labor issues

- General public suspicion of or a hostile attitude toward PPPs.
- Political opposition from unions.
- Fear of opposition by leaders of nongovernmental organizations.

- Possible tariff increases because of the involvement of the “profit-driven” private partnership.
- Fear that local government will be alienated in its role of direct accountability for the privatized service.
- Inherent corrupt practices by some private companies.
- The absence of regulatory regimes to monitor PPPs.

Concerns specific to unions

- Labor force reductions.
- Disparities in the conditions of service of public and private sectors.
- Loss of union membership.
- Division of union membership brought about by PPPs.
- Consequences in case of contract cancellation.

Labor reduction. A primary concern has been that PPPs would inevitably result in job losses. Government has on numerous occasions advocated for a lean, efficient public sector, an approach vehemently opposed by unions. Unions therefore view the initiatives for PPPs as DCD’s new approach to achieving government’s down-sizing strategies at municipal levels.

Service conditions. It is most likely that the service conditions of private companies and those of municipalities will differ substantially. The differences may be in leave days, office hours, sick leave, bonus schemes, employee share ownership schemes, medical aid schemes, and housing subsidies. However, where specific service conditions are provided for in the Labor Relations Act, differences between the two sectors are unlikely or, at least, can be easily addressed.

It must be accepted that disparities may occur in some areas of staff benefits, particularly where staff may not have the option of retaining the benefits they enjoyed and preferred while in the public sector. A typical example is that of Queenstown, Stutterheim, and Fort Beaufort, where staff had to forego their housing subsidy benefit. However, to make good for the lost benefit, staff were compensated with a higher salary, which is proportionate to the loss.

In the absence of an appropriate clause in the contract or a monitoring body to ensure that a benefit is not lost, or that an extra percentage is paid in addition to the annual salary increases over the years, this may be a genuine concern. DCD is revising these contracts to identify any notable disparities. The information gathered will help restructure, where necessary, future bids for municipal services.

Loss of union membership. Democracy is about the individual’s free choice of association, including union membership. However, it is noteworthy that in South Africa there was no loss of union membership as a result of a takeover by a private company. Recognition agreements were signed with the relevant unions.

Division of union membership. The division of union membership has been cited on occasions where the private sector workforce did not participate in organized labor actions. Generally, in the private sector decisions are made promptly, disputes are settled more quickly and therefore the private sector workers may see no need to participate in labor actions over matters that have been resolved with their employer. This is usually viewed as dividing union membership.

Consequences in case of contract cancellation. The general concern here is about what would happen if the contract is canceled as a result of under-performance or if the private company becomes bankrupt. DCD is committed to ensuring that amongst other conditions for participating in PPPs, only financially and technically viable companies will prequalify for submitting bids. These conditions will protect the workforce. In the event of contract expiry, the service will be awarded again on a competitive basis.

C. The Main Elements of a Labor Strategy

The four main areas of labor strategy—consultation, employee participation, restructuring, and social safety nets—are discussed here.

C1. Consultation

With municipalities. DCD regards it as vital for municipalities not only to understand the advantages and disadvantages of some aspects of PPPs, but also their impact on labor. To this end, the department will facilitate greater insight and understanding of what the labor issues are, how these can be addressed, and what the roles of municipalities will be to ensure the protection of the labor force's rights. The labor strategy must be understood by municipalities themselves. Educational programmes will be put in place, and experts in specific fields will design and implement these programs as appropriate.

With unions. Unions must be consulted at early stages about the intended partnerships. The consultation process must be open and transparent. DCD has been aware of the need for education in the use of PPPs in South Africa. It supports retention of municipal assets by the municipalities and shifting of management functions to the private sector. In this way, the private sector can be encouraged to finance the development of infrastructure.

C2. Employee Participation

It is possible for employees to participate in share ownership schemes in PPP arrangements. Private companies can reserve shares for employees on agreed-upon percentages, especially if the RFP mandates this requirement. Special financing arrangements or guarantees can be arranged by the concessionaire or through a special government-financed facility. The advantages of employee share ownership schemes include financial gains for employees, incentive for productivity by employees, and improvement of labor relations.

Possible disadvantages are corporate governance problems where shares are high or financing terms are unsuitable.

C3. Restructuring Options

The consultation process with labor must also explore restructuring options such as the following:

- **Employment guarantees.** Can be arranged for all staff affected by the private sector arrangement. Staff reduction will therefore occur through the process of natural attrition. This route will help reduce opposition to PPPs.

- **Voluntary departures.** Can be encouraged through early retirement or severance packages. While politically attractive, it may result in the departure of high-caliber staff in senior managerial positions. Also the upfront costs are usually high.
- **Contracting out to employees.** Provisions can be made to contract out specific functions of the "privatized" service to public employees. Contracting out can be used to accommodate those staff members who opt for voluntary departures. They can then be employed as subcontractors by the concessionaire. The selection procedures should be well defined and must aim to facilitate quality and efficient service provision. Empowerment through sole-source contracting for disadvantaged groups can be maximized in this manner. An advantage of this option is that it protects employees and encourages entrepreneurial skills. It can also allow for skills transfer by a competent private company, with no long-term (more than five years) guarantees required.

C4. Social Safety Net Options

These include severance packages, retraining and re-deployment support, and job creation schemes.

Severance packages. It is important that a clear severance policy is in place before the implementation of a partnership arrangement. This will allow and assist employees to make sound decisions. The benefits include:

- Employees have high economic and financial returns.
- Losers are compensated.
- Equity is provided for enterprising employees.
- Severance packages are simple to administer.

The disadvantage, however, is that severance packages require high upfront costs.

Staff retraining and re-deployment support. Staff can be trained for functions within other departments of the public sector. The staff so trained can then be deployed to other departments. This will allow for cross-transfers for those who would prefer to stay employed within the public sector. This option allows for investment in human capital and is socially and politically acceptable.

Job creation schemes. This provides temporary jobs for employees who may opt for voluntary retirement before they can venture into other business activities on their own. It also supports infrastructure development using people who have been in that environment for a reasonable time. The disadvantages include the continued dependency on public workers who themselves may have contributed to poor levels of service delivery.

D. Strategy Options to Deal with Labor

Options	Advantages	Disadvantages
Restructure first	<ul style="list-style-type: none"> • Advances settlement of labor disputes • Allows for the development of safety nets 	<ul style="list-style-type: none"> • Delays PPP processes • Serious implications if the process is mismanaged
Identify and include terms and conditions of public-private sector arrangement	<ul style="list-style-type: none"> • Pragmatic • Joint public-private decision-making and cost-sharing 	<ul style="list-style-type: none"> • Lengthens transaction process
Leave to private sector	<ul style="list-style-type: none"> • Market-based approach • Process may be slow 	<ul style="list-style-type: none"> • Political difficulties • Less attention to social safety nets • Lower scale value • Shifting of responsibilities

E. Conclusion

Public-private partnerships have a substantial impact on labor, usually seen as the important asset for the public sector. This requires that all intended transactions of municipal management functions be given comprehensive attention and that labor be involved at early stages of discussions. Absolute care should be taken to ensure that issues relating to union membership, service conditions, and possible implications of the new arrangements are investigated holistically with labor involved before decisions are finalized. DCD will strive to ensure that this process is carried out diligently to create a "win-win" end result for all stakeholders in PPPs at every municipal level.

DCD seeks to ensure that organized labor in general and employees of the relevant municipal service in particular fully participate in all policy formulation processes. In addition, the rights, obligations, and standards of labor should not be affected by the partnership arrangements. Creative and equitable approaches will be used to ensure that labor benefits, through mechanisms such as sole-source contracting, retraining, and other strategies. Strategies will be implemented to empower labor as part of the solution to the problem of improving municipal service delivery.

Training and public education on PPPs will become an important function of DCD. This will facilitate greater insight and understanding of the impact of new arrangements on labor. Stakeholder workshops will be continued to advance the participatory approach, inform and communicate the objectives of reform, review conclusions of the fact-finding mission, and deliberate on broad options for reform

SECTION III

KEY CONSTRAINTS TO MUNICIPAL PUBLIC-PRIVATE PARTNERSHIPS

SECTION III

KEY CONSTRAINTS TO MUNICIPAL PUBLIC-PRIVATE PARTNERSHIPS

Given stakeholder groups' concerns about regulating municipal PPPs in South Africa and considering international experience in this field, constraints to be addressed fall into four areas:

- Legislative
- Capacity and informational
- Institutional
- Financial and structural

A. Legislative Constraints

South Africa's current legislative framework restricts the potential for implementing and regulating municipal PPPs. Most of these restrictions can be overcome by new legislation or implementing rules and regulations. These initiatives are described in Section VI of this report.

A1. Unclear Legality of Local Public-Private Partnerships

Chapter 7 of South Africa's new constitution states, "The object of local government [is] to ensure the provision of services to communities in a sustainable manner." Clearly, local authorities are responsible for providing public services such as water supply, sanitation, and solid waste management. However, neither the constitution nor any national statute states that local governments have the right to enter into partnerships with the private sector to provide these services. Paragraph 160 of Chapter 7 of the Constitution lists the following as one of the functions that may *not* be delegated by municipal council: "the imposition of rates and other taxes, levies, and duties..." Thus, the law neither officially permits or forbids municipal PPPs. This is the justification that the Nelspruit Transitional Local Council is using for its pilot concession for water and sanitation services.

To overcome this ambiguity, it is likely that a national law will need to be drafted and enacted to specifically allow local authorities to enter into partnerships with the private sector to provide public services.

A2. Concentration of Authority within Metropolitan Councils

In several cases in South Africa, metropolitan councils have the authority to make strategic management decisions for local governments. This is the case for the larger urban centers such as Johannesburg, Pretoria, Durban, and Capetown. In Johannesburg, for example, the concentration of authority in the hands of the metropolitan council limits the abilities of member local authorities to identify and implement their own municipal PPPs. In many cases, metropolitan councils are slow or reluctant to agree to partnership projects in particular local authorities. Additionally, it is considered difficult to get metropolitan councils to allocate the resources necessary to analyze, tender, negotiate, and monitor particular PPP projects. In Pretoria, in contrast, authority is reportedly more decentralized, allowing more local authorities to initiate their own projects.

The authority of metropolitan councils is a constraint affecting a limited number of local governments in metropolitan areas. It appears that each metropolitan area will need to develop its

own strategy for dealing with this constraint. In devising ways to decentralize local government decision-making, metropolitan areas will be assisted by further regulatory developments, new legislation, readily available technical assistance, training, and demonstration projects.

A3. Inappropriate Tendering and Procurement Regulations

The current tendering regulations in South Africa are written not for the procurement of long-term concessions, but rather shorter materials and construction contracts. The Department of Public Enterprises, for example, finds that it cannot use the current tendering regulations in its preparations to sell state-owned enterprises. Similarly, the Department of Public Works, which is preparing to bid out concessions to design, build, finance, and operate prisons, finds the current tender regulations constraining.

The new regulatory framework must include implementation rules and regulations for conducting the tendering of concessions. The tendering regulations must cover both the selection of private firms to build and operate municipal services, and the selection of financing sources and advisory services.

B. Capacity and Informational Constraints

As we have seen, almost all stakeholder groups are concerned about the limited experience and capacity of local governments to prepare, implement, monitor, and enforce PPPs. However, the nature of this constraint goes beyond local governments and also beyond the issue of capacity. Limited capacity often stems from limited access to accurate information, affecting national government departments, labor and consumers, as well as local governments.

B1. Limited Capacity of the Local Government

Local authorities, in general, lack the experience and capacity to perform all of the public sector tasks required in the PPP project life cycle. This includes identifying and selecting appropriate projects for partnerships; identifying and analyzing project risks, including market risk, non-payment risk, environmental risk, credit risk, operating risk, and foreign exchange risk; structuring projects to effectively allocate and mitigate project risks; designing and drafting appropriate tender documents; evaluating bids and negotiating concession contracts; monitoring and enforcing performance by the private operator; and periodically revising contracts and solving disputes.

To overcome these, local governments will need intensive training on all stages of the PPP life cycle. They will also need access to readily available, internationally experienced technical assistance. This technical assistance will be required not only in the project preparation phases, but also during the entire term of the concession contracts—often more than 30 years.

B2. Limited Capacity of the National Government

Another constraint is the limited capacity within key national government departments to monitor the performance of a portfolio of local authority PPPs. A new national regulatory framework for municipal PPPs will require some form of informational monitoring by national government departments, such as the Department of Constitutional Development and the Department of Finance. Even though these departments may not be asked for approvals at each stage of the project development cycle, they will need to monitor the progress of projects and

ensure that lessons learned in South Africa are shared with other local authorities involved in implementing partnerships.

The new regulatory framework must be clear about what type of monitoring is appropriate by the national government, and which departments will be responsible for performing those functions. For some of these functions, national government departments will require the assistance of internationally experienced outside advisors to help advise on structuring the monitoring functions and interpreting the data and information received from local government projects. In the initial stages, some training of officials in national government departments will also be required.

B3. Local Authorities' Lack of Information on PPPs

Local governments' capacity to analyze and monitor PPPs is further impeded by their lack of information on such partnerships. While many local governments in South Africa have well-trained and capable chief executives, town engineers, and town treasurers, they do not have ready access to information on important PPP issues and questions. The usefulness of information access is emphasized by officials involved in the preparation of Nelspruit's water and sanitation concession, who noted the importance of daily access to information on how specific project issues had been handled by other governments in the past.

The information constraint can be overcome by developing a program that trains local government officials in PPP techniques. The training program can also include cataloging the partnership lessons learned in South Africa's pilot projects and making this information available to interested local governments.

B4. Labor Groups' Lack of Accurate Information on PPPs

Labor, as a crucial stakeholder, requires access to information about projects to participate in them. In the absence of readily available information about the labor impacts of partnerships, labor unions will develop their own conclusions to provide to their members. For example, because of the growing level of interest in PPPs in South Africa, the South African Municipal Union reportedly commissioned its own evaluation of a familiar international case: the water and sewerage concession for Buenos Aires. While the conclusions drawn by this evaluation may not be entirely accurate, the example demonstrates that organized labor in South Africa needs access to information on PPPs.

Labor's lack of information can be remedied similarly to that of local governments. However, labor will likely require specialized information and techniques dealing with mitigating concerns about job security. For example, a key concern voiced by labor unions is that once a municipal service is contracted out to the private sector, the local government cannot and will not ever take back the responsibility for providing the service. Essentially, PPPs are perceived as being irreversible, and as handing jobs and profits over to the private sector for good. In reality, almost all such partnerships have defined term limits and escape clauses that allow the government to take back the responsibility to provide services. For example, in Westmoreland County, Pennsylvania, water and sewerage services for the county's 400,000 people were managed by a private management contractor from 1943 until 1993. In 1993 the County Authority decided after several cost projections that it could provide the services for less than the private contractor. The County Authority retained the labor and took back responsibility for

managing services. This is an example of the type of information that should be made readily available to South Africa's organized labor leaders.

B5. Consumers' Lack of Information on PPPs

While local governments and labor unions require training and information, one of the most important stakeholder groups needing access to information on the benefits and requirements of municipal PPPs are consumers. Relative to governments and labor, consumers in South Africa are much less organized. However, for a regulatory framework to be effective, consumers must have information on the consumer benefits of PPPs. This information includes specific data comparing the tariff cost per unit for services under a partnership with the same cost under a public monopoly. Other relevant data compare the waiting period for households' access to piped water and sanitation under partnerships with the waiting period under the public monopoly. The potential benefits to consumers from these PPPs are enormous, but they can only be realized if consumers agree to pay the required costs. Therefore, consumers will also need information on why it will be important to pay their service bills to sustain expanded access and increased quality. For example, in the preparation of the Nelspruit water and sanitation concession, several affected representatives of labor reportedly became proponents of the partnership after they learned that they could have their own houses in the peri-urban areas connected with water services much sooner as a result of the proposed concession.

To overcome the information constraint facing consumers, the communication program of South Africa's regulatory framework should include a component targeting consumer groups. A special outreach initiative could provide training and specialized information on consumer benefits and requirements for groups such as the South African National Civic Association.

C. Institutional Constraints

While South Africa's new regulatory framework for PPPs will require drafting new laws and expanding the capacities of many stakeholders to participate in the process, effective institutions will be needed to implement the new framework and provide the means for local governments to use their new capacities. However, at present a number of institutional constraints remain.

C1. Lack of Institutions and Procedures to Prepare and Regulate Partnerships

Local governments currently lack the institutions to be able to identify, analyze, prepare, tender, and negotiate PPPs. Consequently, local leaders, such as chief executives or town engineers, will have to team with outside institutions, such as a national Technical Assistance Unit. However, the institutions needed to prepare and complete municipal PPP transactions are distinct from the kind of institutions needed to monitor contracts and renegotiate concession agreements over 30 years.

To overcome this constraint, the new regulatory framework should ensure that local governments are provided not only intensive short-term institutional capability to prepare and negotiate concession contracts, but also the long-term institutional capability to help them monitor contractor performance, review and renegotiate contracts every five years, and efficiently settle contract disputes. Private water and sanitation operators in South Africa fully expect to review and renegotiate long-term concession contracts every five years. Local governments must therefore be prepared institutionally to handle these important renegotiations. The new regulatory

framework should establish a municipal regulatory institution—distinct from a project preparation unit—to monitor and renegotiate PPPs throughout their 30 or more years of operation.

Another way to overcome this constraint is to help local governments train and develop contract compliance institutions within their structures. This can be achieved through developing model training program and resource materials for local government Contract Compliance Units. The cost of supporting these units can be included in the concession fees paid by the private concessionaires, when appropriate. The skills developed by these contract compliance officers can be used on several different projects at once, including water and sanitation, solid waste management, parking meter management, and many other municipal services.

C2. Perceived Risk of Crowding Out the Private Sector in Project Services

An important potential constraint centers around the design of the institutions that will embody the new regulatory framework. Just as the goal of municipal PPPs is to create a market for design, construction, and operation of public services, it is important that South Africa create a market for the variety of specialized services required at each step of the project development process. To develop such a market requires that a competitive process—rather than the creation of a project advisory monopolist—be used to appoint advisors on project selection, pre-feasibility study analysis, RFQ/RFP development, bid evaluation, and contract negotiation. Several private institutions involved in the PPP process, especially private lenders, have expressed strong concerns that they will be crowded out of opportunities to provide project preparation advisory services to municipalities if a quasi-governmental institution such as the Development Bank of Southern Africa (DBSA) is given the exclusive right to house a PPP project preparation unit. Similarly, private lenders are very concerned about the potential for conflicts of interest regarding project financing decisions: if the DBSA is providing project advisory services and is also bidding on providing project debt, it will be perceived as having an unfair advantage.

These constraints can be overcome by ensuring that a market for project advisory services is created. The institutional role of the project preparation unit ought to be limited to helping local authorities set up competitive bidding procedures for appointing advisors. Similarly, the bylaws of the project preparation unit ought to be specific about how situations should be handled where the host institution is already providing advisory services and is interested in providing project financing as well.

D. Financial and Structural Constraints

The design of a regulatory framework must consider the current state of public finance. The framework ought to consider methods to address the fact that many local authorities in South Africa either have poor credit or no established credit rating at all. It also must consider that many South Africans are either unable or unwilling to pay full cost-recovery rates.

D1. Lack of Creditworthiness of Many Local Governments

Many local authorities in South Africa either have no established credit rating or are considered to have poor credit. Regardless of its causes, this widespread lack of creditworthiness limits the ability of local governments to structure PPPs, due to the “sovereign ceiling” effect. International experience has demonstrated that unless the creditworthiness of the government counterpart institution is raised through some sort of credit enhancement strategy, lenders are reluctant to make funds available. Despite the economic strengths of a specific project, its

creditworthiness cannot counteract the effects of the local government's poor credit rating, unless some form of outside credit enhancement is introduced.

It is important that the new regulatory framework in South Africa strongly consider the implications of this constraint. Without a series of credit enhancement options, many economically strong public-private projects in financially weak municipalities will not be completed. If only the well-financed municipalities reap the benefits of PPPs, South Africa's program will be vulnerable to criticism of "cream skimming" and "cherry-picking." To avoid this, the national government and the DBSA will have to develop a series of credit enhancement techniques. These can include financial performance guarantees to back local authority obligations to pay the invoices submitted by private contractors. Similar performance guarantees from development finance institutions have worked well to strengthen the creditworthiness of municipal public-private projects in Mexico and the Philippines. However, these techniques require the willingness of the national government to honor the financial obligations of local governments under specific conditions when the latter are unable to do so.

D2. Inability of Many Consumers to Pay Full Market Rates for Services

Many of the economically disadvantaged residents in South Africa's municipalities are not able to afford the full cost of the municipal services they consume. This poses a significant market risk to many potential private investors considering long-term investments in public services. This risk is exacerbated by the continuing "culture of non-payment" for public services: not only are many consumers unable to pay, but many of those who are able are unwilling. Thus, the risk of nonpayment is added to projects already facing market risk. The new regulatory framework must develop strategies to help local authorities mitigate these risks effectively.

One strategy is cross-subsidization, by which more affluent residents, commercial, and industrial users pay higher rates per unit for the services they consume to partially subsidize poorer, economically disadvantaged users. In the water and sanitation sector, cross-subsidization will be required for almost all concession projects that plan to serve both affluent white areas and disadvantaged black areas. However, it will be important that the new framework provide municipalities with realistic estimations of how much cross-subsidization is possible for given projects. During the preparation of the Nelspruit concession, the Transitional Local Council assumed that the project would rely upon cross-subsidization to work. However, the council did not always have an accurate measure of how many of its almost 250,000 disadvantaged users it could subsidize and to what level it could subsidize them through the rates paid by its 25,000 white users.

Another set of strategies addresses the unwillingness to pay of users who can afford the cost. Since some users may be unwilling to pay because they have never received reliable public services, some projects might first begin providing reliable services for a set period before expecting users to pay. A second strategy is to strengthen local government systems for service monitoring, billing, and collection. Some local authority officials interviewed in the Johannesburg area noted that many residents in the black former township areas do not know where to go to pay their public service rates. In Nelspruit, some of the former black township areas have high collection levels among ratepayers while other, similar areas do not. The difference, apparently, is that some areas are represented by town councillors who emphasize to their constituents the need to pay their rates. Finally, many local governments will need to consider strengthening the local regulations for shutting off services to non-paying users, thereby creating an effective incentive for users to pay their rates.

SECTION IV
MARKET STRUCTURE FOR THE PRIVATE PROVISION
OF MUNICIPAL SERVICES

As in other countries, the key issue facing public-private partnerships in South Africa is: How can such partnerships be structured to ensure as much competition as possible before and after project award so that consumers have affordable, accessible municipal services?

This section reviews why competition among private sector firms generally improves productivity and discusses issues in generating competitive forces before and after contract award, including the role of a Municipal Infrastructure Investment Unit (MIIU).

A. Why Public Sector Provision of Municipal Services Is Often Suboptimal

Global experience indicates that exclusive public sector provision of municipal services is often unproductive, frustrating consumers and restricting economic growth. Most public sector entities are units of the government, without a legal corporate status, budgets, accounts, auditors, board of directors, or much sense of managerial and performance accountability. Thus, most elements of effective "corporate governance" are missing, even though public sector entities purportedly serve the public interest.

During the apartheid regime, managers in public sector entities often owed their position to patronage rather than competence. Employment policy in practice was one of "jobs for the boys," resulting in over-staffing and under-performance. Political pressure of this kind often resulted in setting prices of goods and services below true costs, especially in the gas, electricity, and water sectors. Required maintenance and new investment suffered, service to customers deteriorated, and economic growth was impaired.

Public sector entities often lack true financial accountability and seldom face hard budget constraints. If faced with losses, many are successful in lobbying government for subsidies, often their only real source of competitive advantage. In contrast, private sector managers who do not provide an acceptable rate of return for shareholders are fired, or there is a corporate takeover. In the public sector, this rarely happens. Given the contradictory objectives that public sector entities usually face, it is not surprising that performance is poor and incentives for efficient operations are lacking.

B. Empirical Evidence on the Benefits of PPPs

It has been argued that the main benefits come from greater efficiency and productivity. Free from government control and its set of incompatible objectives, PPP projects can focus on being competitive by producing, at low cost and acceptable quality, the services consumers want. This would lead to more efficient use of resources and improve economic output overall.

What does the empirical evidence indicate about the benefits of PPPs and related measures to involve the private sector in the economy? The World Bank and Boston University analyzed 12 cases of such partnerships in four countries, Great Britain, Malaysia, Chile, and Mexico. The team described their findings as "striking....In eleven of twelve cases, the gains were positive and large, amounting to an average 2.5 percent permanent increase in GDP." Benefits that followed unbundling to the private sector included an increase in investment, a rise in prices

toward levels that reflect scarcity values, greater productivity, and better marketing and diversification.

A broader study by Megginson, Nash, and van Randenborgh compared the performance of 61 companies in 32 industries in six developing and 12 developed countries before and after unbundling to the private sector. The study indicated that there were significant increases among newly private firms in profitability, output per employee, capital spending, and employment. Profitability, as measured by return on sales, increased on average by 45 percent. Efficiency was measured by inflation-adjusted sales per employee and net income per employee, and indicated average increases of 11 and 32 percent respectively for the 61 enterprises. The study also indicated that investment, as measured by the ratio of capital expenditures to sales, increased 44 percent on average. Output, measured by increases in real sales, increased 27 percent on average. The study's most surprising conclusion was that employment in the 61 enterprises actually increased on average by 2,346 employees, or 6 percent, following unbundling.

A range of related studies on municipal PPPs indicates that the average cost of services decreases by about 30 percent after the private sector becomes involved, with equal or better levels of service.

C. Competition and Unbundling

The efficiency and welfare gains from PPPs, though, need a closer look in those cases involving partnerships with integrated monopolies, such as telecommunications, power, water, gas, and transportation. Since private sector involvement in integrated monopolies alone will not automatically increase competition in these sectors, governments must consider unbundling parts of the monopoly state-owned enterprise, that is, identifying the segments of the monopoly that are potentially competitive (such as power generation for a power company) and promoting new entry and competition by the private sector in these segments.

Yet to investors an integrated monopoly will generally be more attractive than an unbundled monopoly. The government, in its desire to gain revenues from PPPs, may therefore decide against unbundling and sell off the monopoly at a premium. However, over time the loss in efficiency to the economy will outweigh any short-term gain from greater revenue.

D. Competition for and in the Market

It has often been thought that many municipal services were natural monopolies. Consequently, government control and provision of municipal services were deemed necessary to safeguard the interests of the consumer. However, empirical evidence, discussed above, indicates that when government provides and controls services, it often does so inefficiently. Moreover, when these services are opened up to the private sector, efficiency and productivity increase and accessibility, affordability, and quality improve.

D1. Competition for the Market

Enabling a private sector company to provide municipal services will not *ipso facto* benefit consumers. Early in a PPP program, many governments fail to consider all the possible providers of services and, for one reason or another, select—often without competitive bidding—a provider that may not be able to offer the best service at lowest cost.

Municipalities that award PPP concessions to the private sector should generate as many competitive bids as possible so that the municipality may choose that firm (or firms) that best meets its needs. The criteria for evaluation of bids include technical capability, track record, quality of service and cost, as well as other factors that may be of local importance and sensitivity, such as how labor will be treated in the transition to private sector service provision. The key to generating competitive bids is proper project identification, structuring, tendering, marketing, evaluation, and negotiations. These activities, in fact, are at the heart of what an MIIU does (see Section V of this report).

For example, in Nelspruit, one of the initial pilot projects for South Africa's PPP program, a RFP was developed that attracted the interest of seven potential bidders for a municipal water partnership, including many well-known international firms that specialize in water PPPs. These results will strengthen the hand of the municipal authorities and ultimately the users of these services in Nelspruit, as the evaluation and negotiation process unfolds.

D2. Competition in the Market

It is often thought that once a PPP project concession is granted, it is difficult to generate competitive forces to reduce costs and keep services at a high level during the concession period; the only means to protect the consumer is through post-award regulation. However, while governments, especially the MIIU, identify and structure PPP projects they, can often structure a market for these services that ensures competitive forces remain strong during the concession period. For instance, the MIIU can work with municipalities to identify multiple services zones and award contracts to multiple services providers. This will stimulate indirect or "proxy" competition after the award so that the private sector provider has an ongoing competitive environment and challenge to keep costs low and standards high, while expanding services to those who currently lack them.

In providing solid waste collection, a municipality such as Johannesburg could divide into several different service zones and choose different private sector contractors. This implicitly creates competition among the contractors because they know that the municipality will monitor their performances to see which ones are performing well and which are not. Depending on how the tender is structured, it also allows for the possibility that if one contractor falls well below expectations or defaults on contractual obligations, it could be replaced by another contractor with minimum disruption in service. Such an arrangement strengthens the hand of the municipality in using the private sector to better ensure that constituents have affordable, accessible services.

Municipal bus service is another area suitable to ongoing competition in the market. Different bus routes can be identified and tendered to different contractors. This strategy again provides for ongoing competition among private sector contractors to provide good quality at low cost.

In large municipalities, the provision of water services can also be awarded to multiple private sector providers covering different geographical areas. The size of the contract areas is a consideration in deciding the extent to which this strategy can be used. For small municipalities, it may not be feasible to divide a limited market into different service zones. In these cases, pre-award competition for the market will take on special importance, since post-award competition will be limited, and regulatory provisions and structures will have to carry more of the burden in ensuring that consumers receive good quality and low cost.

With multiple contracts for different service zones, it is possible and sometimes desirable for the existing public sector provider to compete for one of the contracts. In fact, the creation of such competition between public and private providers has been shown to dramatically improve the performance of the public sector providers because they are faced with competition for the first time. Of course, it is important that public sector providers do not benefit unduly because some of their costs, such as employee benefits, are covered by budget line items not directly reflected in the cost of doing business. This would be tantamount to a hidden subsidy by the government to the public sector provider of municipal services. But assuming that a level playing field exists, there is no reason why an existing public service provider should not be able to compete for the right to provide municipal services.

SECTION V
INSTITUTIONAL ARRANGEMENTS FOR A MUNICIPAL
INFRASTRUCTURE INVESTMENT UNIT

This section summarizes the main points of international best practices that are relevant for South Africa in designing and implementing public-private partnerships and establishing a Municipal Infrastructure Investment Unit (MIIU).

A. International Best Practices for PPP Technical Units

Certain practices are deemed “best practices” because they create the means to provide consumers with the lowest-cost, highest-quality municipal services possible. Some of the costs involved in developing PPPs are beyond the control of government. However, most of the costs can be reduced or managed through effective legal, institutional, and regulatory procedures and operations.

A legal, institutional, and regulatory infrastructure must be designed to:

- Clarify the responsibilities and authority between and within national and local government agencies that will identify, review, evaluate, and approve PPPs.
- Develop effective procedures that streamline the process of project selection, approval, and monitoring.
- Develop legal, institutional, and regulatory capacity within a PPP technical unit so that the unit has the authority to facilitate professional and transparent treatment of investment proposals, both solicited and unsolicited.
- Build on the lessons of experience to standardize requirements for project preparation, such as model RFPs and other project documentation.

To date, the best PPP practices are those that have recognized the complexity of the process and the requirements of the investor and financial community to structure bankable, cost-effective proposals and transactions. For all parties, transparency is an important objective, as it reduces uncertainty, assures developers and consumers that the process is fair and competitive, and establishes credibility for future and more systematic transactions. The legal, institutional, and regulatory framework should reflect the stages of a PPP project:

- Project identification and conception.
- Project analysis (financial, technical, economic, environmental).
- Bidding and tendering.
- Contract formulation and negotiation.
- Financial engineering and closing.
- Project implementation.
- Project regulation or contract monitoring.

B. Establishing a Municipal Infrastructure Investment Unit

In reviewing international best practices, the Department of Constitutional Development (DCD) has, in collaboration with other key groups, proposed that a Municipal Infrastructure Investment Unit be established to assist local governments implement municipal PPPs. The MIIU will be demand-driven, with all assistance targeted to municipalities and their communities. The role of the MIIU is to ensure that the partnership process is well managed in the interests of both public and private sectors and facilitate investment in municipal infrastructure. The MIIU will work to stimulate a market for the provision of technical assistance to municipalities. Operationally, the MIIU will assist in preparing project proposals and offer funds to hire local consultants for this purpose.

Design and structure. It is envisioned that the MIIU will consist of the following three components:

- A board of trustees with a broad oversight and policy role and a specific fiduciary duty with respect to the grant fund. Trustees will include representatives from the Department of Finance, DCD, the Development Bank of Southern Africa (DBSA), private sector financial institutions, the donor community, and local government.
- A grant fund, seed-funded by government, which provides direct assistance to municipalities for the preparation of projects involving private sector funding.
- A Project Preparation Unit (PPU) to serve as the operational core of the MIIU. The unit will process applications and manage the grant fund.

The proposed organization of the MIIU is shown in Exhibit V-1.

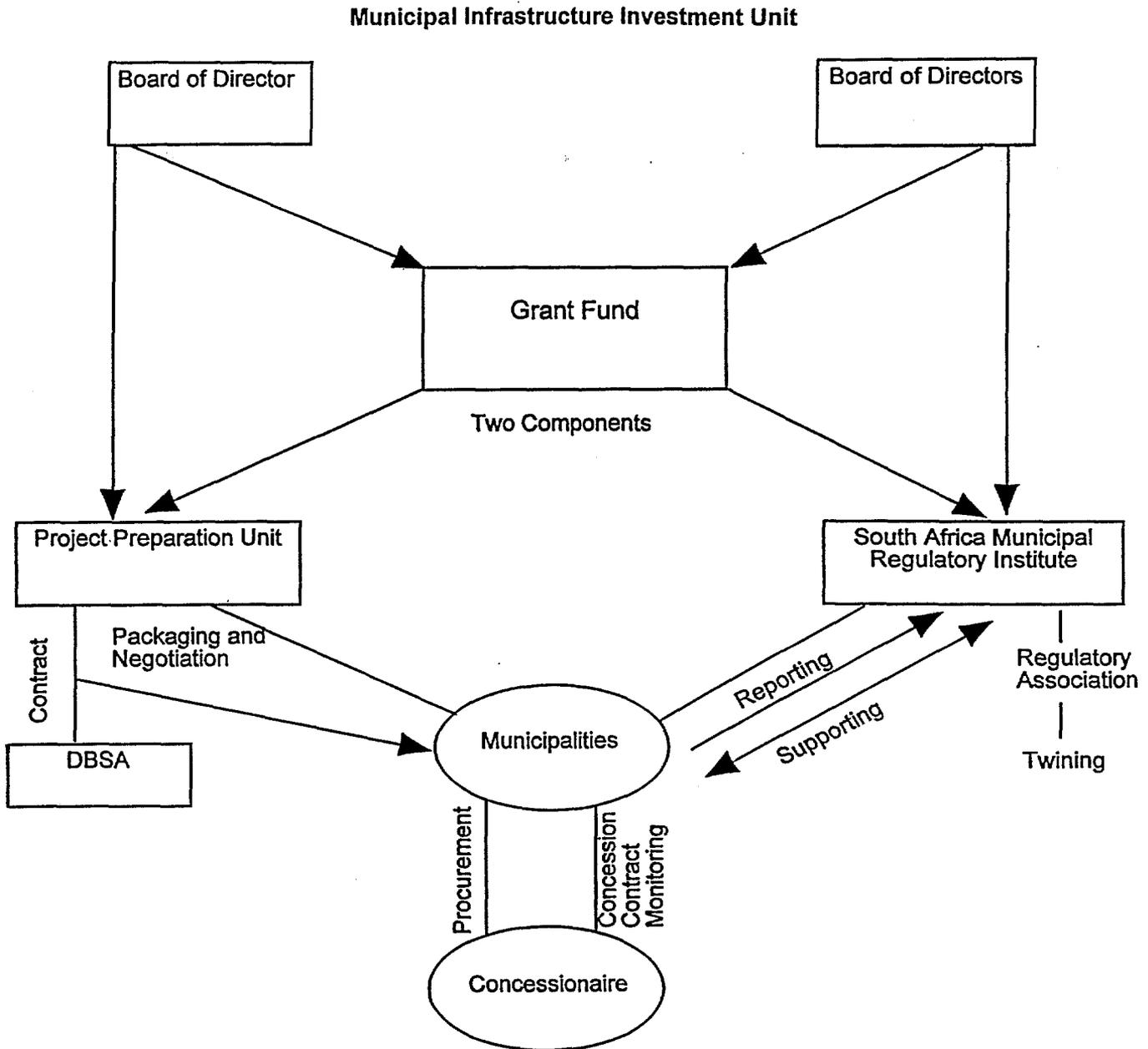
The PPU will work with local governments to oversee and manage the hiring of appropriate expertise for the preparation of project finance documents for private investment. It will provide grant funding to local authorities to hire project preparation assistance from the private sector; help local authorities in the process of hiring private sector advisors, where necessary; and help local authorities to manage contracts with private sector advisors, where necessary.

The DBSA will provide an initial institutional base and core management support for the PPU. This function will be performed on a contractual basis, and remunerated from funds set aside for this purpose within the grant fund.

The grant fund will serve as a financial resource for municipalities seeking to hire consultants to prepare project finance documentation and RFPs. In effect, the grant fund serves as a project preparation fund for local authorities that are preparing documentation for private capital for PPPs. The board will initially establish the operating procedures for the fund. Day-to-day management, application processing and approval, contracting oversight, and the collection of the fund's resources will be the responsibility of the PPU. DCD is committed to capitalizing the fund, and a number of donors have expressed a strong interest in providing additional grant resources.

Exhibit V-1

Framework for Municipal Privatization and Regulation



1. Regulate by contract
2. Support in regulatory analysis and monitoring
3. Monitor officer paid for as a % of sales of concessionaire
4. NMRI provides review in regulatory cases
5. Binding arbitration

The MIIU is conceived of as a medium-term (five years) intervention to develop a mature market for technical assistance to local government. Over the long term, technical assistance to municipalities to assist in packaging infrastructure projects for financing should be provided by the private sector, and the costs of such technical assistance recovered via successful contracts.

C. Principles, Objectives, and Activities of the MIIU

International best practices reveal that of critical importance for PPPs is the quality, clarity, and political authority of the *guidelines or regulations* governing the process of bidding, award, and monitoring. To date most successful PPP programs are those that produced guidelines or regulations that promote clarity, reliability, regulatory certainty, and competition for the market in a given sector, with or without overarching PPP legislation.

By providing transparency in all phases of the PPP project life cycle, governments are more likely to attract a higher number of competitive bids, provide confidence to lenders and other financiers that long-term financial and performance commitments will be honored, and give the public the sense that the process is fair and will withstand scrutiny.

Transparency does not always require international competitive bidding, however. Under certain circumstances it may be appropriate for the government to entertain unsolicited proposals or conduct limited tenders or direct awards. By formalizing the unsolicited or limited tender process and ensuring adherence to standards, transparency can still be achieved.

Best practices such as the development of guidelines and procedures are necessary but not sufficient. PPP award can be a one-time occurrence. However carefully this event is conducted, continual project oversight is generally required to ensure that contract terms are being met and that unexpected effects are not interfering with societal concerns. Such ongoing oversight involves developing regulatory capacity and institutions to balance the interests of investors and consumers. As with contract award, the process—and hence transparency and accountability—of regulation is at least as important as its technical features. Countries that have concluded seemingly successful PPP projects and awards, yet have still to develop the PPP monitoring or regulatory function to ensure compliance, have only made partial progress.

The MIIU, composed of a small cadre of officials and the capability to outsource technical assistance as needed, would be guided by the following objectives:

- Develop the technical capacity within municipalities to identify, analyze, implement, and monitor successful PPPs.
- Ensure that candidate projects meet established socioeconomic, technical, and environmental criteria and promote competition where possible.
- Ensure that proposed projects conform to program guidelines and governing acts and procedures.
- Build the inventory of municipal services projects that can be implemented by PPP techniques.
- Promote and market PPPs in South Africa and abroad.

- Structure and match projects with potential sources of finance, commercial and concessional services, to leverage infrastructure development resources.
- Monitor and evaluate approved and implemented projects.

D. Identifying and Processing PPP Projects in Municipal Services

In accordance with international best practices, DCD believes that the typical skills required for the PPP Technical Unit would include legal, financial, economic, and technical (engineering and skills in water, wastewater, solid waste, municipal transportation, etc.) The staffing of this unit, and its strategic use of technical assistance outsourcing, should be driven by the goal of achieving a cohesive, "lean and mean" staff that can provide the following activities and services to municipalities in South Africa.

D1. The Master List

Identifying viable PPP projects plays a vital role in determining the future of the entire PPP program: It is the foundation upon which the entire pyramid rests. Unless the pyramid is broad enough, with a suitable number of candidates, there will be an insufficient number of projects at the "top" that are fully studied, bid out, evaluated, negotiated, and constructed. More important than quantity, however, is the quality of the projects identified to be structured on a PPP basis.

The first step in project identification is to develop a project master list for a municipality, especially one that is unfamiliar with the PPP process. This list of candidates is developed through the collection of data, consolidation of existing feasibility studies, and analysis of sectoral candidates from the water, waste management, transportation, and other municipal service sectors.

D2. Unsolicited Proposals

DCD believes, in accordance with best practices, that one of the best methods to ensure identifying the maximum number of quality municipal infrastructure projects is to invite private sector firms to identify PPP projects and present them to South Africa's MIIU and the relevant municipal authorities. This technique can significantly enlarge the number of project candidates that are fed into South Africa's inventory of PPPs. This involves the acceptance of unsolicited proposals from the private sector to undertake PPP projects. It is vital for the success of the PPP program to provide an opportunity for the private sector to identify and structure projects on their own initiative. This is in recognition of the fact that the private sector proposers may have better "bottom line" cost control capability, knowledge of new technologies, or special insight into market solutions to development problems than municipalities or even the MIIU.

Sponsors of an unsolicited project are urged to discuss it an early stage with the MIIU and municipality. If the unsolicited project is consistent with PPP guidelines, and if the sponsors are prepared to proceed with the development of a detailed proposal, the MIIU will provide the sponsors with a terms of reference (TOR) for proposal requirements. This TOR will give more detailed guidance on the sectoral specifications and requirements that any proposal must meet to advance to the next phase. Additionally, guidance will be given on the format in which the proposal shall be submitted.

At this stage the PPP Technical Unit will provide the proposer with a letter acknowledging and thanking the proposer for the submission and will, in cases where the proposer's project meets the evaluation criteria, provide the proposer with a TOR to prepare a detailed proposal. Next, to promote program transparency and integrity, the MIIU will announce through public notice that the government has received a proposal and has offered the proposer a TOR to move to the second stage.

The issue of the TOR, letter of acknowledgment, and public announcement do not represent in any way a commitment by the municipality or the MIIU to the proposed project. Only until a final and more detailed proposal is evaluated and approved will the government provide the proposer of an unsolicited project with a letter of intent. Procedures should be in place that lay out the terms of both parties in the event that the project does not advance to a letter of exclusivity, and re-bidding must be undertaken.

D3. Project Screening and Analysis

If the project identification process forms the foundation of the PPP "pyramid," then the project evaluation process determines the slope of the pyramid's sides. The two most important elements of the project evaluation process are: 1) screening out projects that are not economically important or environmentally feasible, and 2) structuring projects to become financially more attractive to the private sector. Thus, the MIIU can help South African municipalities to avoid PPP projects that are not viable, while at the same time undertaking beneficial projects that require some structuring to become viable.

Because projects will require significant levels of effort during the project development and negotiation stages by both municipalities and private investors, the project screening process must be effective at ensuring that only projects with a high potential for success—financially, technically, legally, and environmentally—are developed. Therefore, the objectives of the PPP project screening process should be comprehensive and specific.

The objectives of PPP project structuring in South Africa are to:

- Initiate projects that are already economically and developmentally important for municipalities and structure them to be financially more attractive to the private sector investors and operators.
- Produce guidelines for effectively and equitably allocating risks among all of the parties to the PPP project. These guidelines could include arrangements and clauses to deal with PPP contracts, project completion and turnkey contracts, and "take-or-pay" arrangements and guarantees.
- Ensure that projects that are economically important and financially attractive are also environmentally sound.

D4. Preparing Tendering and Bid Packages

The projects selected from the previous stages that have met or exceeded the technical unit's "litmus test" of project candidacy will be prepared for tendering. In this activity, the Project Preparation Unit, working with municipalities and outside technical assistance providers, will plan, design, draft, structure, and package tender documents for competitive bidding.

The tendering package is the principal instrument for the government to solicit serious private sector proposals for infrastructure projects. It is typically comprised of a completed project prefeasibility study, the invitation for bid proposal describing the evaluation specifications established by the municipality and the PPU, financial and economic parameters, a legal package, environmental requirements, and a model PPP agreement and criteria for evaluation.

D5. Bid Evaluations

After bids have been received, the municipalities, and the PPU on an as-needed basis, will evaluate eligible bids. The technical unit will need to develop the bid evaluation criteria and standards in compliance with the PPP program guidelines.

D6. Negotiations

After the bid evaluation, the municipality, with support from the PPU, will engage the leading bidder or bidders and begin negotiations. Negotiation activities will include not only project award terms and conditions but, in some cases, result in the granting of agreements such as letters of intent or memoranda of understanding to the successful proponent to either commence construction or conduct full feasibility assessment.

D7. Public Awareness

International best practices strongly indicate that a fundamental element of any PPP initiative is promoting an awareness of and support for private infrastructure within the bureaucracy, business sector, and general public. The public awareness element of the PPP process will consist of several efforts to disseminate information about the objectives, rationale, and benefits of PPPs in municipal services and infrastructure development.

The primary objective of this component is to disseminate information about the program, using a variety of media, to the general public about PPPs in municipal infrastructure. This effort should result in a greater awareness of and support for the benefits of private infrastructure in South Africa. The communications effort will also convey information regarding the procedures of the program so as to preempt any confusion about the process, especially the bid award and negotiation process, the point at which criticism about the merit of awards is typical. This is an activity that the MIU should contract out to relevant firms with skills in public relations and mass communications. The substance of the public awareness should be determined by the MIU.

The MIU will also be responsive to the concerns and questions of individuals or communities who may be affected by the program or by individual projects. This ombudsman role is part of the process of consensus-building and communications, especially among key stakeholders. Such consensus-building promotes awareness, consensus, and support for the program within the government bureaucracy itself. This component aims to include, to the fullest extent possible, the relevant ministries, departments, and agencies within government and key stakeholders such as labor and unions to ensure cooperation and involvement. Without their participation and awareness, the program could suffer.

The second objective is to ensure that local participation and input of South Africa citizens is maximized at all project stages. Vital to success is the support for and understanding of functioning municipal services provided by PPPs.

D8. Marketing

International best practices underscores the fact that without an effective marketing strategy, local and foreign investors will seek opportunities elsewhere. Additionally, attracting the maximum number of credible bids from local and foreign sources protects the long-term interests of municipalities and the public.

The objective of this activity for the technical unit is to generate the highest number of competitive bids from the broadest possible community of bidders, including local and foreign investors and operators. The MIU will need to develop capacity in private infrastructure promotion and marketing.

An additional constraint the MIU will need to overcome is the relatively low level of local capacity among the emerging South African private sector to participate in infrastructure project development. Currently, the emerging private sector does not have the market information, size, and financial stamina to undertake many projects of scale. The MIU intends to seek creative ways to empower the emerging private sector, which historically has been denied opportunity to participate fully in the economy, to participate in the provision of municipal infrastructure without compromising other objectives such as efficiency and affordable, accessible municipal services.

Marketing not only enhances the likelihood of receiving the highest number of competitive bids for projects, but also can serve as a link between local and foreign partners. The MIU marketing activities to be undertaken should promote informational and commercial exchanges so as to ensure local and foreign collaboration in as many projects as possible.

E. Developing Professional Capacity

For the MIU to undertake the preceding activities, it will be necessary to recruit and train staff for core skill areas: finance, economics, legal, procurement, project development, and sector specific skills. The MIU will not have all of the required skills and competencies to undertake needed tasks; rather, it will outsource most of these. At the same time, it will take a pro-active stance, through targeted training on the principles and practices of PPPs, to create capacity and empower segments of the population that have historically been denied an opportunity to participate fully in the economy.

E1. Quality of Staff

It is imperative to recruit from within and outside government the best and brightest to have professional staff of a quality equivalent to any other government agency. In some instances, a PPP program could be responsible for assisting in the development of hundreds of millions of dollars of projects representing untold savings in government expenditures and providing services to millions of people. The sense of responsibility should be enormous, and the staffing of the MIU and the technical assistance consultants selected, should reflect this responsibility.

E2. Flexibility in Staffing

Quality does not necessarily require quantity. The last thing a high-level economic policy implementation unit should be is another layer of bureaucracy. The MIIU should be lean, focused, and expandable, capable of fairly and rapidly outsourcing technical assistance.

E3. Training

Regrettably, most officials responsible for PPPs in developing, emerging market, and former socialist nations did not receive early training in such partnerships, nor did they anticipate that they would require it as much as they do.

The countries that successfully implemented PPP projects in the last five years and those that will successfully implement them in the next five will have at least one thing in common: small but capable staffs well-trained in the variety of important technical and political issues.

F. Financing Mechanisms

Financial needs are twofold:

- Will there be sufficient financing to provide municipalities the necessary assistance from the MIIU to bring PPP projects to the tendering, evaluation, award, and monitoring stage?
- Will financing be available, either from foreign or domestic sources or both, to support a wide range of municipal PPPs in South Africa?

On the first point, the MIIU has specifically been structured to provide financing for pilot PPP projects, whose lessons and techniques can be transferred to municipalities. The grant fund will serve as a grant facility for municipalities seeking technical assistance to undertake the PPP process for projects in the municipal sector. In effect, the grant fund serves as a project preparation fund for municipalities. The board will initially establish operating procedures for the fund. Day-to-day management, application processing and approval, contracting oversight, and the collection of the funds will be the responsibility of the PPU. Cost sharing with the municipalities' own resources and competitive bidding will be key elements in the design of the fund. As far as possible, grants from the fund will be blended with municipalities' own resources and the municipalities will recover their own costs by including these in the bid proposals. DCD is committed to capitalizing the fund, and a number of donors have expressed a strong interest in providing additional grant resources.

On the second point, DCD is optimistic about the prospects for financing municipal infrastructure projects in South Africa (although this will obviously depend on the particular project and its terms and conditions). Ongoing dialogue with the banking, business, legal, and international sectors indicates that finance is not a constraint per se to South Africa's program of municipal PPPs. South Africa has a well-developed banking system and, because the rand is relatively strong, has acceptable foreign exchange risk. Capital flows relatively freely in and out of the country. These two factors alone give it a significant competitive advantage over many other emerging market countries. Our discussions indicate that financing can be found for attractive projects, as long as they are properly identified, tendered, and awarded.

Financing for PPP projects is especially challenging: Projects tend to involve large sums of money, are highly leveraged (i.e. the ratio of debt to equity is high), and are of long duration. PPP projects tend to draw on the main components of the financial markets and require that each be relatively developed and competitive: the equity markets, the banks, and possibly the bond markets.

In an emerging market country, there are additional challenges to raising finance for a project. PPP projects quickly uncover any inadequacies of domestic capital markets. South Africa's financial and capital markets are relatively well developed. Still, in view of the large amounts of capital required to bring municipal services up to acceptable standards, many PPP projects will need to seek foreign investment as a part of the financing package.

However, the availability of foreign investment, for both debt and equity, is often limited because of concerns about country risk and a variety of investment restrictions. In PPP projects, the project sponsors will typically commit a certain amount of equity to a project, and seek other equity partners. This equity usually comes from foreign sources, although occasionally some local equity can be raised. The key is to raise debt finance: these projects are highly leveraged, implying that the majority of the finance—typically 70 percent and higher—is in the form of debt. For many municipalities in South Africa, debt finance at the level required for PPP projects is not available from purely commercial resources. Although the debt crises are perceived to be in remission in most countries, levels of foreign debt remain high for many countries, and concerns about country risk remain.

Worldwide, many PPP type projects have been financed—that is, have secured debt finance—through a special window for commercial banks under the aegis of the International Finance Corporation, which also commits its own financial resources.

Another important source of concessional finance, which should be directed to pilot projects, is the World Bank. The Bank can create onlending mechanisms to support individual PPPs on a non-recourse basis.

SECTION VI
ELEMENTS OF A STRATEGIC APPROACH TO REGULATE
PRIVATE PROVIDERS OF MUNICIPAL SERVICES IN SOUTH AFRICA

Section V summarized the structure for planning and implementing municipal public-private partnerships in South Africa, including a Municipal Infrastructure Investment Unit (MIIU) to bring private participation and competition into the municipal sector and support identifying and analyzing viable pilot projects. This section addresses the regulatory features of such a program, analyzes a range of possible regulatory models to oversee competitive service delivery at the municipal level, and proposes a model for South Africa to adopt.

The Department of Constitutional Development (DCD) is aware that international best practices must be followed if the South African program is to succeed. In addition, conditions unique to South Africa must be acknowledged in the efforts to design regulatory strategy and framework.

A framework that supports the development, structuring, financing, and tendering of viable municipal PPP projects is not sufficient by itself. In addition, a sound, flexible regulatory framework and set of clear procedures for oversight of the market post-award must be put in place as soon as possible. Often referred to as “regulation of the market,” this framework should assure consumers and public sector agencies that municipal services will be efficient, high quality, and competitively priced. Moreover, an effective regulatory framework provides investors and financiers the clarity and security that they seek to ensure a “reasonable or risk-adjusted” return on investment. By offering all parties transparency in the regulatory setting, transaction costs and uncertainty can be reduced, thereby greatly facilitating the “win-win” merits of partnerships.

However, the design and implementation of the post-award regulatory framework entail several critical decisions in South Africa and will require consensus and capacity building initiatives immediately. Development of a regulatory framework must consider a number of factors, many of them identified and discussed with stakeholders (see Section I) during the diagnostic study.

A. Regulatory Gaps Exist

While no explicit prohibitions to municipal PPPs exist in South Africa, there are a number of regulatory gaps. With the rapid consolidation of the new South Africa and emergence of new legislative initiatives, several potential regulatory contradictions may affect PPPs. For example, the proposed Water Services Act, in its present form, may contain clauses that contradict or undermine other enabling legislation. While a more thorough review of the body of laws and regulations relevant to PPPs must be performed as soon as possible, here we present the “gaps” to be addressed in the development of a more coherent regulatory regime.

A1. What Are the Regulatory Norms for Municipal PPPs?

Currently, no structured or transparent set of regulatory procedures is in place to govern municipal PPPs in South Africa. Within and between sectors such as water, wastewater, solid waste, and urban transport, consumers, investors, and municipal officials are not in full agreement on a variety of matters. While some ad hoc transactions have been successfully

implemented (based on early indications of performance and customer satisfaction), such as Benoni Fire and Ambulance and Queenstown Water and Sewerage, the majority of future transactions will suffer without clear procedures and standards in place. Consumers, investors, and unions all want to know the basis for regulatory decisions, such as determination of tariffs, accountability and feedback mechanisms, and dispute resolution procedures. Moreover, the lessons of success and failure must be disseminated to other units of local government, so that the legal and regulatory framework will represent the experience to date from both the progress and the weaknesses of the initial ad hoc projects.

A2. Law on Procurement Insufficient and Not in Accordance with Best Practices

The current legislation on procurement and the use of tender committees is based on the traditional role of government purchasing goods and services such as office equipment, construction services, and vehicles. It does not, in any way, reflect the complexity and strategic nature of procuring private infrastructure services. Issues such as minimum standards and specifications in the bidding documents, bid and tender strategies, prequalification, evaluation criteria, financial engineering, negotiation, and many of the sensitive issues unique to PPPs must be transparently addressed in law or regulations. Conversations with several parties active in the initial transactions to date, including Benoni Fire and Ambulance Services, Queenstown, and Nelspruit Water, indicate that due to the inadequacy of the current procurement regulations, separate and additive standards were followed. This independent "make it up as you go" approach, while perhaps understandable for the initial project or two, will not stand the test of time as consumers, developers, financiers, and government require fair, open, and standardized procurement approaches. Bid and award procedures and outcomes must be defensible and based on best practices lest the process lose legitimacy. For example, in Brazil the absence of a law on public bidding for infrastructure projects stifled initiatives to unbundle water and wastewater services. Due to the lack of clarity in the legal and regulatory framework, investors were more interested in participating in other investment opportunities in infrastructure at the national level. After a year, Brazil passed legislation on concessions as well as a law on public bidding, which integrated and harmonized the respective rights and obligations of all parties in the process. This for the first time established the procedural steps and legal rights of the participants in municipal concession projects. More than 10 projects have since been implemented using competitive and transparent bidding. A similar process is likely to be necessary in South Africa.

A3. Solicited and Unsolicited Proposals

The advantages and disadvantages of competitive bidding are well documented and DCD is aware of the lessons learned from other countries. In South Africa at the local and national level, competitive bidding best practices have not always been used and the submission of unsolicited proposals has been used to form the basis for a competition. It is feared that this practice will continue, and that consumers and investors alike will eventually protest the lack of procedure and transparency, thereby undermining an otherwise worthy effort. The question facing South Africa is not so much whether unsolicited proposals or direct selection should be permitted but, rather, what is the process governing limited bidding. A formal policy and regularized program showing the why, how, what, and when of solicited and unsolicited bids must be established so that all local governments are using best practices, the market is encouraged to use risk and innovation without fear of losing proprietary rights, and consumers know the basis upon which service is being performed by private providers. This is a regulatory issue because of the downstream impact of non-competitive bids or projects by the private sector that are not congruent with the needs of the municipality. Once a standardized bidding procedure is in place, regulators and

monitors will be in a better position to determine compliance and take the required enforcement steps.

DCD believes that South Africa should examine the municipal privatization programs in Brazil, Philippines, Malaysia, and Chile, where competitive bids are required of all municipalities seeking to unbundle public services. However, in the event of special circumstances (such as prior agreements, unique and advantageous approaches, lack of response from private firms, or other established and published criteria), unsolicited proposals and direct selection could be allowed. The procedures should also stipulate how the municipality retains the right, in the event of an unsuccessful negotiation over a specified period of time, to rebid or renegotiate the project with other qualified bidders and what, if any, financial or other compensation is owed to the original developer.

A4. Fiscal and Other Incentives

What can or should be offered? What are the tradeoffs and limits; does each municipality have the flexibility to be creative and resourceful? Is there any recourse to national government?

Both a policy gap and a regulatory gap exist in the commitment to provide fiscal incentives to facilitate projects at the municipal level. This is a critical issue in South Africa, where, in a recent workshop conducted by DCD, the liquidity of scores of municipalities has come into question and the resources available from central government to pass through to local governments are limited and increasingly unavailable. If the creditworthiness of South Africa's municipal governments and the ability of the consumer to afford commercial tariffs are in question, the investor and its lenders will price these risks accordingly. The unfortunate result may be a higher than expected cost per unit offered in the bid. This higher pricing will affect non-core municipalities in particular, many of which are financially strained and less well-off than the larger municipalities, often referred to as the "top 25." While project structuring and credit enhancement techniques can be applied to these projects to make them more attractive, the use of fiscal incentives by municipalities to attract more risk by the private sector to leverage private finance is useful and, in some cases, vital.

Fiscal and other incentives such as tax exemptions, rebates, in-kind contributions, depreciation incentives, income credits, environmental credits, and other instruments can strengthen a project's financial viability without placing a strain on municipality balance sheets or raising tariffs. The leveraging of private finance hurts local government finances by reducing fiscal revenue, but these effects are more than offset by shedding financial and overhead expenses to the private sector. However, each municipality must be careful when entering into such contracts and must require operating principles and guidelines on offering incentives to attract greater private sector risk. In South Africa, fiscal and other incentives at the municipal level could effectively transfer risk and respond to calls for direct financial guarantees, which ultimately are transferred back to national government. The scale and scope of fiscal incentives that municipalities could and should employ must be embodied in guidelines and additional regulations.

A5. Performance and Financial Guarantees

What forms of guarantees, if any, are to be provided by municipalities or national government? Is there recourse to national government? Do municipalities have the track record to make good on payments or guarantees?

This is a critical regulatory and policy gap to be addressed in South Africa. Around the world, public and private bodies have negotiated municipal concession agreements whereby the national or local government provides performance or financial guarantees to support, on a contingent basis, the payment or revenue of a project. While contingent guarantees are an improvement on sovereign guarantees where risk is still borne entirely by the public sector, the inappropriate use of contingent and performance guarantees can undermine the risk-reward dynamic so often cited as the driving benefit of PPPs in the first place. To date, financial contingent or other guarantees have not been used in South Africa. On the other hand, performance guarantees have been and will likely continue to be provided in cases involving third-party providers or participants. Increasingly, financial guarantees are viewed as unnecessary if fiscal incentives and credit enhancement schemes can be developed to mitigate the need for direct financial guarantees. Efforts to create contingent mechanisms for some aspect of the revenue stream or non-performance can also be developed to enhance project viability.

From a policy and regulatory perspective, all municipalities and projects should be supported by terms no less favorable than the other. Best practices and determining how far local governments can go to provide the greatest amount of risk sharing must be communicated through operating procedures and implementation guidelines: in effect, as part of a regulatory act.

Other best practices that could be incorporated in such guidelines or in a regulatory act would discourage cheap finance that ultimately represents a government subsidy, require minimum levels of equity by operators, and limit the sale or transfer of assets or concessions to passive investors. Without regulatory guidance on the scope and scale of performance and financial guarantees provided by local and national governments, project transaction costs will be higher than necessary and best practices may not be followed by each municipality and with each transaction.

A6. Credit Enhancement Facilities

What types of credit enhancement instruments are available? What types of projects should receive credit enhancement and on what criteria? Should national government make resources available to certain projects on a credit enhancement basis? What are the criteria for credit enhancements and do they represent a claim on national government?

Credit enhancement techniques and strategies can make the difference between a bankable project and one that does not qualify for advancement. Credit enhancement techniques such as on-lending, subordinated debt, contingent cover, grace periods, in-kind contributions, longer concession periods, and soft finance have been used in several countries to improve a project's financial viability without inefficiently redistributing risk. However, credit enhancement often starts with a government decision or obligation and therefore must be well coordinated and scrutinized. In the absence of a formal facility such as a private sector infrastructure development finance facility (such as those in the Philippines, Colombia, Jamaica, Pakistan, and Sri Lanka, which provide broad credit enhancement resources to eligible projects), policy and regulatory decisions must facilitate credit enhancement in South Africa. Several issues must be examined in addressing credit enhancement policy and regulations: Which projects are eligible and on what basis is credit enhancement used? Should municipalities have the authority to agree to credit enhancement schemes even though some national-level resources may be involved? If so, what form of approval and review must national government undertake to ensure that excessive commitments are not made? Should the Development Bank of Southern Africa be the focal point

for credit enhancement activities, including on-lending soft money to projects to capitalize contingent or subordinated debt funds, or help municipalities structure projects using credit enhancement resources? If not, what agency or other focal point in government or the private sector should make these commitments?

Without an organized approach to credit enhancement strategies, the regulatory burden on the proposed regulatory institution will increase as tightly structured and highly leveraged projects are undertaken.

A7. Regulatory Overlap and Coordination of Responsibilities

Municipal regulation of PPPs in South Africa involves financial regulation, safety and health regulation, and quality/performance regulation. There are also a number of other quasi-regulatory responsibilities and requirements to be met before project approval and award. In the absence of clear and overarching regulations, substantial overlap and inefficiencies can be encountered. Reinventing the current legal and regulatory framework to reduce overlap and redtape will be an important part of establishing a modern, effective regulatory regime for municipal PPPs. A critical objective is to minimize regulatory and administrative overlap within national, provincial, and local government.

A8. Coordination

It is essential that national, provincial, and local agencies act in accordance with clearly understood common principles of policy and regulation. The lack of coordination can polarize investors and consumers, stifle competitive market response to tenders, and ultimately increase transaction costs. While the Project Preparation Unit (PPU) represents a form of project coordination, it will be important to have a regulatory focal point similar to the PPU to provide investors and consumers confidence in the long term.

B. Regulatory Best Practices

Many countries have succeeded in developing effective market structures for municipal service provision together with developed regulatory capacity and institutions. While some countries such as Indonesia, Mexico, Hungary, and India have argued that independent regulatory capacity and enforcement should be developed gradually and in pace with the unbundling of municipal enterprises, most countries in developed and emerging markets that have successfully unbundled municipal service delivery have: 1) developed independent regulatory models prior to or as a result of significant transactions; and 2) used the passage of a Regulatory Act on Public-Private Partnerships or other relevant legislation to clarify and authorize policy, procedures, and regulations. Countries such as the Philippines, Argentina, Brazil, Chile, Colombia, Canada, the United States, Uganda, and Jamaica have used umbrella legislation and accompanying rules and regulations to eliminate regulatory gaps and begin enforcement.

DCD believes that South Africa is in a unique position to learn from both the success and failure of countries that during the last 10 ten years have developed regulatory experience and unbundled municipal service delivery to promote competition, higher quality, and lower costs. Lessons that should guide the development of the South African Regulatory Model for Municipal Services are as follows.

B1. Competition Is the Best Form of Regulation

Competition for the market and competition in the market drive down cost, keep firms accountable to consumer needs and, in most cases, weed out inefficiency. Competition can also, if managed well, lead to levels of service higher than would otherwise be provided or guaranteed. The experience in the United States of benchmarking targets of service and price as part of the competitive bidding process is a useful example to emulate. Both the PPU and the regulatory institution will seek to promote the highest level of competition in bidding for projects and drafting of concessions.

B2. Efficiency in Design Is Critical to Avoid Deregulation Trauma

Financial regulation is expensive. In developed countries, the cost of maintaining staff and full-time outside experts has led to calls for dramatic regulatory reform. South Africa can benefit greatly from the experience of developed economies that have had to downsize regulatory institutions and introduce more modern methods. South Africa can use modern regulatory techniques that help to finance or defray the costs of regulation, such as building administrative fees and surcharges into contracts.

One must also bear in mind, however, the lack of regulatory history in South Africa and the persistent mistrust of the private sector. An appropriate balance must be struck between the need for a modern and cost-effective regulatory regime and preserving and protecting the interests of the government and the consumer with an effective regulatory institutional capacity. Additionally, a cadre of regulatory and monitoring officials should be developed in South Africa to manage the process over the long term.

B3. Development of Viable Projects and Effective Contracts Minimizes Regulation

Essential to the success of a regulatory model is packaging viable, high-quality projects and drafting bankable and long-term project agreements/concessions. Projects that are poorly structured or concessions that leave too many factors open for interpretation lead to disputes, some of them regulatory. Regulatory review and renegotiation are most common when one party feels that ambiguities in the concession justify re-opening the financial or performance terms of a contract.

The PPU will assist municipalities in preparing "win-win" contracts, minimizing the need for constant and expensive regulation and emphasizing contract monitoring instead. To be sure, regulatory activities will be required and several regulatory cases will occur in South Africa over the years to come. However, it is essential to reduce the number of unnecessary regulatory and dispute resolution cases—those that can be avoided through the use of high-quality contracts and capable institutions.

B4. Consumers Must be Heard in the Regulatory Process

Mechanisms must be developed to provide the customer with access to service providers and regulators alike. Customers must be able to voice concerns and questions about service, reliability, and rates. Regulators and providers also benefit from the feedback mechanism, as it helps to determine the appropriate level of regulation through customer management and

satisfaction. Customers should ideally be served by the provider and voice concerns about service directly to a customer relations officer. However, it is critical that any regulatory structure have a Consumer Affairs Department where consumers can lodge protests and complaints about chronic problems. The department should also undertake public education and awareness actions to help consumers understand their rights. The recommended structure will emphasize dual accountability and feedback mechanisms of the service provider and regulator alike.

B5. Investors Require Certainty and Credibility

Whatever the form of regulation ultimately adopted, it must be viewed by all parties as certain, consistent, and long-lasting. If weak regulatory guidelines and procedures are in place, the investor will likely "price" the regulatory uncertainty as a part of his bid. This pricing of regulatory risk is one of the components in the risk-adjusted rate-of-return formula that private firms and their banks run on financial models. If regulatory risk is minimal, due to either a strong regulatory law or institution or municipality with a history of creditworthiness and honoring contracts, pricing impacts will be minimal.

One reason many countries are turning to regulate-by-contract models is that they do not have the regulatory tradition or capacity to effectively regulate private firms, and the volatility of ministerial regulation, with its political implications of social pricing, led to higher pricing of regulatory risks. South Africa, with a sound tradition in contract law and a reasonable though inconsistent level of capacity in local governments, should strive for a regulatory model that reduces regulatory uncertainty.

B6. All Parties Seek Real Transparency and a Level Playing Field

Transparency is an oft-cited goal of procurement and regulation. Transparency will be achieved only if systems and procedures that promote transparency are established and adhered to. In most countries that have developed credibility, transparency was advanced through laws and implementing regulations. South Africa must ensure that at the procurement, award, and post-award stages, independent evaluators and independent regulators/monitors will be used and that the process for decision-making is based on published and pre-established criteria. In the United States, the General Accounting Office, and Auditor General are often brought into the process to review and approve the credibility of the process and, in some cases, to correct irregularities. This authenticates the process and makes investors feel that competition and regulation decisions are neutral and fair. South Africa should consider similar roles by independent and credible bodies to validate the transparency of the process.

B7. The Regulatory Regime Must Stress Certainty with Flexibility

While regulatory certainty reduces transaction costs and assures investors and consumers that the rules of the game will not be changed, one must recognize that regulatory practices and institutions change. Flexibility to incorporate new approaches, best practices, and improvements must be built into any initial legislation or regulations. Some countries are practicing regulatory activities based on antiquated laws and procedures due to the rigidity of their initial framework. South Africa would be best served by ensuring that the foundation for regulation is clear and

consistent, yet the regulatory instruments and techniques practiced are based on appropriate application and benefit to the consumer.

B8. Independence Is Desirable, But Accountability Is Equally Important

Independent regulation is important because it theoretically protects the consumer and investor from frivolous or politically motivated decisions and controls. However, many countries are unwilling to relinquish total control to independent regulators for fear that these lack the capacity and history to fulfill their missions. Independence may undermine accountability unless institutional design and support is in place. In Panama, independence is built into the Independent Regulatory Commission through long-term appointments and financial independence through self-supporting fees. Accountability is ensured through transparency and review of all concessions and contracts by an independent panel of experts. In Indonesia, independent regulators are not considered appropriate; rather, the municipality and national government are empowered to enter into contracts with long-term conditions monitored by independent auditors. South Africa should develop a framework that strives for the financial independence of regulatory bodies, with mechanisms for accountability at the level where it matters most: locally.

B9. Effective and Efficient Dispute Resolution Is Critical

Modern regulatory practices increasingly emphasize effective means to reduce the costs of regulation. Many of these practices involve alternative dispute resolution methods, such as mediation and arbitration, as opposed to full-scale litigation proceedings. Early, contractually mandated and competent dispute resolution should facilitate competitive markets and form a model for other transactions. However, formal structures for mediation and arbitration must be established early in the process and detailed in each contract. Moreover, credible and mutually agreed-upon procedures for dispute resolution must be in place and the decisions of the arbitrator or mediator must be binding, albeit with limited appeal rights. In South Africa it will be essential to facilitate the capacity of local mediation and arbitration professionals and institutions so that this modern approach can be used and traditional forms of adversarial proceedings avoided. The regulatory commission or body should be the court of last resort, if at all.

C. Creating a Better Framework Using the Existing Foundation

While DCD believes that there is a need to initiate a more comprehensive, coherent, and concrete set of regulations and guidelines for municipal PPPs, we also believe that the basic foundation for a regulatory framework exists and should not be reinvented. We believe it would be a mistake to significantly alter and divest regulatory powers and authority from agencies and units of government that currently wield those responsibilities. The design of any Regulatory Model in South Africa should be based on the premise of keeping intact what is functioning and introduce best practices and innovation in areas where regulatory gaps exist. Exhibit VI-1 shows where the current regulatory responsibilities rest in South Africa.

The gaps in regulatory responsibilities in South Africa are minor compared with those of other countries. However, authority and decision-making on procedures, commitments, and strategic issues are more ambiguous. This ambiguity has led to delays and disputes in other countries, during the project tendering and negotiation stage as well as over the life of a project.

Exhibit VI-1. Current Regulatory Responsibilities

Regulatory Activity	Regulatory Responsibility
Project identification	Municipality, province, DCD, private sector
Project tendering	Municipality (with support from MIIU)
Project award	Municipality (with support from MIIU)
Financial guarantees	?
Fiscal incentives	?
Price Regulation (form, monitoring, etc.)	?
Environmental regulation	Sectoral Ministry and Department of Environment
Health and safety standards	Department of Health
Dispute settlement	?
Note: "?" indicates a regulatory gap.	

C1. Lessons of Experience in South Africa

A useful way to assess regulatory gaps is to review South Africa's two experiences with municipal PPPs in the water sector to date: Queenstown and Nelspruit. Both of these transactions, one well into implementation and the other at the bid and tender stage, show how the current system is adequate but not sufficient.

C1a. Queenstown Water and Sewerage Contract

In 1990, Queenstown concluded a 25-year rehabilitation, operation, and maintenance contract with Water and Sanitation Services of South Africa (WSSA) to run the entire water and sanitation system of Queenstown. After five years of operation, the project is considered an overall success. Quality of service has increased, labor relations have improved, employment has been created, and tariff increases have been maintained below inflation as stipulated in the agreement. Regulatory pluses and minuses include the following:

Regulatory accomplishments

- **Water use, policy, and standards.** Planning, standards, and water policy issues complied with Department of Water Affairs requirements and those of the municipality. Water resource issues, licensing, and permitting remained the regulatory responsibility of the Department of Water Affairs, with the municipality responsible for obtaining permits on behalf of the operator. Overall planning and regulatory issues remained the jurisdiction of the municipality.
- **Environmental and health issues.** The concession complied with and received approval from the Department of Water Affairs and the Department of Health. No significant regulatory delays or overlaps were cited in the discussions with WSSA and Queenstown regarding these issues.

- **Labor issues.** The municipality negotiated acceptable arrangements with labor and complied acceptably with labor regulations. In fact, labor has benefited from the transaction.
- **Dispute resolution and arbitration.** The contract explicitly uses mediation and arbitration as the agreed-to form of dispute resolution and provides a mechanism to regulate changes in the contract fairly. The willingness of the investor/operator to use arbitration as a mechanism bodes well for future transactions. When the operator was asked to take on a broader service area to incorporate the communities of Mhlunghisi and Ezibelini, the contract was amended and renegotiated with little need to resort to dispute resolution mechanisms.

One reason that the Queenstown project was implemented with relatively little difficulty was that the operator was not asked to provide large amounts of capital expenditure. In other transactions involving significant investment capital, regulatory details and rate-of-return issues will have to be more extensively examined in the contracts. While the project has been viewed as a success and despite the relatively small risk capital, there were some regulatory imperfections.

Regulatory imperfections

- **Limited competition and transparency.** The project was developed in the absence of true competition and without a detailed RFP. Through open competition, the municipality may have been able to attract a higher number of competitive bidders offering different terms, including the expansion of the system, which subsequently WSSA was asked to do. In future transactions involving larger systems, open and transparent competition should occur if the municipality is to receive the highest number of competitive bids.
- **Price re-openers and renegotiation.** Despite the success of the project to date, no formal regulatory mechanism spelled out the method and basis for price review and renegotiation. While a financial model and formula were agreed to in the contract, the lack of a detailed price regulation model left the door open for either side to trigger price renegotiation. In fact, discussions are taking place currently to review adjustment to the tariff and to reallocate payment risk from the municipality to the operator. One must ask if it is national government's role to reopen this aspect of the contract, or whether future contracts could incorporate mechanisms to address these possibilities from the beginning. In larger transactions, reopening price and investment issues would be much more problematic. According to the operator, there is an assumption that these issues would be reviewed every five years, although the concession does not clearly state this.
- **Monitoring: price, quality, and performance.** The contract does not spell out the monitoring roles and responsibilities that enable the municipality to ensure it is being well served. From an institutional standpoint, the municipality should be developing long-term capacity to monitor the project independent of the operator. This will be especially true in "greenfield" projects where the operator will control most of the information about price, costs, performance, and quality.

C1b. Nelspruit Request for Proposals for Water Concession

This RFP represents an improvement in the regulatory sphere by combining what works in South Africa with some of the lessons learned from the Queenstown project. Although it is far too early to tell if the approach will lead to a successful outcome, it can be said that some, but not all, of the regulatory imperfections were addressed.

With the support of DCD and as a preview of how the PPU will work to support viable projects and their packaging, the effort featured:

- A competitive procurement including a reasonable attempt to short-list a number of qualified firms using a request for qualifications.
- Interest promotion and reduced bidding costs through holding a bidders conference.
- “Outputs” as a basis for setting targets in the bid documents and inclusion of model agreements to get bidders focused on the municipality’s requirements.
- Risk allocation strategies outlined in the RFP, such as the private sector taking payment risk and the public sector providing a subsidy to increase financial viability.
- Stipulation, albeit insufficient, of financial regulation and renegotiation issues, in the bidding documents. While a term sheet was offered, which several bidders believed lacked enough information, the bidding documents also included triggering mechanisms and guidelines on how they will be reviewed and renegotiated.
- Contract monitoring was explicitly spelled out and the scope, scale, cost, and reporting requirements of such monitoring will form the foundation for the regulatory approach. The contracting monitoring team will be primarily financed through the sales of the concessionaire.
- The bidding documents made reference to dispute resolution arrangements, with emphasis on mediation and arbitration as a method of regulation for the project.

While both Queenstown and Nelspruit are projects in progress, they provide DCD a basis from which to evaluate the elements for regulatory oversight that are functioning in South Africa and those that do not yet exist or have limited capacity. Regulatory requirements and challenges will grow as the PPU prepares and packages projects of all forms—including concessions, leases, build-operate-transfer, build-own-operate-transfer, build-transfer-operate, management contracts, and service contracts—across water, wastewater, solid waste, and transport sectors. However, the structure of PPU and its powers and authority should reflect some policy considerations as well.

D. Regulatory Imperatives in South Africa

The design and implementation of a model for regulation of municipal services in South Africa cannot only be based on best practices, but must also reflect salient policy objectives. Chief among these are the efforts of the government to legitimately devolve responsibilities and decision-making from national to local levels of government. This effort to decentralize actions as well as resources must include the regulatory process. However, decentralizing the regulatory responsibilities involves trade-offs that must be considered.

Real constraints to effective regulation and institutional development exist at all levels in South Africa. Recognizing these constraints and developing a strategy to overcome them, instead of accommodating them, is a challenge facing all three tiers of government. Issues that the regulatory strategy for South Africa in combination with the PPU must consider are presented below.

D1. Constitutional Directives

The constitution directs that certain powers and decision-making be devolved to local government units. Any proposed regulatory institutional arrangement that is centralized and removes jurisdictional powers from local government could well be unconstitutional. Other constitutional issues include labor, consumer, and good governance issues that must be addressed in the regulatory design.

D2. Stakeholders' Concerns

As indicated throughout this report, DCD is committed to ensuring that the regulatory model developed to oversee municipal PPPs reflects the concerns and input of a variety of stakeholder groups. The concerns of labor, local governments, national agencies, private sector, and consumers must be part of the design of such a framework and must be articulated and represented formally through the institutions themselves. Labor must feel that the regulatory structure is fair and will create opportunity; local governments must feel empowered and not intruded upon by national agencies; national agencies must feel satisfied that national concerns are being addressed and that risks are being shared equitably without recourse to national government; private investors must feel that the regulatory model is supportive, not hostile, to private initiative, hard work, and profit-making. Lastly, consumers must be made aware that the regulatory model protects their interests and that they have a voice and a responsibility as citizens and users of municipal services.

D3. Constraints

Several general constraints have been identified in this report that must be addressed as municipal PPPs are developed. The establishment of any of the regulatory options contained in the following pages will be challenged by several specific constraints. Therefore the proposed regulatory structure must be accompanied by a specific strategy to overcome the principal constraints. As noted, in South Africa the majority of the constraints to effective regulation and oversight are rooted in issues of capacity and information.

Capacity at the national and local levels must be developed for any regulatory structure to function. Through developing regulation and monitoring experience, local and national professionals will become more aware of the strategies and techniques of effective regulation. Information, or the lack thereof, is more problematic. Consumers and local governments lack information about the implications of PPPs and the methods to determine if the consumer and municipality are being well served. Any proposed regulatory structure must use strategies to encourage and require private operators to provide as much information as required to monitor progress and compliance with contracts. Both of these constraints will be overcome through education, outreach, and success.

D4. Short-Term Requirements, Long-Term Impact

Although establishing a working regulatory framework as soon as possible is critical, it must be done with the long term in mind. DCD recommends that within the next few months a draft regulatory act be prepared that details the proposed structure and strategy. Some of these recommended practices and procedures should be followed by municipalities and national agencies even before the act is ratified. Through the use of guidelines, training programs, and technical support to municipal governments, the spirit and content of the act can be practiced by municipalities and the private sector alike. In some ways, this has been the case with the Nelspruit Water Supply Project. Projects must not be delayed due to the absence of a formal legal and regulatory framework. In Brazil more than 25 water and wastewater concessions were delayed until the passage of the Law on Concessions and Regulation in 1995. South Africa cannot afford to delay project packaging and tendering. However, best practices and regulatory strategies must be conveyed to each municipality. This information dissemination is a goal of the DCD capacity-building effort through the grant assistance program.

D5. Integration and Regulatory Fit with PPU

Lastly, the PPU and the grant assistance program must be well integrated. It is not sufficient to assume coordination and intellectual conformity. The advisors within and outside the Development Bank of Southern Africa must be packaging projects, bid and tender documents, and model contracts that are consistent with the proposed regulatory regime. Without "regulatory fit," the project bidding documents could contradict the proposed regulatory structure, leading to inefficiency and dispute. Communications and information sharing will be an essential part of this process. Both streams, the project preparation unit and the regulatory support unit or entity, need to conduct a formal dialogue to ensure fit. Several examples from around the world show that a lack of coordination between these two distinct but related activities results in delayed projects, disputes, redtape, etc. For example, the Communications Authority of Zambia, whose law on Telecommunications explicitly states that RPI-X shall be used as a basis for price regulation, was shocked to find that those responsible for developing the tender documents for the privatization of the Zambia Telecommunications Corporation were using rate-of-return regulation and were developing tenders on that basis. Because the regulatory body did not have a formal role on the privatization committee, the parties did not communicate. The result was a long delay while the strategy and the relationship were repaired.

In South Africa, the creation of coordination will be even more complex due to the variety of municipalities and sectors involved. Communication and coordination mechanisms must be in place to ensure integration and dissemination of experiences.

E. Decentralization of Regulatory Responsibilities

As stated above, DCD believes that regulatory responsibilities can and should be decentralized as much as possible. The primary advantages of decentralized approaches are as follows:

- Promote local ownership and autonomy based on local needs.
- Allow monitoring to be performed more effectively and facilitate information flows between the regulator and the regulated.

- Provide consumers a local presence and feedback mechanisms for concerns and complaints.
- Eliminate or reduce the need for more bureaucratic and expensive approaches at the national level.

However, the decentralization of regulatory activities must recognize a number of implementation problems, including:

- There is overlap of national, provincial, and local responsibilities.
- There is lack of confidence at the national level in the capacity of local units of government to effectively manage the process, pre-award and post-award.
- Economies of scale at the local level may not support full-regulatory capacity on a small project basis.
- Some projects (such as regional landfills, transfer stations, transport terminals, or regional water systems) involve regional regulatory requirements that are difficult to coordinate between municipalities.
- Risk of regulatory capture presumably increases as regulatory responsibility moves to lower tiers of government. The lack of capacity at the local level exacerbates this threat.

In contemplating regulatory design, DCD believes that two issues must be considered: the regulatory instruments to be used and the institutional model to be adopted. Exhibit VI-2 summarizes the range of options for both regulatory instruments and oversight as well as institutional models. We believe that the selection and use of regulatory instruments should not be limited. Rather, the Regulatory Act and guidelines should allow each municipality and other regulatory bodies to use the appropriate regulatory instrument based on the merits and structure of each sector and project. Therefore, rate of return, price cap, incentive-based regulation, yardstick, and alternative dispute resolution models could all be considered. For example, the National Regulatory Commission of Jamaica, which is responsible for regulating municipal services such as energy, water, telecommunications, solid waste, and transport, uses price cap regulation for telecommunications and water, rate of return regulation for energy and dispute resolution, and no price regulation for solid waste and transportation. Rather than prescribing instruments, the law sets forth the standards and form of regulation and how they are to be enforced through rule-making and arbitration.

F. Five Particularly Relevant Regulatory Models

Advantages and disadvantages notwithstanding, there are a number of regulatory models around the world that are useful examples for South Africa. More than 15 regulatory models and options were considered during the diagnostic mission. Five models are particularly relevant to South Africa. In the following, each model is presented briefly and its pros and cons discussed. Finally, a recommendation and proposed course of action are presented.

Alternative Forms of Regulatory Oversight in South Africa

Alternative	Implications	Key Advantages	Key Disadvantages
Rate of Return Regulation	Maintains "top-down" process of state oversight of utility operations, rate of return, and revenue requirements	Protects economic welfare of utilities and consumers, provides some incentives, and adds comfort to pro-regulatory institutions	Very expensive to operate, highly legalistic, does not promote efficiency, innovation or market positioning
Price Cap Regulation	Caps prices and adjusts per agreement based on economic indicators	Reduces costs, encourages efficiency, shifts risks to shareholders, promotes innovation	Establishing cap is difficult, can lead to high profits, service can be affected if not contractually mandated
Performance-based Incentive Regulation	Replaces traditional regulation through performance-based contracts. Performance triggers financial and regulatory audits and adjustments	Reduces regulatory costs, allows long-term service and planning goals to meet, encourages efficiency and risk sharing, allows consumers to participate in process to keep operators accountable	Requires high-quality contracts, difficult to get benchmarks perfect. Must develop monitoring capacity and enforcement.
Simplified Procedures	Maintains traditional central government oversight but simplifies reporting requirements	Allows private sector more control and freedom, responds to small systems and promotes local participation	Only applicable where performance and capacity are high. Could be exploited; lacks consistency and is difficult to enforce.
Alternative Dispute Resolution	Emphasizes resolving contractual disputes through mediation outside of institutional structures	Efficient, bilateral approach, reduces regulatory costs, facilitates teamwork, and can be replicated easily.	Initial success depends on strong contracts and due process, can lead to regulatory capture if not supported by third-party interests and controls.

Range of Regulatory Institutional Models for South Africa

Model	Implications	Key Advantages	Key Disadvantages
National Public Utilities Commission	Multi-sectoral, command and control model, responsible for approvals and regulatory renewals	<ul style="list-style-type: none"> -Centralized and coordinated -Standards replicated among sectors -Independent and high-level of capacity sharing 	<ul style="list-style-type: none"> -Does not empower municipalities -Is not consumer-friendly -Difficult to coordinate -High bureaucratic costs
Regulate by Contract Alone	Contract-specific regulation through monitoring at the local level. Disputes mediated and resolved via arbitration.	<ul style="list-style-type: none"> -All performance and financial terms agreed to up-front -Promotes local "ownership" -Promotes consumer relations at local level -Very efficient and cost-effective 	<ul style="list-style-type: none"> -Local capacity required up front -Independence must be ensured -Best practices difficult to disseminate -Relies on quality contract
Single-Sector Regulator and "Czar"	Each sector has regulatory capacity, institution, and authority. National guidelines and procedures overseen.	<ul style="list-style-type: none"> -Unilateral yet clear -Sector-specific expertise is developed -No need for coordination -Standards and enforcement likely 	<ul style="list-style-type: none"> -Insufficient when regulatory practices could be coordinated -Limits local participation -Information flow is limited -Overly reliant on individual
Transaction and Ad-Hoc Regulation	Each transaction develops its own regulatory model. Large systems differ from small systems	<ul style="list-style-type: none"> -Specific and specialized based on local conditions -Can create regulatory capacity quickly -Flexible and efficient 	<ul style="list-style-type: none"> -Not easily transferred to other projects -No standardized approach -Lacks transparency -Limited institution-building
Locally driven, Nationally Supported Hybrid	Regulate by contract with oversight by municipality, but national guidance and support provided to foster best practices and decentralization	<ul style="list-style-type: none"> -Efficient and modern -Empowers local governments and consumers -Creates professional regulators and monitors paid by % charge -Easily replicated -National participation -Concessionaire abides by terms 	<ul style="list-style-type: none"> -Requires local capacity -Must be coordinated within sectors -Independent monitors must be identified -Mediation and arbitration procedures must be fair and binding

50

F1. National Public Utilities Commission

In many countries, regulation of municipal services is brought into a single, multisectoral, nationally based commission. Often the commission is empowered, for reasons of efficiency and economies of scale, to oversee the economic, financial, performance, and quality regulations for sectors involving utility or monopoly characteristics. Usually, these multisectoral regulatory commissions have five or seven commissioners appointed for five-year terms and cannot be removed for any reason, save malfeasance. The commissioners' terms are staggered, for political affiliation reasons. The commissions operate under a legal framework and regulate by statute and license. As the commissions are multisectoral and oversee entire sectors of an economy, they require large staffs of professional and sectoral experts and are constantly engaged in rate reviews, monitoring, and cases. The ultimate authority is held by the commissioners, often through a hearing, and a varied range of regulatory instruments is used.

Examples of independent, multisectoral regulatory commissions are found in small countries where pooling expertise and functions make sense, for example, in Albania, Jamaica, Chile, Trinidad, and Panama and in the 50 states of the United States, which each has an independent regulatory commission.

Exhibit VI-3 illustrates the basic structure and relationships between the typical independent regulatory commission and its line agencies and private provider.

Pros

- Command and control structure allays concerns about the capacity of local governments and institutions to effectively manage the process.
- Pooling of resources at the national level allows for greater efficiency and sharing of expertise within and between sectors.
- Independent and effective institutional strength is achieved if the model is designed correctly and empowered under the Regulatory Act.

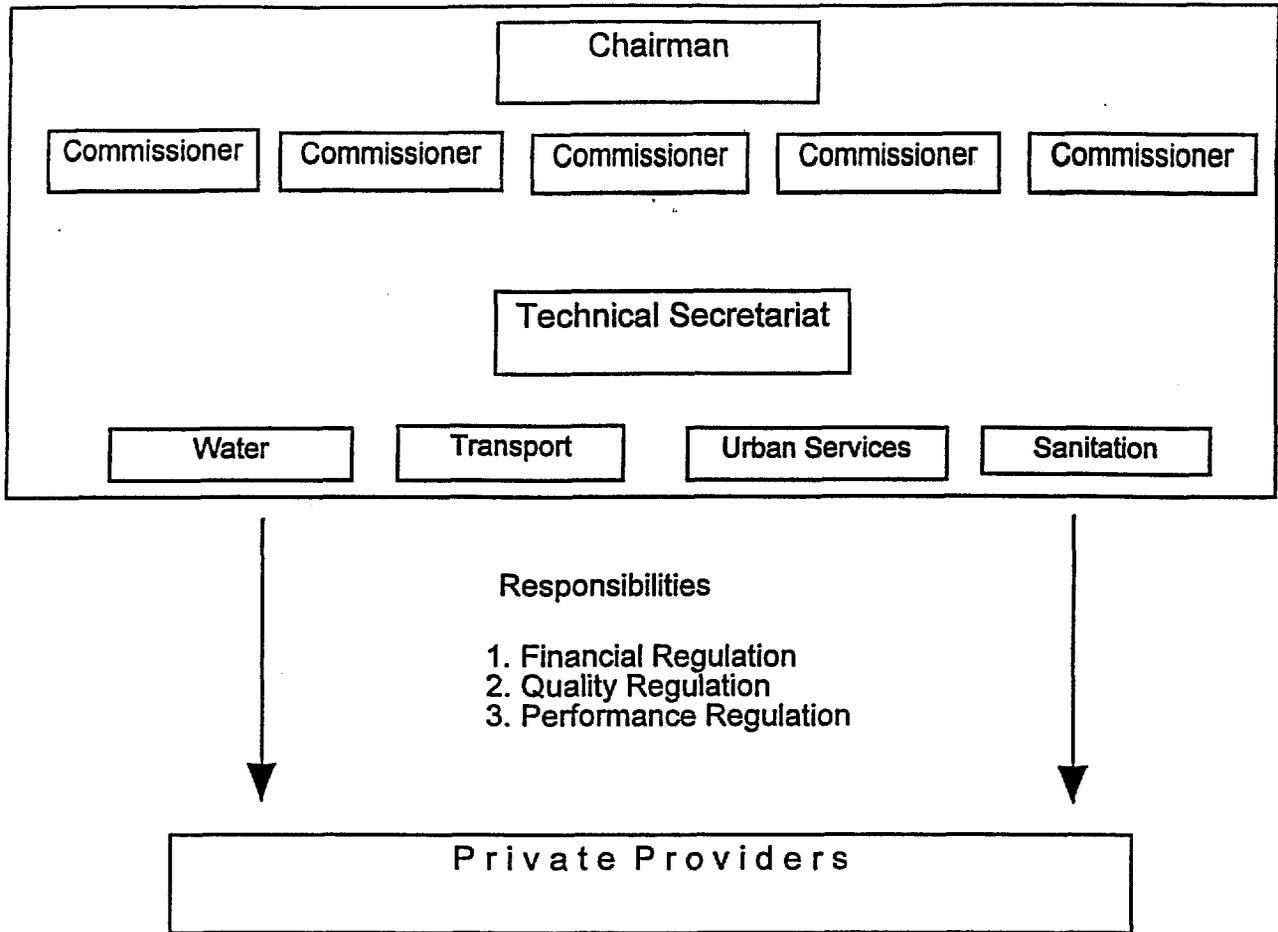
Cons

- Intrusive, non-local approach is not congruent with South Africa's vision of decentralized authority and development of local institutions.
- South Africa is too large for economies of scale to be a regulatory issue; rather, the number of municipal transactions in one sector alone argues for a different approach.
- The structure is extremely expensive to maintain and will only become more bureaucratic with time.
- The approach is consumer unfriendly—out of touch with local issues, needs, and concerns.

Conclusion. The national, multisectoral model is not appropriate for South Africa. One could argue that national utilities such as energy, telecommunications, and transport may operate well under this model for capacity and scale reasons. However, for municipal PPPs, this structure would likely be more of a bureaucracy than facilitator of competition.

Exhibit VI-3

Multisectoral Municipal Regulatory Commission Option



Institutional Features

1. Central or Provincial
2. 3 -7 Commissioners
3. Commercial Regulation
4. Regulate by Statute and License
5. Economies of Regulatory Scale Realized by Combining Municipalities

Regulatory Features

1. Multiple Regulatory Instruments Possible (rate of return, RPI-X, etc.)
2. Regulatory burden sharing between professional staff
3. Command and Control Regulatory Style Allowed
4. Rate Setting/Adjusting Powers/Decisions at the Commissioner Level

F2. Regulation-by-Contract Model

Regulation-by-contract models are increasingly being used in countries that have learned the lessons of regulatory efficiency and are “deregulating” through contracts. In the regulation-by-contract model, the regulatory regime is built into the contract itself and each municipality is responsible for establishing a capacity to monitor the price, quality, and performance of the concessionaire. All of the terms and standards are agreed to in the contract and it should be relatively straightforward to determine, through monitoring, if the concessionaire is complying or not. Foreseen and unforeseen events that trigger reviews, sanctions, or renegotiation are identified up front in the contract, and mechanisms such as negotiation, mediation, and arbitration are agreed to *ex ante* as a form of dispute resolution.

Several municipalities are using regulation-by-contract as an alternative to large, cumbersome, and often distant regulatory bureaucracies. The costs of regulation and monitoring are covered out of a percentage surcharge on sales by the concessionaire, and penalties or fines are sometimes rebated directly to consumers as a deduction in their monthly bill. Practiced widely in the United States, Mexico, Philippines, and Canada, regulation-by-contract requires a capable, vigilant team, acting under some regulatory supervision to ensure that the conditions are being met and performance is being measured.

Exhibit VI-4 illustrates the regulate-by-contract model and the typical relationships among client, consumer, and developer.

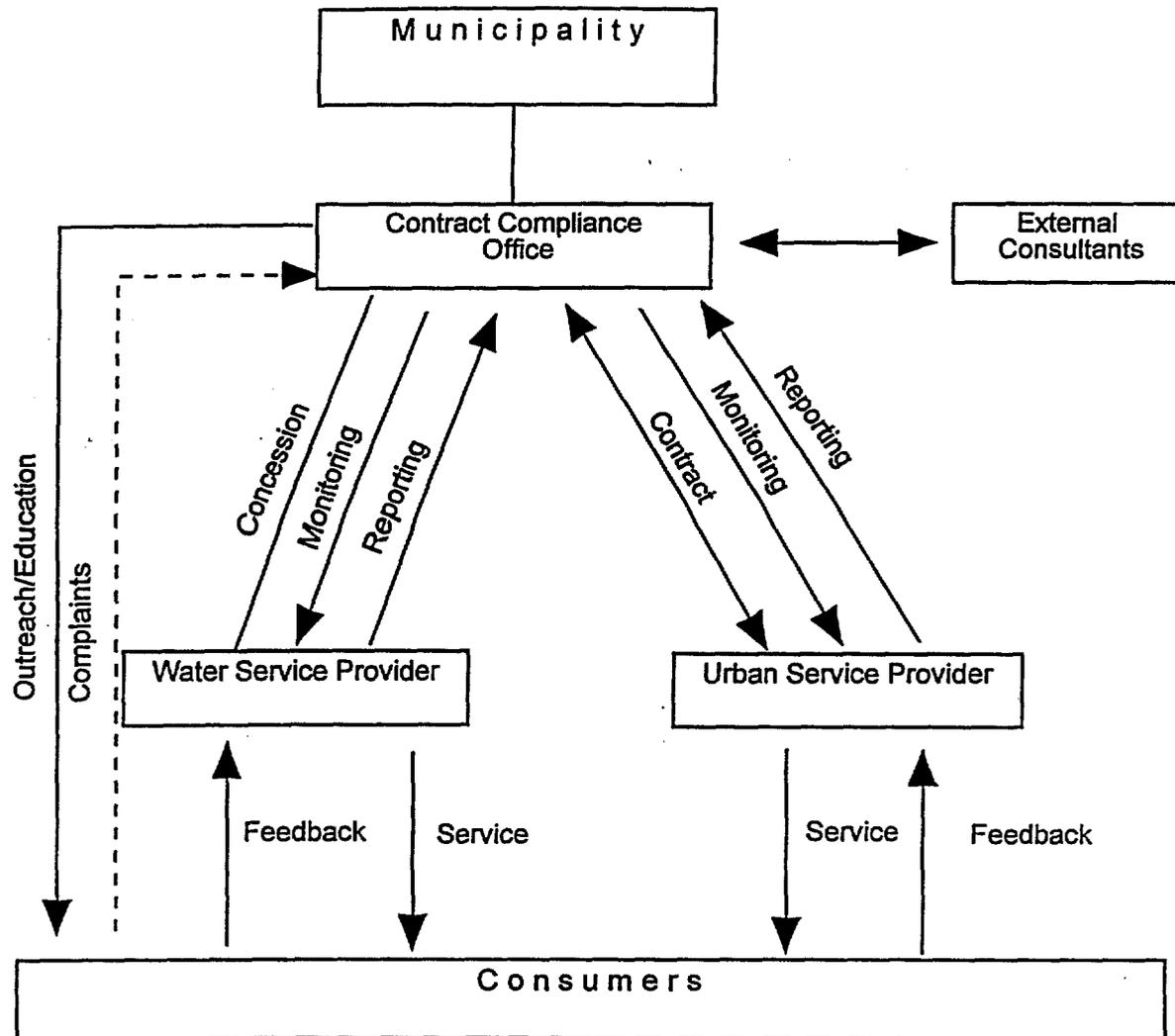
Pros

- The approach is extremely local and personal.
- Contract is efficient and self-financing if agreed to in the bidding documents.
- The consumer has recourse to both the private firm and the contract monitor.
- Through daily monitoring, disputes are minimized and problems are solved more readily. Disputes that do occur are subject to a process of correction, negotiation, mediation, and arbitration.
- Outside experts can be called in on an as-needed basis to assist the contract compliance officer or monitor without having to carry the high cost of expertise 365 days a year.

Cons

- South Africa today has inconsistent capacity among municipalities to manage and monitor contracts.
- Limited pool of trained individuals to monitor contracts could hamper pilot projects.
- Risk of regulatory capture exists and could jeopardize monitoring and independence.
- Central government feels left out and wants to be involved in more than passive regulation.
- What types of efficiencies can be gained or lost if multiple contracts are operating in a given municipality? Could one contract compliance officer monitor more than one contract at a time?

Exhibit VI-4

Regulate by Contract Model Option**Highlights**

1. Regulatory compliance monitored daily
2. External auditing outsourced as needed
3. Consumers have two interfaces (consumer mgt.) with private firm and CCO
4. Contract Compliance Office staffed as needed
5. Financial, environment, performance disputes negotiated

Conclusion. The regulate-by-contract model alone, while ideal, is perhaps slightly premature in South Africa. Central government must provide a foundation for regulatory capacity and empower municipalities, yet cannot afford any mistakes. There are few examples in developing countries where scores of contracts between municipalities and private providers exist without some modicum of institutional, technical, and legal guidance and support from national government.

F3. Single Regulator Model or Czar

In this model, each sector has its own regulatory body (or department) and accompanying legislation and guidelines. The director (or czar) of regulation of the given sector is empowered to make decisions, or decisions can be delegated to a commission. The director or commissioners are appointed for five-year terms and cannot be removed for political reasons. Essentially, the body is a non-ministerial government department, but the director preserves a degree of independence and is subject to only limited controls from central government. The department has to coordinate with other policy and regulatory bodies on health, environmental, and other matters, but is essentially responsible for all financial, quality, and performance regulation. The costs of regulation can be covered through surcharges levied on the regulated industry or through direct government funding.

The department can use a variety of regulatory instruments based on the specific needs and characteristics of the industry. Customer relations is also a responsibility of the department and could be established through local offices or at the provincial level. Representative examples of the single regulator model are the Office of Water Services in the United Kingdom, the Federal Energy Regulatory Commission in the United States, and departments such as the Comisión de la Agua in Mexico.

Exhibit VI-5 illustrates the typical institutional relationships and highlights of such a single sector model.

Pros

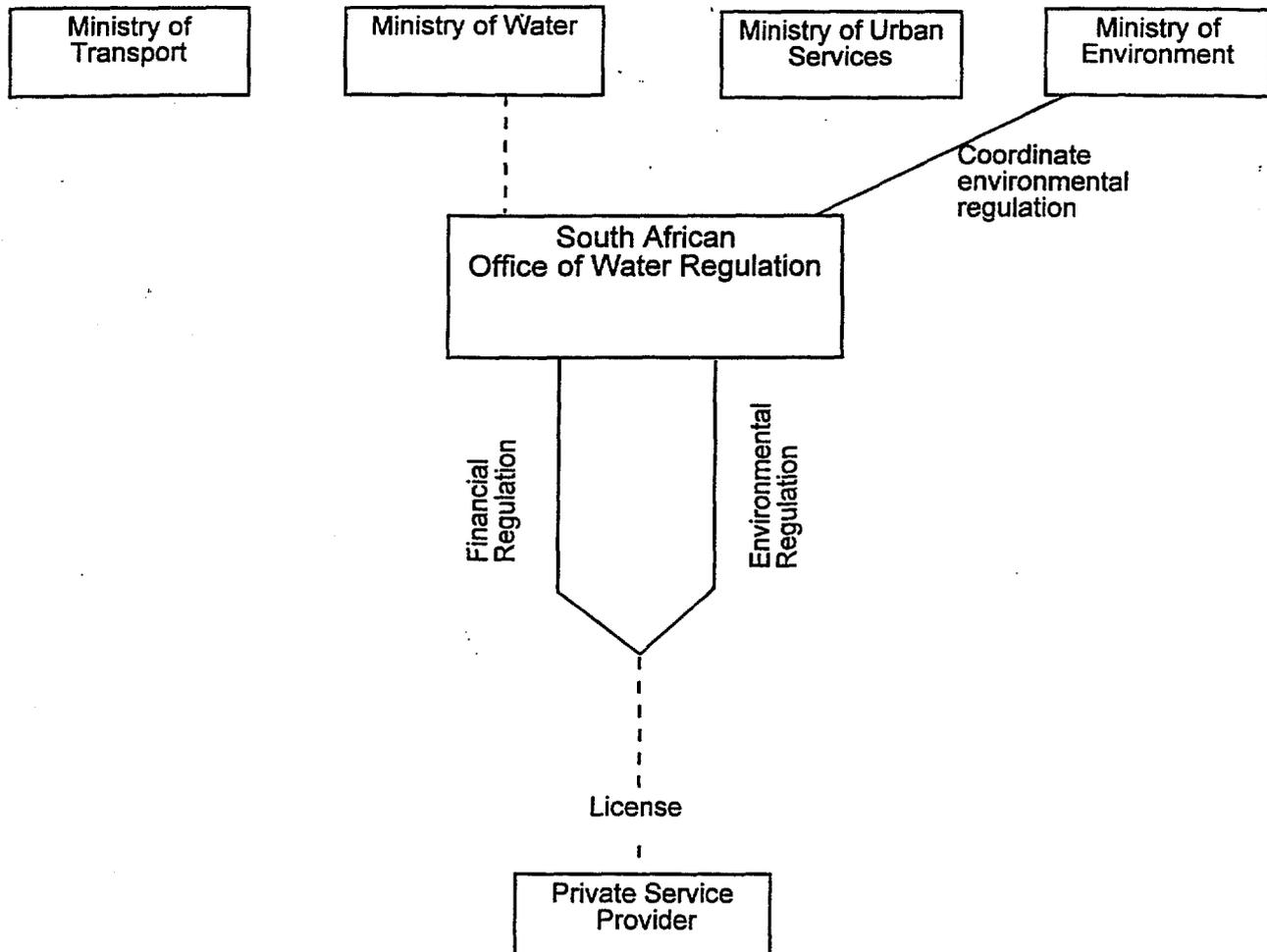
- The single sector model would be appropriate from the standpoint of scale in South Africa, i.e., there are several contracts per sector that could be regulated over time.
- Sector-specific expertise and knowledge can be developed and cultivated.
- Experts from the department can be given provincial or municipal responsibilities to assist local government in developing regulatory practices.
- A single department establishes a point-of-contact responsibility and provides the private sector with some degree of comfort.

Cons

- The approach is overly centralized and authoritative.
- Czar approach can lead to overreliance on individual and "cult of personality syndrome."
- Regulatory capture still exists as a possibility.
- The model is bureaucratic unless well designed and delegated and could grow into an empire.
- This approach may only be appropriate for one or two sectors and is not sensitive to municipal needs and conditions.

Exhibit VI-5

Single Regulator Model Option



Highlights

1. Regulatory Act would spell out powers
2. Single Regulator issues licenses
3. Financial Regulation embodied in licenses
4. "Czar" appointed to five year terms
5. All encompassing regulatory authority requiring large staff
6. Central approach in long-term funded by service providers themselves

Conclusion. The disadvantages outweigh the merits. This model would be difficult to establish and inefficient, since each sector would require its own institutional, legal, and regulatory design and approach. It is most likely appropriate for South Africa's telecommunications and energy sectors, which lend themselves more readily to this approach, due to their "national" characteristics.

F4. Transaction/Ad Hoc Regulation Model in South Africa

Under ad hoc regulation, the establishment of a regulatory body, procedures, and capacity are a result of a transaction design. In ad hoc regulation, the specific regulatory instruments and procedures reflect the needs and requirements of the parties to a transaction and are outlined in the contract and the enabling legislation or regulations surrounding the project. This model has been used mostly in the last few years in large urban projects in countries where no competent or qualified regulatory presence existed. The transaction drives the regulatory design including the establishment of a standing regulatory commission, its powers, authority, and instruments. The regulatory body serves as both regulator and monitor and is generally responsible for approving investment plans and revisions in tariffs, as well as quality and performance standards.

The regulatory body is generally funded through a surcharge on sales and has broad regulatory and enforcement powers and capabilities. Ad hoc regulation has been used in cities including Buenos Aires, Manila, and Jakarta to create regulatory institutions from the ground up.

Exhibit VI-6 depicts the role of the Ad hoc regulator and the typical institutional relationships found in such a design.

Pros

- This could be a reasonable approach to larger-scale municipal transactions in the absence of existing regulatory bodies.
- It is concession-based and regulated by contract authority.
- The private sector, if consulted, would be amenable to this type of approach if it were transparent.
- If part of the design, consumers would be responsive to a newly created regulatory function for each municipality.

Cons

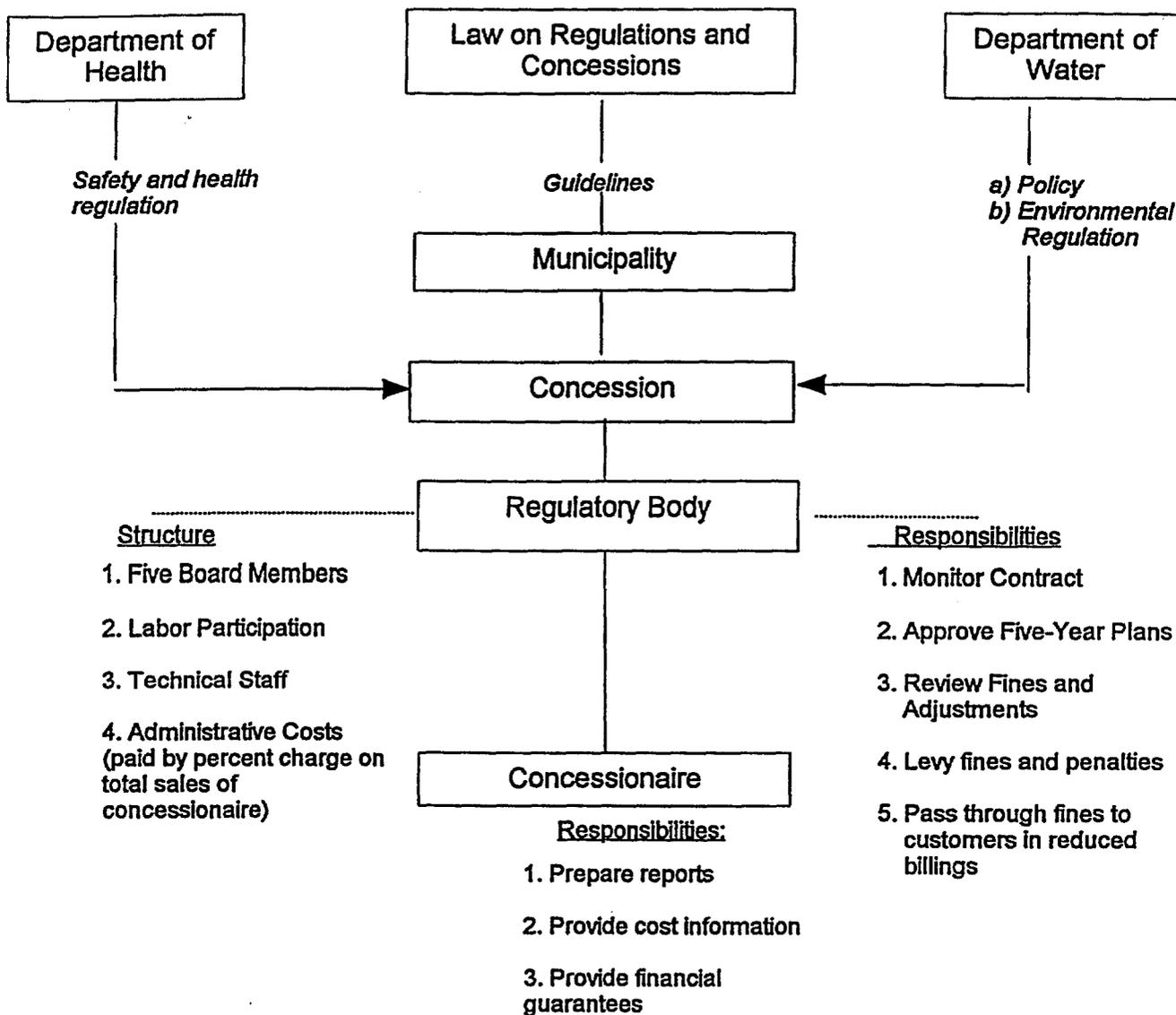
- Every municipality that creates a concession would establish its own body.
- This approach is relevant only for large cities.
- It does not facilitate information sharing and dissemination of best practices.

Conclusion. While this model has some attraction, it does not serve South Africa's needs in terms of speed, standardization, efficiency, multisectoral approach, and decentralization. Elements of the model can be applied but duplication would be common and could foster a dual approach to municipal regulation.

Exhibit VI-6

Ad-Hoc Regulation Model Option

(Transaction by Transaction Regulation)



F5. Locally Driven, Nationally Supported Hybrid for South Africa

South Africa is in a position to learn from the mistakes that other countries have made and develop a modern, progressive, regulatory framework. As one can see from the previous models, elements of each could be applied in South Africa, but each lacks the integration of central and local interests that is necessary for the model to be truly useful. Rather, a South African model needs to be developed based on the unique constraints, opportunities, precedents, and long-term goals of the country. *It is proposed that a hybrid be developed.* The hybrid approach would:

- Build on the lessons of Queenstown and Nelspruit.
- Give local governments autonomy and capacity.
- Reduce regulatory uncertainty.
- Allay central government concerns about capacity.
- Provide consumers with confidence.

The hybrid would be a locally driven, nationally supported model in which *local* institutions and experts provide regulatory service, but are supported by and accountable to *national* interests to ensure that municipalities are successful and the lessons of success can be replicated in other municipalities.

In the hybrid model, regulation-by-contract is the form of regulation and administration. All of the regulatory issues relevant to price, quality, performance, disputes, renegotiation, etc. are agreed to upfront by the parties. Concessions, leases, service contracts, and BOT are all regulated by contract. The responsibility for ensuring and enforcing compliance is vested in the contract compliance officer (CCO) or department. Each municipality will have a contract compliance department, generally under contract to government, which is responsible for daily monitoring and oversight of the contractor. The CCO will receive reports and briefings from the contractor on a predetermined schedule and will conduct spot-checks. The consumer will be able to bring complaints directly to the company, and such consumer contact will be reported to the CCO. The consumer will also be able to contact the CCO with complaints about service. These complaints will be registered and managed by the CCO and presented to the contractor for action.

Dispute resolution will be identified and specified in the contract and will rely on efficient and cost-effective methods including consultation, negotiation, mediation, and arbitration. The concession will specify what types and forms of disputes qualify, the time period allowed for each phase of dispute resolution, and what remedies are available in the event of further disputes. Disputes over price, performance, and quality will advance to each stage of dispute resolution until solved. If the parties cannot settle differences through negotiation and mediation in a reasonable period of time, the parties move to binding arbitration as agreed in the contract.

During binding arbitration, each party, as agreed in the contract, appoints referees and presents evidence. The CCO, advised by outside experts, will assist the municipality to build a case on behalf of the consumer. This form of dispute resolution is practiced widely in the United States and Latin America and will likely supersede adversarial and expensive court proceedings that could go on for years. The costs of the CCO and its experts to perform monitoring functions will be funded from a percent surcharge on sales agreed to by all parties when the contract is signed. In Nelspruit, the monitor and his staff will be funded directly out of the contract. (It should be noted that the percent charge in Nelspruit was slightly higher than normal and some of those costs will be passed on to consumers in fees.)

However, local autonomy, management, decision-making, and efficiency is not enough. As stated previously, central government still requires some information and control to serve its own needs. Moreover, some municipalities require more assistance than others. Information dissemination, training, and research should be spearheaded at the national level in order to develop a regulatory and monitoring industry of practitioners. Therefore, the hybrid model proposes the creation of the South African Municipal Regulatory Institute (SAMRI). SAMRI will be established not as a bureaucracy, but as a center of technical support, training, and research to do the following:

- Support the efforts of municipalities and the PPU as they draft and negotiate contracts.
- Provide technical support to municipalities on monitoring and regulatory analysis.
- When disputes arise and on a demand-driven basis, provide regulatory, financial, and economic analysis to assist CCOs to develop evidence to submit at the negotiation, mediation, and arbitration stages of dispute resolution.
- Conduct training and workshops on all aspects of regulation and monitoring.
- Provide certificate-based training to municipal contract monitoring and sanction a South African Association of Municipal and Utility Regulators and its research and training arm, the SAAMUR Institute.

The success of the hybrid approach, as with any regulatory approach, relies on the quality of the contracts and concessions themselves. Through the Regulatory Act, guidelines, and support from the PPU to eligible municipalities, it is anticipated that high-quality, “win-win” concessions can be drafted that are relatively simple to monitor and that regulatory disputes can be solved if not preempted.

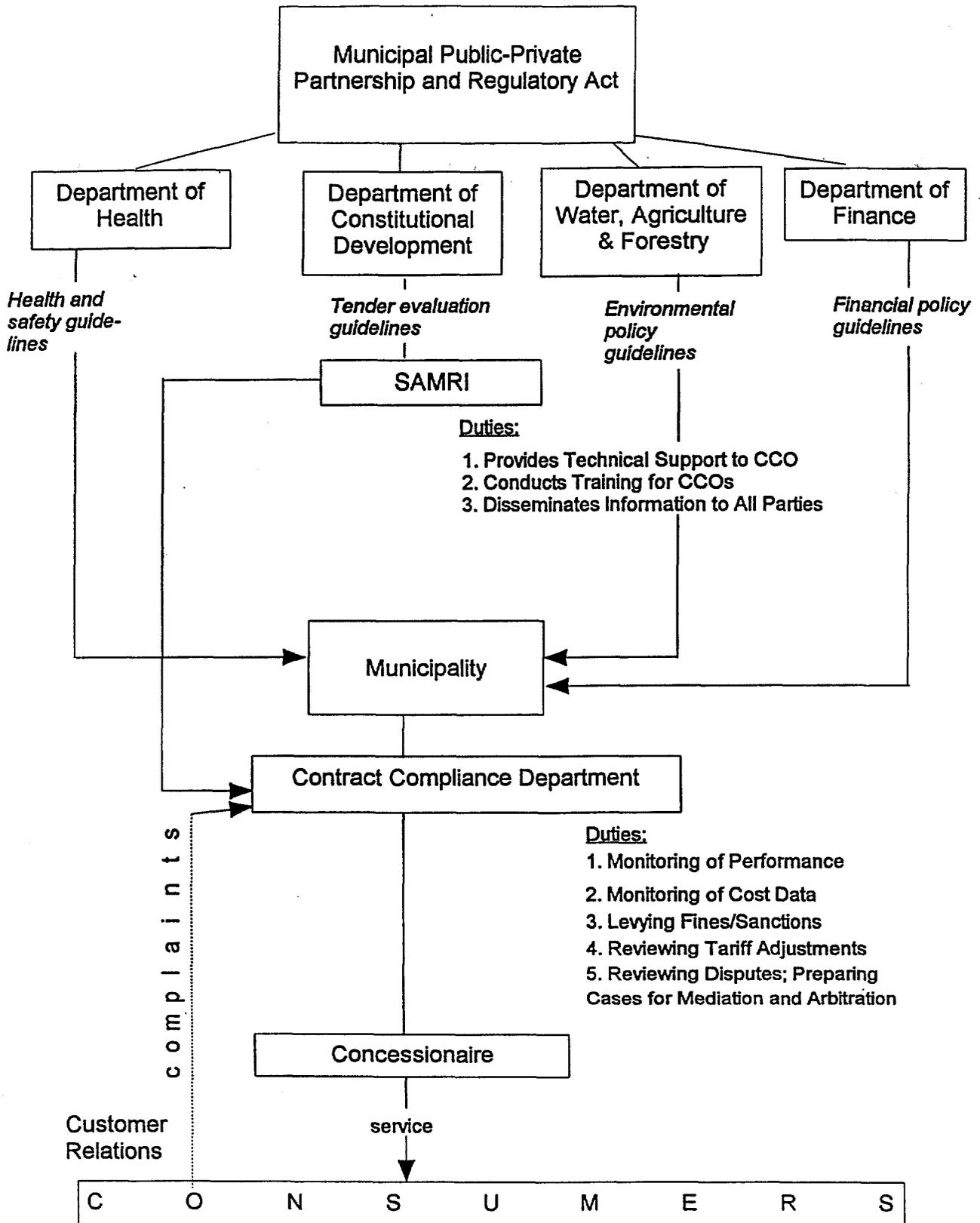
Exhibit VI-7 illustrates the roles of the parties in the hybrid model and how national and local regulatory interests are served.

Pros

- Sensitive to local needs and concerns that are project-specific.
- Combines local and national resources to achieve results.
- Establishes a working approach to monitoring supported by outside experts that is self-financing.
- Overcomes initial capacity constraints until capacity can be developed for the medium and long term.
- Provides consumers with multiple avenues for feedback and accountability.
- Holds contract compliance officers accountable for performance and professionalism.
- Develops national regulatory resources to “farm-out” to other municipalities.
- Coordinates with national and local agencies to ensure regulatory fit and compliance.
- Can be efficiently expanded as municipalities enter into more transactions. As contract compliance departments grow, they can contract out duties. Contract compliance officers could conceivably handle more than one assignment at a time.
- Incorporates international as well as domestic best practices. (Precedent exists in Nelspruit project.)

Exhibit VI-7

Locally Driven, Nationally Supported Regulatory Model



Cons

- The role for provincial governments is ambiguous.
- SAMRI must be established early to have an impact on municipalities that need assistance.
- Most municipalities lack capacity to perform or even manage contract officers.
- This approach requires coordination with PPU, but absolutely must be separate from PPU. Contract monitoring and regulation is a full-time job. Conflict of interest or capture must be avoided.
- Must address weaker and smaller municipalities to be equitable and effective.

Conclusion. The hybrid has little regulatory downside and significant chances for pilot project success. There is ample time to overcome capacity constraints if SAMRI and an Association for South African Regulators are established to assist the emerging pilot transactions. Since SAMRI is envisioned as a non-profit organization or technical unit, there is limited risk of SAMRI developing into a bureaucratic empire or facing regulatory capture. While the PPU has an exit strategy of five years, SAMRI and municipal regulatory bodies must be in operation for the long term. Regulatory oversight and consumer protection are the ongoing responsibility of government. As PPPs proliferate in South Africa and competition for and in the market increases, the need for regulatory oversight may diminish but the need for effective regulation does not.

G. Next Steps

The proposed hybrid regulatory framework seems to meet most needs of the South African environment. It is important to bear in mind that no regulatory framework is perfect or will meet all needs now. Regulation and institution-building is an evolving process. Regrettably, in the interest of "getting it perfect," many countries fail to begin establishing a working framework. The predictable result has been the delay of transactions, institutions, and capacity. While elements of the strategy will change over time, its core thrust must begin immediately, that is:

- Empowering municipalities.
- Developing a cadre of contract compliance officers and monitors.
- Establishing the South African Municipal Regulatory Institute.
- SAMRI will provide oversight, guidance, support, and training to municipalities and support the South African Association of Arbitration to establish capacity to resolve disputes through mediation and arbitration.

It is recommended that DCD begin the process of consensus-building and work on the South African Act on Municipal Public-Private Partnerships and Regulation. While the act is developed, several stand-alone projects could begin in earnest to fill the regulatory gaps before the legislation is complete. These projects would include training, providing technical support on some of the upcoming pilots to ensure compliance with the proposed regulatory structure, policy design, draft regulations, and model contracts. Work should also be performed on detailed design of the regulatory structure including draft legislation on procurement, government support, solicited and unsolicited proposals, fiscal incentives, and linkages between SAMRI and DCD.

G1. How the Structure Would Work

Several conceptual issues must be addressed that relate to how the proposed structure should work and which elements require further analysis to ensure the most appropriate model. Starting with the local level, the following issues should be addressed.

Contract compliance officers. For each transaction, each municipality should hire a contract compliance officer. The CCO would be funded by a surcharge on the concessionaire's sales and some grant support for further expertise if required. Depending on the size, nature, and complexity of the contract, a Contract Compliance Unit could consist of:

- Contract compliance officer
- Technical monitoring specialist
- Financial monitoring specialist
- Customer services monitoring specialist

Based on a defined mission statement for this unit, an agreed reporting authority, and specific job descriptions, a staff selection process would be initiated. SAMRI would assist in this process under DCD supervision. Once the staff is selected, a training needs assessment would define the specific training needed.

When staff has been selected for each municipal contract, a training program would be designed to address the needs of the municipality and the Contract Compliance Department. It would consist of the following:

- Background on project and all contracts and loan agreements
- Customized instructional training on municipal contract monitoring
- Study tours of selected concession/contract operators
- Hands-on, on-the-job training involving actual monitoring issues for the concession.

Responsibilities and authorities. CCOs would be full-time and under strict contractual arrangements. They could be municipal employees or consultants but will have to sign non-disclosure and other agreements to ensure accountability. Possibly CCOs could monitor multiple contracts based on the strength of the capacity building program. Each municipality and contract compliance departments should have resources made available to them to hire outside, short-term experts for specific tasks.

Financing of CCOs. As discussed above, CCOs should be financed out of the surcharge placed on sales by the concessionaire. The Nelspruit budget for CCOs is a useful model.

Special regulatory needs. When disputes arise that must move into the negotiation, mediation, and arbitration phases, the CCO should turn to SAMRI to provide quick, responsive technical support to conduct economic, financial, technical, and legal analysis of monitoring data. Through use of internal and external resources, SAMRI will assist municipalities in providing evidence and expert analysis at each phase of the dispute resolution process. Exhibit VI-8 shows how this process and access of support would function. Over time, SAMRI will rely less on outside specialists and increasingly access the South African Association of Regulatory Professionals.

Regulatory Review/Renegotiation by Contract

Three Phases of Effective Dispute Resolution

Trigger

1. Price Review or Tariff Adjustment
2. Performance Review or Non-Compliance
3. Unforeseen Exogenous Events
4. Contractually Mandated Renegotiation

Benefits of Renegotiation-by-Contract System

1. Efficient and cost-effective to all parties
2. Binding, agreed-upon procedures ex ante by both parties
3. Municipality supported by technical experts
4. Development of local capacity in mediation and arbitration
5. Standardized approach to concessions and renegotiation represents best practices.

CONTRACT

Dispute Resolution Mechanisms and Phasing

Phases: 1. Negotiation → 2. Mediation → 3. Binding Arbitration

Regulatory Responsibility

- * Contract Compliance officers
- * Support, as needed from SAMRI and external specialists
- * National Regulatory Association

Regulatory Responsibility

- * Contract Compliance Officer
- * SAMRI
- * Outside, contractually mandated mediator

Regulatory Responsibility

- * As stipulated in contract
- * Municipality and concessionaire abide by arbitration
- * S.A. Association of Arbitration

G2. SAMRI

SAMRI should be established as a non-profit, independent unit, sponsored initially by DCD with funding by the donor community. It should be governed initially under a contractual arrangement with DCD and have a board of directors made up of representatives from DCD, Department of Finance, Development Bank of Southern Africa, the donor community, and the private sector. It should have a work program aimed at assisting municipalities in developing regulatory capacity, especially for the initial pilot projects, and developing national capacity on regulation and monitoring. A large part of its work should be the training and dissemination of information between transactions and municipalities. It should participate, as regulatory expert, in the design phase of projects that the PPU is working on to ensure regulatory fit. Lastly, it should sponsor certificate training to develop a cadre of regulatory and monitoring professionals as is done in the United States, Singapore, Switzerland, Germany, and Japan.

G3. What the Proposed Structure Needs to Function

For the proposed structure to work, both the PPU and the regulatory framework must be initiated. The launching of pilot projects is already underway and DCD is supporting up to 25 projects in packaging and design. The more difficult task is to begin the regulatory capacity building and legal and regulatory preparation that should accompany each of the 25 pilots as they proceed apace.

While DCD, through a grants program, is sponsoring the PPU and the assistance to municipalities, the regulatory framework will be funded through different sources. Contract compliance departments are self-financed. However, the preparation of the Regulatory Act and guidelines, capacity building for municipalities, and ongoing regulatory support provided to municipalities by SAMRI and the South African Association of Municipal and Utility Regulators for all phases of contract monitoring and dispute resolution will be funded by a combination of DCD resources, USAID, World Bank, and other donor assistance. While the costs of regulation under this structure are lower than usual, the development of a regulatory body at the local and national level is an expense that adds value to the economy and protects the rights of consumers.

H. Conclusion

The regulatory framework must be consistent with the vision for public-private partnerships in South Africa. Depending on its design, regulation can be a barrier or a complement to economic growth and efficiency. The PPU must coordinate and complement the regulatory structure and unit. Lessons from other countries are highly instructive about the poor results when project preparation and market oversight are not coordinated. The regulatory act and concomitant guidelines must begin as soon as possible. No regulatory model is perfect or complete. The Philippines, which is often cited as a useful example for economies in transition, has gone through several iterations of laws and procedures, with private sector and consumer confidence growing at each phase. DCD believes that a modern regulatory framework is consistent with the goals of the new South Africa. The country has several advantages that augur well for successful planning and implementation of public-private partnerships at the municipal level.