Development of a framework for franchising in the water services sector in South Africa

Final Report to the
WATER RESEARCH COMMISSION

by

Dr K Wall
Boutek CSIR

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EXECUTIVE SUMMARY

Internationally, it is recognised that there is a need for partnerships between public, private and civil institutions to achieve water services delivery objectives. The variety of partnerships that has been implemented, including private sector concessions and Build-Operate-Train-Transfer (BOTT), has enjoyed mixed success overseas and in South Africa. These have generally been partnerships for large-scale contracts in which investment in new infrastructure plays a prominent role.

There is an alternative service delivery institutional concept that is suited more for the ongoing operation and maintenance of water services systems, rather than for investment in new infrastructure. This alternative is the franchising of water services. However, there is little experience of this concept internationally, and no experience in South Africa, although some partnerships have some of the characteristics of the franchise concept.

A franchise concept would, it is envisaged, be made available to emerging entrepreneurs as the basis of a viable business. The franchise would be in respect of a component of the water services value chain that is suitable for small business because it can be readily systematised. Franchising firstly systematises the operation, then facilitates the setting up of the business, and thereafter supports and disciplines it. Franchising as an option also provides opportunities for local economic development.

The exploratory study that is described in this report aimed:

- To explore the concept of franchising and its relevance to the South African water services sector;
- To explore different concepts of franchising within the legal, socio-economic and institutional context of the water services sector;
- To develop a report for dissemination and discussion; and
- To develop a strategy/proposal for further investigation of franchising concepts.

The study constituted the first step towards creating an understanding and a framework for franchising as a service delivery option in the water services sector in South Africa.

The study's review of the water services that have been developed in South Africa (that is, the infrastructure investment that must be operated and maintained), and of the current delivery mandates and methods, concluded that there is a strong "push factor" motivating the need to investigate water services delivery institutional concepts as alternatives to those currently in use.

The principles and characteristics of delivery of goods and services by franchise, and the franchising industry in South Africa, were reviewed by the study. The study considered the process, success and failure factors associated with the franchising, and the extent to which franchising can achieve its delivery objectives without seeking a profit. Franchising has a very creditable track record in creating net jobs and in small, medium and micro enterprise (SMME) development.

A survey of overseas literature, while admitting that the topic of water services franchising is a very new one, and implementation even at a pilot scale is yet to take place, indicates that water services franchising shows great promise. Especially this is so in respect of water services to towns and to multi-village schemes. However, franchising would by no means be free of many of the issues that equally affect other alternatives, in particular the financial self-sustainability (or not) of the system.

A review of local economic development in South Africa concludes that there is a strong "pull factor", viz. the need for local economic development, and in particular for the creation and nurturing of SMMEs, that strongly supports the need to investigate franchising in South Africa as a water services delivery concept in addition to, and probably complementary to, the current models. Resources allocated to a programme for the franchising of water services would be well spent in terms of achieving sustainable jobs and entrepreneurs, not to mention the water services delivery that would ensue. It is found that many useful pointers for the water services franchisee development programme that will be needed, if franchising of water services is to take off, can be found not only in business format franchising franchisee development programmes, but also in engineering infrastructure contractor development programmes that already have a track record in South Africa.

The study found that the need for alternative water services provider systems, and for local economic development, is indisputable, and that through water services franchising there is potential to simultaneously:

- deliver water services, and
- promote local economic development, SMME development and Black economic empowerment.

Thus "franchisee" must be added to the list of possible water services provider types in South African water services practice.

The study also found that it is essential to the success of water services franchising:

- that service to customers meets the specification in the franchise contract with the water services authority;
- that suitable franchisors are willing and available;
- that local entrepreneurs are willing to take up water services franchise opportunities;
- that the funding partners support water services franchising in the same way as they support in comparable circumstances water services provision by other institutional means; and
- that franchising proves to be a viable business for franchisor and franchisee alike.

The study recommended that a South African research programme must commence by learning from the performance of other water services institutional arrangements, as the overseas research programmes have. Experience must also be derived from franchising experience in business sectors other than water services. Only thereafter can such a programme contemplate implementation, and even then initially at pilot scale as field experiments, and subject to structured research methodology. Furthermore, piloting must only be done in the easiest of circumstances, where there is the greatest chance of success. If piloting is attempted in a problematic area, and if the pilot were not completely successful, not enough would have been learned from the pilot implementation to draw any worthwhile conclusions.

The overall conclusion of the study was:

- that the potential of water services franchising in South Africa is clearly demonstrated; and
- that the circumstances are now most appropriate for a more in-depth investigation of water services franchising to be commenced than has been accomplished by the current study.

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DEFINITIONS

*(These definitions are taken from the Water Services Act (*South Africa 1997b*, page 10).)*

"Water services" means water supply services and sanitation services.

"Water services authority" means any municipality, including a district or rural council as defined in the Local Government Transition Act, (South Africa 1993), responsible for ensuring access to water services.

"Water services institution" means a water services authority, a water services provider, a water board and a water services committee. This institution can be a statutory authority, private company, group of individuals, or an individual, or any combination of these.

"Water services provider" means any person who provides water services to consumers or to another water services institution, but does not include …… any person who is obliged to provide water services to another in terms of a contract where the obligation to provide water services is incidental to the main object of that contract.

ABBREVIATIONS/ACRONYMS

BEE	Black economic empowerment
BOTT	Build-Operate-Train-Transfer
CBO	Community-Based Organisation
CIDB	Construction Industry Development Board
CMIP	Consolidated Municipal Infrastructure Programme
CSIR	Council for Scientific and Industrial Research
DBSA	Development Bank of Southern Africa
DCD	Department of Constitutional Development
DFID	Department for International Development (of UK government)
DPLG	Department of Provincial and Local Government
DWAF	Department of Water Affairs and Forestry
FASA	Franchise Association of Southern Africa
FRAIN	Franchise and Advice and Information Network (of NAMAC)
HSRC	Human Sciences Research Council
IGFR	Intergovernmental Fiscal Review
IMESA	Institution of Municipal Engineering of Southern Africa
IMFO	Institution of Municipal Financial Officials (of South Africa)
IRC	International Research Centre (at Delft in the Netherlands)
LED	Local Economic Development
MSP	municipal services partnership
MXA	McIntosh, Xaba and Associates
NAMAC	National Co-ordinating Office for Manufacturing Advisory Centres
NGO	Non-governmental Organisation
SAICE	South African Institution of Civil Engineering
SALGA	South African Local Government Association
SCDP	Soweto Contractor Development Programme
SMME	small, medium and micro enterprise
SSA	support services agent
USAID	United States Agency for International Development
WEDC	Water Engineering, and Development Centre (at Loughborough University, UK)
WRC	Water Research Commission
WSA	water services authority
WSP	water services provider

1. Introduction

1.1 Background

The capacity of many municipalities in South Africa to adequately provide even basic levels of water services to all their citizens is in question. It would seem that, generally, the less urbanised the municipality is, the less the capacity (although this general statement conceals great variations). The need for alternative service provider systems is very apparent. Both Rand Water and the National Department of Water Affairs and Forestry (DWAF) have for a number of years considered that the potential for franchising in the water services sector ought to be investigated. For various reasons this has never been done.

The barriers to entry for the smaller or start-up company are substantial. But if these could be overcome, perhaps through franchising, then there will be many opportunities for local economic development. The twin driving forces of the franchising concept are:

- an incentive in the form of a focused and quantifiable financial outcome (profits, dividends or surplus), and
- a successful business model that can be copied widely.

Neither of these is currently in evidence in the water services sector. Furthermore, there are many pitfalls when it comes to implementation even under the most favourable of circumstances.

1.2 The objectives of this study

The objectives of this study were:

- to explore the concept of franchising and its relevance to the South African water services sector;
- to explore different concepts of franchising within the legal, socio-economic and institutional context of the water services sector;
- to develop a report for dissemination and discussion; and
- to develop a strategy/proposal for further investigation of franchising concepts.

1.3 Study approach

This was a scoping study, which set the framework for more in-depth research with respect to specific elements of franchising and its application to the water services sector.

This study was seen as the first step in the formulation of a "framework" for franchising, and the eventual acceptance and implementation of franchising, in the water services sector in South Africa. This framework includes principally, definition of franchise structure, indication of circumstances in which the franchise concept should be considered/would be appropriate, and development of business and operations model(s), all backed by sound research.

The principal components of this study were thus:

- setting the scene of water services delivery in South Africa;
- background investigation on franchising generically (i.e. not in the water services sector)
- research of the literature, international and South African experience and best practice, and of the environment;
- background investigation of research into and experience in franchising in the water services sector; and
- investigation of appropriateness of franchising to the water services sector in South Africa.

1.4 Structure of this report

Following this chapter:

- Chapter 2 builds the background to water services delivery in South Africa;
- Chapter 3 is a generic description of the delivery of goods and services by franchise;
- Chapter 4 reviews overseas literature on the franchising of water services;
- Chapter 5 describes franchising in South Africa, a well-developed industry, but hardly if at all providing social goods, and not yet providing water services;
- Chapter 6 discusses local economic development in South Africa;
- Chapter 7 draws many of these issues together, and discusses water services franchising in the South African context; and
- Chapter 8 sets out the findings of the study, and lists the recommendations.

2. Water services delivery in South Africa

2.1 Introduction

This chapter and its findings provides the foundation for the description in following chapters of a water services franchising option.

Whereas this chapter does not take a view on water services franchising, it is necessary, before proceeding any further with the report, to establish if this need for alternative institutional forms does or does not exist, and how compelling the need is. If there is a demonstrated need, then this represents a "push" factor to explore alternative forms.

At the same time, it is as well to note that it would be futile to propose institutional forms that could not be broadly acceptable in civil and political society. Some forms, such as private ownership of water services assets, have been rejected by DWAF. Other forms, such as the outsourcing to the private sector under short-term contracts of disaggregated components of a service, have received varying degrees of favour in the socio-political environment.

In addition to the "push" factor (if there is one), there is a national imperative, often emphasised by leaders in all spheres of government, for local economic development (see Chapter 6 below).

Thus, if a need from the point of view of water services delivery is established, then the current study in effect investigated the subject of water services franchising from two directions, viz.:

- there is a need (an institutional gap) in water services delivery, and water services franchising should be among the alternatives considered. ("Push" factor.)

- if water services franchising is a feasible means to create local economic development (LED), then for this reason (in addition to the "push" factor), ways should be found to enable it to become a more viable and better-known alternative (in a significant number of situations) to the more current methods of water services delivery. ("Pull" factor.)

Finally, what is "delivery", as in "delivery" of water services?

It is necessary to free the notion of “service delivery” from being only the initial capital investment in delivery infrastructure (both bulk and connector infrastructure). There is a need to get away from the widely held notion that "service delivery" ends with the laying of the pipe in the ground. This is a notion that is more widely held by default than it is held deliberately, that is, once the infrastructure has been constructed, the activities necessary to ensure that the infrastructure continues to deliver the service are so often not carried out.

Thus “delivery” needs to be universally understood as embracing not just the pipe, but also the water in the pipe, where the pipe is, and the fact that the water must flow, not just for a few years, but for the entire design life of that pipe. For the service to be sustained, "delivery" must not just encompass physical engineering infrastructure delivery, but must include planning, financial sustainability issues such as billing and cost recovery (including setting up an indigent policy), community consultation, ongoing operations and maintenance.

Fundamental as this concept is, there is no guarantee whatsoever that reference in many reports other than this report to "delivery" indicates anything beyond that pipes have been laid in the ground, the treatment plant has been commissioned, etc.

Nonetheless, this investigation of water services franchising is largely motivated by recognition that institutional forms must be put in place that have better chances of ensuring truly sustained water services delivery than do some of the other forms currently employed.

2.2 What has been delivered

2.2.1 Asset value as measured by construction cost

Enormous sums have been spent on water services capital works. Any figure obtained by adding up the annual capital works budgets of the many funders would provide no more than a guide to current replacement price, for the following reasons:

- budgets are generally expressed in Rands at the time, which would need to be escalated to current worth;
- the historic figure is of less value to assisting the current discussion than is present-day replacement price;
- much double counting abounds, for example some of DWAF's annual budgets also appear in the budgets of entities that the Department funds, e.g. municipalities (National Treasury 2003, page 205 footnote);
- figures are not readily available of the split between water services and other infrastructure in for example annual reports of DBSA and DPLG.

No doubt a painstaking reconciliation could sort all these out. However, this effort was unnecessary for the purposes of the current study.

Sufficient indication can be provided by the following listing. (Note that these all cover the period since 1994 only. The replacement price of water services infrastructure constructed prior to 1994 and still in service (or that ought to be in service, but needs repair or rehabilitation) is surely of an even larger order of magnitude than the replacement price of that constructed since 1994.)

- DWAF 1994 through 2003: "Between 1994 and April this year (2002), my department (i.e. DWAF) spent R5 268 million providing water supply infrastructure to 7.2 million people." (DWAF 2002b, page 2) "This year's budget therefore provides not just R1,2 billion for new water supply and sanitation infrastructure but also R116 million for refurbishment ……" (DWAF 2003a, page 3)

- CMIP (Consolidated Municipal Infrastructure Programme of DPLG) 1997 through 2003: From the start of the CMIP programme (in 1997) to November 2003, R7,1 billion had been spent. And if "water supply projects" (excluding sanitation) are "fluctuating around 50%" (CMIP website), then (and adding a very much smaller percentage for sanitation) it can be said that of the order of R4 billion has been spent on water services new capital works, or upgrading or rehabilitation.

- DBSA: Over the 5 years 1998 to 2002 inclusive, DBSA disbursed R10,9 billion, also much of it on infrastructure. In the 2002/2003 financial year, an additional R3,7 billion was disbursed. (DBSA 2003) Of this grand total of R14,6 billion, approximately one third (say just short of R5 billion) was spent on water services new capital works, or upgrading or rehabilitation. (Note that whereas there is no consolidated figure, and the

DBSA 2003 report does not identify the proportion spent on water services, in the 2001/2002 financial year, of DBSA's disbursements to municipalities, 47 per cent was for water services. (DBSA 2002 page 23) So "approximately one third" is conservatively chosen for the above estimate.)

Whereas the overlap between the three sets of figures is likely to be insignificant or not at all, and municipalities from their own budgets and using private sector funding have spent further sums, it can be seen that of the order of at least R15 billion (at the prices of the time) was between 1994 and 2003 spent on water services new works, upgrading and rehabilitation.

All of this is, or will become, the responsibility of municipalities to operate and maintain.

The point of the above exercise is not to calculate an accurate figure for the cost, at the prices of the time, of the water services infrastructure. Much less is it to proceed from there, and from the assessment of the state of that infrastructure (and removal from the calculation of, for example, the figures for the instances where some of the earlier expenditure has proved to be wasted in one or other of the many possible ways) to calculating an accurate figure for the current value (however "current value" might be defined) of this infrastructure. (This calculation needs to be done sometime, if an accurate understanding is to be gained of the total operations and maintenance responsibility borne by water services authorities in this country. But it does not need to be done for this report.)

The point of the exercise is to gain a sufficient understanding of the order of magnitude of new (and upgrading and rehabilitation) water services construction since 1994, in order to provide the context for the discussion that follows, inter alia,

- that even if, say, 10% (or whatever the figure is) of schemes are not working for whatever reason, this represents significant infrastructure that needs repair, rehabilitation or even replacement, or just needs to be operated better;
- that even if, say, one third (or whatever the figure is) of municipalities are struggling to operate and maintain their water services infrastructure, this represents significant infrastructure that will have to be operated and maintained with alternative funding or by alternative methods altogether;
- that extension of water services to those South Africans who still do not have basic levels of service (11% or 5 million with "no access to safe water supply" and 41% or 18 million who "did not have adequate sanitation services" (DWAF 2003b, page iii)) represents a lot of infrastructure to be built, and thereafter to be operated and maintained; and therefore
- it cannot be said that there is no need for additional institutional forms, to do this kind of work, to be investigated.

Not forgetting, as mentioned above, the billions spent on water services infrastructure prior to 1994.

There might be nothing intrinsically "wrong" with existing institutional forms, except that it is evident that they cannot fully cope. The task is so huge, that the desirability of looking at alternative concepts cannot be denied.

2.2.2 How much of this built infrastructure is still delivering?

Before investigating alternative delivery methods, it is of value to overview how much of the above water services infrastructure is no longer "delivering" in the sense that "delivery" of, for example, a pipe in the ground, is of little use to the intended beneficiaries if that pipe does not provide water on an on-going basis. This distinction was crucial to the current research study, as it was found that it is in the operation of the service, rather than the construction of the infrastructure, that current delivery methods are most frequently inadequate.

An extended quotation from the 2003/2004 budget speech of the Minister will be a sufficient description:

“But many people have asked whether the systems we have built are working as we intended. Water supply does not end when pipes are put in the ground. What happens when a pipe bursts? When diesel must be bought for the pump? When the operator fails to open the valves to a community? When some people take more than their fair share of water at the expense of others further down the pipeline? These issues are confronted every day in communities across the country.

For an objective view, I asked Dr. David Hemson of the University of Durban Westville who had highlighted these challenges, to investigate a representative sample of DWAF-funded water projects in KwaZulu-Natal. His report did not give us 100%. I would have been surprised if it did. His team visited 23 schemes across the province. 17 (74%) were supplying water as intended. Only one had a technical problem – needing a new pump. In three, there was no water because neither community nor local government had paid for diesel or electricity. In the last two, there was community conflict over how the scheme should be run and who should benefit.

These findings are encouraging because, once those problems are solved, it will be possible to get the schemes back in operation and providing water to the communities in a sustainable way.

We have also surveyed 1544 departmental schemes valued at R9,95 billion as we prepare to transfer them to local government. While the vast majority of the schemes are working, some rehabilitation is needed, 40% because of normal ageing, 19% due to vandalism (including theft of diesel engines, illegal connections which caused leaks and reduced pressure, depriving whole communities of their supplies), 18% because normal maintenance had not been done.” (DWAF 2003a, page 3)

Hemson provided more detail of the sample of KwaZulu-Natal schemes visited:

- 28 percent are delivering without problems;
- 42 percent are "problematic"; and
- 30 percent are out of action and require significant remedial work or replacement.

The "problematic" schemes have one or more of the following problems:

- bills not paid (e.g. for diesel, or to Eskom)
- repair is needed
- water pressures are too low
- certain people are denied access, by warlords or other reasons. (Hemson pers comm 2003)

Even in the well-resourced cities, water losses (both commercial and physical) are significant, due largely to a legacy of under-funded maintenance budgets and inadequate maintenance practices. Generally, the situation is worse in less well-resourced areas. The financial cost of these losses far outweighs any profit that a private sector operator might make.

To conclude: Whereas massive construction of water services has taken place, keeping this operating is proving to be no mean task.

2.3 Current delivery mandates and capacity

2.3.1 Mandates

The responsibility for water services rests with municipalities. The Water Services Act (South Africa 1997b) assigns municipalities alone the water services authority (WSA) function. The actual delivery of services is undertaken by distinct entities known as water services providers (WSPs). These WSPs can be selected by the WSAs from a range of institutional options and are appointed by the WSAs. Whilst many municipalities retain a direct involvement in the delivery function through internal departments that are their own WSPs, some municipalities utilise municipal entities (Johannesburg Water, ERWAT (Ekurhuleni)), water boards or contracted service providers (e.g. community-based organizations or private sector operations contractors) as their water services providers.

Other municipalities disaggregate the service delivery functions into components that are separately outsourced to the private sector, for instance for construction, for maintenance, or for billing and revenue collection.

The national Department of Water Affairs and Forestry (DWAF) performs functions in respect of both water resources (such as dams) and water services.

The Water Services Act provides for the establishments of water boards. The primary activity of these boards is seen to be the provision of bulk water to users such as municipalities, by bringing water from dams and rivers to local reservoirs. The regional water boards abstract, treat and transport bulk water to service providers such as municipalities. As a secondary activity, some water boards also undertake retail water supply on behalf of poorly capacitated municipalities, and operate bulk wastewater treatment works. For example, the variety of public-public partnerships in terms of which water boards provide retail services in areas such as Harrismith and Maluti-a-Phofung.

While metropolitan municipalities are the water service authorities for their jurisdiction, this power is divided differently in two-tiered municipalities. A government gazette early in 2003 (24228 of 3 January 2003) issued by the Minister of Provincial and Local Government made this determination, taking into account regional and capacity considerations. This division of functions took place on 1 July 2003, and involved some reallocation of assets, liabilities, personnel and budgets between the two types of municipalities in the same areas.

Current arrangements also allow for public-private partnerships, where private companies are contracted to provide water on behalf of a municipality. There are currently four public-private partnership contracts in the water services sector, viz. covering Dolphin Coast, Mbombela (Nelspruit), Durban (Southern Wastewater Treatment Works) and Queenstown. In each of these cases, new investment in assets by the private sector is a component of the contract. Another category of public-private contractual arrangement exists that involves only the operations and maintenance of existing assets (without any new investment). An example is that of Fort Beaufort (recently terminated) and Stutterheim. Johannesburg Water's management contract provides for a mix of operations management and institutional development. The innovative BOTT (Build, Operate, Train and Transfer) form of public-private contract (mentioned further below) has also been used extensively in four provinces where service delivery capacities were severely challenged.

The water services policy recognizes the role of community-based organizations (CBOs) as water services providers (DWAF 2003b, page 22), particularly for small-scale rural water services schemes. An effective policy framework to ensure that these community-based organizations receive an appropriate share of the financial transfers intended for water service provision has still to be developed within the context of service providers in terms of the Municipal Systems Act. (National Treasury 2003, page 207)

DWAF is currently undertaking water services provision directly, operating 512 large water schemes and a further 1032 rudimentary schemes (totalling the 1544 mentioned by the Minister in his 2003/2004 budget speech), serving approximately 8 million people. Most of these were inherited in 1994 from the water departments of the former homelands but, in addition, since 1994 DWAF has through the Community Water Supply and Sanitation Capital Programme of the RDP built and/or operated some basic water and sanitation capital projects. In order to give effect to the constitutional and other legal frameworks regulating water services provision, DWAF needs to transfer to municipalities all these water services works that it currently owns and/or operates. The Department has a schedule to transfer the schemes to municipalities. ("By 1 January 2005, "DWAF isn't supposed to still be a water services provider."" (Balzer pers comm 2003).)

However, many municipalities are reluctant to take transfer, citing their unwillingness to take over existing staff (approximately 8100 all told, currently on DWAF establishment, that need to be transferred) and that they need further financial resources to operate and maintain the services, let alone undertake the upgrading which is in many cases needed. (National Treasury 2003, page 207. For more detail, see Balzer and Stander 2003. Balzer estimates that approximately R710 million must be spent on "refurbishment" before the schemes can be handed over. (Balzer pers comm 2003))

The procedure for the transfers is laid down in some detail in a policy position jointly drawn up by DWAF, the South African Local Government Association (SALGA), DPLG and National Treasury. (South Africa 2003a)

2.3.2 General perspective on municipal capacity

(By "general perspective" is meant perspective on municipal capacity to deliver services, not specific to water services.)

It is not possible, conceptually or in practice, to separately analyse the responsibility of municipalities to deliver water services, completely ignoring for the purposes of analysis their responsibility to perform any of their other functions. Disposal of the municipal budget is at the discretion of the municipal councillors, and the Council has to decide on priorities. Pressure to spend on specific services or in specific areas can prove stronger in a financial year than a motivation to budget for water services, almost irrespective of the merit of that motivation.

The new municipal demarcations that came into effect in 1995 and 2000 made more visible to South Africa's urban dwellers what had always been known but had not been tackled with the necessary will, viz. that the vast majority of our citizens living in villages and rural areas, and even many of those in small towns, had not enjoyed safe water services. Nor had it been sufficiently visible that even that proportion of the several million living in what the Urban Foundation had in the late 1980s collectively described as the "dense rural settlements" of the homelands, while they had enjoyed reticulated water supply, for example, this supply was (with few exceptions) not remotely financially self-sustaining. ("Dense rural settlements": characterised by rural location, but much higher density than typically rural, and very little household income from rural-type activities but deriving income rather from urban activities (such as remittances from migrant workers).)

This increased visibility, and the representation on the new municipal councils of municipal voters living in these areas, coupled with the voters' demand for improved services but their little if any ability to pay for them, has had important consequences for the municipalities that now include large peri-urban and rural areas. One of the most important consequences has been that the technical capacity of many municipalities, previously focused almost entirely on the larger urban centres within these municipalities, and with finances (other than national government sources) almost entirely raised from the larger urban centres, has been very severely stressed.

To be fair, the achievement in terms of rolling out new infrastructure has been very considerable. As the Minister of Provincial and Local Government stated in his summing up of the achievements of the last five years: "People legitimately complain about the billing systems. [But] very few municipalities in the developing world have delivered services to their citizens in the scale that ours have done. People would not be complaining about billing systems if government [had not] made significant progress in rolling out the electrification and water provision programmes." (DPLG 2004)

A number of studies of various aspects of municipal capacity have appeared in the last couple of years. Given that the interest of the current study lay more with towns and villages than with either cities or rural areas (see more fully in Chapter 4), the most useful of these studies is represented by the work of Atkinson (Atkinson pers comm 2003. Atkinson was also the principal author and "compiler" of the Centre for Development and Enterprise 2002 publication (CDE 2002)). A summary of the salient points from this communication and this publication is sufficient source material for the current Section 2.3.2.

In her analysis of "third-generation issues" facing local government in South Africa, Atkinson made it clear that the difficulties are not because the fundamental vision regarding municipal government is at fault. "Rather, it is because various role players (particularly at national level) are directing diverse, and often contradictory, mandates and requirements at municipal governments." This is done by national government with the best of intentions, but there is a lack of strategic direction and integration. (CDE 2002, page 11)

(Definitional note: "Third-generation issues" are those issues that have dominated local government since the local government elections at the end of 2000. "These concern questions of practical development management ….. They concern the desirable outputs of municipal activity (i.e. municipal developmental policies and programmes) as well as the way in which activities should be conducted (e.g. by means of integrated planning, public participation and "alternative service delivery")." (CDE 2002, page 5)

Points of relevance to the current study included:

- The extremely inadequate number of experienced change agents and management specialists in municipalities. And a reluctance to involve former and some of the serving officials who do have experience. (Ibid page 11) The huge staff changes due to amalgamation and reorganisation have taken up a lot of energy, and have eroded the already fragile skills base in many municipalities. (Ibid page 17)

- Insufficient knowledge of the benefit actually effected of the vast sums hitherto transferred by national government to municipalities. (Ibid page 14)

- The fact that many of the municipalities (TLCs) prior to 2000 were bankrupt "creates a double whammy, institutional amalgamation and financial reorientation which need to be undertaken simultaneously." (Ibid page 15)

- Relationships between councillors, ward committees and officials are not sufficiently clarified, and need to be institutionalised. (Ibid pages 17 and 19) The turnover rate of councillors is high. (Ibid page 17)

- That the formulation of IDPs, even if poorly done, is creating a change in mindset to integrated municipal planning, which is a breakthrough. (Ibid page 22)

- Many IDP visions and priorities are "shallow", largely because these are often untested against practical considerations until budget time, when the municipality has to make hard choices. (Ibid page 23) However, even though IDPs are often deeply flawed, they do suggest clearly what the key developmental challenges and priorities are likely to be and, even if by default, revealed the "huge capacity deficits". (Ibid page 24)

- Implementation of the IDPs should have several dimensions, including the need for integration of effort, the need for policies on various of its activities (such as a policy on service delivery) and programmes to carry out these policies, and the need for municipalities to have the capacity to implement, "or, at a minimum, to be able to outsource development in a coherent and effective manner, and monitor the results". (Ibid page 25)

- Unfortunately, the system of development funding "is a hit-and-miss affair, generally consisting of applying for as much funding from as many sources as a municipality happens to be aware of. When funding is made available to the municipality, it tends to be for priorities determined by the funders (sectoral departments or donor organisations), with little regard to strengthening diverse projects by creating mutually supportive and sustainable administrative or developmental measures." (Ibid pages 25 and 26)

In summary, there is a large task ahead, and municipalities should focus on those tasks they alone can do, or best can do to, inter alia:

- create development-oriented municipal organisational structures;
- resolve spatial tensions;
- resolve the problems that have arisen because expertise in the new municipalities has been drawn to the "head office" town, and away from the rest of the (often spatially huge) municipal area;
- improve the skills of and the access of the public to the front-line staff;
- improve the information base of the municipality, and access to this information (not just information such as demography, but information on how the municipality is affecting the citizens and the economy within the municipal area);
- resolve tensions, between Council and citizens, around credit control;
- improve the effectiveness of public participation. (Ibid pages 26 through 53, wherein may also be found many practical suggestions as to how the above may be effected).

There is also a need for national and provincial government to:

- resolve tensions around the relative roles of district and local municipalities;
- create an intergovernmental system that is much more supportive of municipalities.

On the latter, Atkinson stated that national and provincial departments are increasingly looking to municipalities to assist with, or take over, certain functions. This, in itself, cannot be argued with, since the constitutional and legal changes since 1994 have clearly signalled that municipalities must take the lead in developmental initiatives in their areas. However, municipalities lack capacity, and there is a lack of a supportive intergovernmental relations structure. (Ibid pages 54 and 55) Atkinson pointed to the aggravating effect of formal assignment of functions to municipalities, and also "creeping assignment", whereby national departments approach municipalities to undertake specific developmental tasks. That some of these mandates are not funded, or not adequately funded, is only part of the problem. The other is that lack of capacity.

An example of a creeping assignment is the obligation on municipalities to use the equitable share to subsidise indigent people's municipal accounts. This has thrown a "massive workload" onto municipalities, which now have to register indigents, verify their income, and so on. (Ibid page 63) (This workload is alleviated for municipalities that choose not to follow the "free to the poor only" policy for free basic services. DWAF guidelines recommend the "free to all" approach. (Sussens, pers comm 2004))

Another example of a creeping assignment is local economic development. However, very few municipal staff have any experience of entrepreneurial support. (Ibid page 66) (An issue partly caused by this lack of experience, and partly caused by other factors such as lack of clarity of purpose in the national LED Fund itself, is that municipalities tend to become involved directly in enterprises, rather than creating the environment for and supporting entrepreneurs. "All developmental programmes which include the promotion of emergent contractors or SMMEs are currently unfunded mandates. This includes community-based public works projects, water infrastructure projects and housing projects. …… Not only does [this] require a great deal of time, ….. but it also requires very different skills from the traditional municipal activities." (Ibid pages 66 and 67))

Atkinson concluded that there is a need:

- to finalise the powers and functions of local and district municipalities;
- for national funding to municipalities to enable them to create development management posts; and
- to examine more closely, and then address, the "host of practical questions regarding the functioning of municipalities" (as noted above in the current report) (Ibid page 84)

2.3.3 Outline of the view of government

Ability of municipalities to deliver services

Of the many government reports dealing in some or other respect with abilities of municipalities, the most relevant for current purposes was the report of the study tour of municipalities undertaken by the Portfolio Committee (of Parliament) on Provincial and Local Government early in 2003. (South Africa 2003b)

Apart from its general insights on municipalities, the report's greatest interest lies in Section 9 "Delivery of services". Three key conclusions of the Portfolio Committee in respect of services were:

- while significant progress has been achieved in the provision of free basic services, especially water, it is vital that these reach people in the rural areas who are not currently receiving, "and who are often those most in need of it". "DPLG, DWAF, SALGA and other stakeholders need to work closely with municipalities"; (ibid page 36)

- whereas it is in accordance with the Constitution and legislation that the water projects currently being run by DWAF should be handed over, "if this handing over of full responsibility is not dealt with appropriately, it would seriously undermine the free basic water programme"; (ibid page 37)
- "over time, the equitable share will have to be increased significantly more if municipalities are to effectively and comprehensively deliver services to the people". (Ibid page 37)

Municipalities expressed many concerns on the transfers from DWAF. For example, concerns about salaries for the new staff to be taken over. ""The DWAF said take 308 water staff with the handover of the water project. Yet I have 308 staff now" said a municipal manager." Also, "DWAF says we give your salaries for two years. Then phase it out. How (are) we going to pay their salaries then?"

On involvement of the private sector, some municipalities (mostly larger ones) have a "favoured option" that seems to be public-private partnerships for what are identified as "core" services, and other forms, including privatisation, for what are seen as "non-core". Others stated that "we're not looking at privatisation of core services, not in our lifetime."

The Minister in his 2003/2004 budget speech, immediately after describing the problems with sustaining delivery (see extended quotation in Section 2.2.2 above), made mention only of strengthening municipalities. "The next phase of our work will therefore focus on strengthening local management and local government. This year's budget therefore provides …. [inter alia] R93 million for capacity building and R25 million for strengthening our oversight role." (DWAF 2003a, page 3)

The Director-General of DWAF has however made reassuring remarks with respect to the transfer programme. ""In SA in 2003 we had a lot of local government that isn't doing what it should be doing, so to regulate without providing support would be off the wall. We have to be careful not to transfer things in a way that has services collapsing," says Muller." (Financial Mail 2003a, page 27)

The capacity building programme that the Minister mentioned is by the way not the only initiative of its kind. Among the many other programmes for strengthening local government to undertake the tasks for which it is responsible, water services often among them, is the DPLG "Programme to strengthen local government in Mpumalanga and Limpopo provinces", funded by the European Commission. There are also working groups or support centres for municipalities, among them the "Municipal Institutional Support Centre" of the Department of Local Government in Gauteng Provincial Government.

Many have pointed out that the ability of a municipality to deliver services would generally need to be improved in more ways than could be assisted by capacity-building programmes. (Wall 2003; also Atkinson in CDE 2002, pages 71 and 72) Assuming, that is, that the municipalities are in receipt of as much finance as they can usefully spend, and the Minister of Finance has for a number of years stated that finance need not be an obstacle to infrastructure delivery by municipalities, as the Ministry will facilitate the finding of finance for worthwhile projects as and when the municipal sector improves its ability to spend funds responsibly. (For example: Business Day 2001)

Briefly, these other ways to enable functional municipalities, a prerequisite for sustainable delivery of services, include improved business processes, improved incentive systems, reduction in tensions between political and administrative structures, elimination of corruption, improvement of labour relations, and improvement of community participation.

When all that can apparently be done has been done, and the desired improvement has not yet been achieved, sometimes what is needed is simply a period without any further changes, during which systems shake down and trust and confidence (within the municipality, and between the municipality and stakeholders outside it) are improved. But these other ways to enable functional municipalities could also include structures that would enable others to partner with the municipality, to mutual benefit, in the provision of sustainable services.

Private sector alternative service providers

Firstly, what does legislation make provision for and secondly, what appears to be the current sentiment in DWAF?

Section 19 of the Water Services Act states that a water services authority may perform the functions of water services provider itself, or may contract with a water services provider, or may perform a joint venture with another water services institution, in order to provide water services. However Section 19 (2) states categorically: "A water services authority may only enter into a contract with a private sector water services provider after it has considered all known public sector water services providers which are willing and able to perform the relevant functions." (South Africa 1997b)

The then Department of Constitutional Development some years ago tabled a policy on municipal services partnerships (MSPs). (Constitutional Development 1999) However the pertinent local government legislation is the Municipal Systems Act (South Africa 2000, Chapter 8 "Municipal services", Section 73 et seq refer). While this Act does not make reference in as many words to the private sector as an alternative service provider, Sections 77 and 78 lay down the procedure to be followed by a municipality when it is deciding upon "the appropriate mechanism to provide a municipal service". Issues to be taken into account include capacity of the municipality, direct and indirect costs and benefits of the alternatives, the likely impact on development and job creation in the municipality, and the views of the community and of organised labour. (Ibid Section 78)

Recent references by DWAF to water services provision by the "big" private sector (i.e., private sector but not SMMEs) in towns and rural areas have tended to convey less than complete satisfaction. For example, "In 1996, as the capital works programme expanded rapidly, DWAF recognised that progress was constrained by a shortage of delivery capacity. So it started four partnerships with private sector consortia to undertake BOTT (Build, Operate, Train and Transfer) contracts in the four provinces (Eastern Cape, KwaZulu-Natal, Mpumalanga and Northern Province) where the backlog of services was greatest. The aim was to achieve a flexible mechanism for speeding up delivery while minimising administration and bureaucracy, and by using the resources of the private sector to achieve the vision of the public sector. These partnerships had mixed results. The extra capacity available through the BOTT contract was not fully used since many [community-based] project steering committees preferred alternative arrangements, while the BOTT contractors were not able to respond with sufficient flexibility to the unpredictable demands. This resulted in relatively high unit costs. In addition, although the BOTT consortia included skills in institutional development and social communication, there was little evidence that the BOTT system was any more successful than the traditional government system in transferring schemes to sustainable community management. Approaches that emphasise construction tend to mean that cost recovery and sustainability suffer, and the BOTT system was no exception." (World Bank 2002a, author given as Mike Muller, Director-General of DWAF)

Perhaps not too much should be read into this, but the Minister in his budget speech did not suggest expanding MSPs, much less suggest the involvement of SMMEs. (DWAF 2003a, page 3)

The "Strategic Framework for Water Services", endorsed by the Cabinet in September 2003, makes several references to engagement of the private sector, and outlines the ground rules for this. In the opening statement, under the name of the Minister, it is acknowledged that the capacity to provide services effectively and efficiently is a critical constraint in many areas in South Africa. Inter alia, "the role of the private sector in the provision of water services is welcomed, provided that consumer interests are protected." (DWAF 2003b, page ii) The private sector can be involved in a wide range of ways, including but not limited to the following: acting as an external water services provider in terms of a contract (service delivery agreement) with a water services authority, investing in a public utility (provided (that the) ownership control vests with national government), and supporting other water services providers as water services agents." (Ibid page 18) "Privatisation", in the sense of "private investment and perpetual ownership of assets", is completely ruled out. "In terms of South African law and policy for water services, this is not allowed at all." The Minister is quoted on this topic: "While privatisation is an emotional and very much political issue in South Africa, the private sector has played and will continue to play an important role in water services. The challenges facing us are simply too big to be addressed by government alone. We will, however, not sell our public water services infrastructure to the private sector, but this is no obstacle to the private sector getting involved in a whole range of activities." (Ibid page 19)

The above seems to rule out any alternative service delivery concepts that involve ownership of existing infrastructure by the private sector. There does however, appear to be room for private sector investment in new infrastructure. The official statements almost invariably refer to opposition to "selling to" the private sector. While the quotation from page 19 rules out private "investment and perpetual ownership", the quotation from page 18 does allow private "investing in" providing that the ownership is not private. (As an aside: the reference to "ownership control vests with national government" is odd. Surely in so many instances the ownership would be by local government?) (As another aside: the ruling out of "perpetual ownership" appears not to preclude forms of ownership by the private sector for a period of 10 or 20 or more years, after which the assets are in terms of the contract handed over to the public sector. (Such forms of ownership could be Build-Operate-Transfer and Build-Own-Operate.))

The requirements with which a water services authority must comply before appointing "a public or private external water services provider" are laid down in the Strategic Framework, including the need to "make a sound business case for the benefits to be achieved". And then comes the bald statement: "Public preference. The provision of water services by public institutions is preferred." (Ibid page 18) The promise is made that DWAF will in due course "provide guidelines to assist water services authorities in selecting appropriate institutional arrangements for the provision of water services."

An additional value of private sector capital investment in water services provision in a municipality lies in that it can release public funds, allowing that municipality to spend elsewhere an equivalent sum from its limited capital budget. ""Private sector involvement will flow to selected places where there is a real economic case …. [and that may release public funds] to be focused where they ought to be, meeting the basic needs of the poor," says Muller." (Financial Mail 2003a, page 28)

In summary, the water services provider options set out in the above and in other literature cited, (i.e. DWAF publications, policy documents, ministerial speeches, etc.) invariably comprise the municipality itself (either the district or the local municipality), other public sector or parastatal agencies, community-based organizations (CBOs), and combinations of these in the form of municipal service partnerships (MSPs). In special circumstances private sector WSPs will also be considered. But when MSPs are discussed in the literature, it is clear that, aside of community-level schemes, only public sector or NGO or CBO partners are envisaged at the moment.

The thorough (but not exhaustive) search by the current author could not find evidence that DWAF was considering water services delivery by SMMEs, with the exception of the DFID/DWAF initiative described in Chapter 7 below, and support in principle to the concept (e.g. a letter in support of a Boutek CSIR November 2001 bid for study funding). Provision by SMMEs is not ruled out as an option, it is simply not mentioned. And it would appear from the literature search that no thought has been put into ways of supporting SMMEs. (A DWAF spokesperson commented that: "There is certainly nothing to preclude SMMEs, even though they might be private sector, from being WSPs, especially if it results in local economic development or empowerment. I suspect that the seemingly low level of DWAF support for the use of CBOs/SMMEs and the franchising concept is based simply on it being new and untested. It is easier to go with what you know." (Sussens pers comm 2004))

2.4 Chapter conclusions

Municipalities in South Africa already have a huge responsibility for water services operation and maintenance, and are soon to acquire more (in particular via the DWAF programme to transfer substantial additional infrastructure). In addition, millions of South Africans do not enjoy safe water and/or acceptable sanitation. This represents an equally huge responsibility for new infrastructure, a responsibility shared with a number of role-players, the principal of them being DWAF, and after its construction it will have to be operated and maintained.

Many municipalities are a long way from being able to cope with all of their responsibilities. While water services delivery may generally enjoy some priority, the situation is often far from satisfactory.

Even if all the existing institutional role-players were coping with the needs, there would be good reason to investigate alternative institutional concepts for water services delivery, on the grounds that it needs to be found out if alternatives could be more cost-effective, could allow existing role-players to focus on their other responsibilities, or could offer a range of other advantages (including greater community participation). However, whereas the existing institutional role-players are clearly <u>not</u> coping with all the needs, there is definitely a "push factor" reason to investigate alternative institutional concepts for water services delivery.

While DWAF statements welcome the involvement of the private sector in many ways in water services provision, this is not the preferred option. The sale of water services infrastructure to the private sector is firmly ruled out, but investment by the private sector in infrastructure, provided that ownership vests in the public sector, is permitted.

It does seem that DWAF has not yet taken a stance on SMMEs as alternative water service providers. (The response by DWAF to an initiative motivated from DFID, described in Chapter 7 below, notwithstanding.)

3. Delivery of goods and services by franchise: The generic view

3.1 Introduction

To reiterate a conclusion from Chapter 2: That, given what is widely understood to be the inability of many South African municipalities to adequately deliver water services to all of their citizens, there is a need to investigate alternative service provider arrangements.

Whereas franchising may be a suitable provider arrangement, the purpose of this chapter is to explore franchising in the generic sense, i.e. not specific to water services, nor specific to South Africa.

Issues explored in this chapter are –

- what franchising is;
- how franchising works;
- the franchising process;
- success and failure factors; and
- the extent to which franchising can achieve its delivery objectives without seeking a profit.

3.2 Franchising

The word "franchise" has meanings in several different contexts (for example, the right to vote), but common to all these meanings is the concept of a privilege or right granted by an entity (such as a government or a company) to another, smaller, entity (such as to an individual or a body corporate).

And thus publications in the business or development field refer to "franchise" in senses such as a government giving (or taking away from) a private company the "franchise" to operate a bus service in a specific area (in Jamaica, Erhardt 2000, page 19) or a government giving a private company the "franchise" to supply water to a specific area (in Argentina, Chisari et al 2001, page 16.)

(Aside for later consideration: The latter example is of interest. The government, or the regulator, in order to have services extended to a commercially unviable area, agreed to a deal with a private company which gave that company the exclusive right to supply to a profitable area. The objective was: "Effectively the company is allowed to generate monopoly profits for longer, or from a broader base, and so [generate a surplus which is then used to cross-subsidise] from these monopoly-supplied consumers to benefit those to whom the system is extended. …….. in order to cover the collection deficit in infrastructure charges, which occurred when the extension works reached poor neighbourhoods farther and farther away from densely populated districts." Note however that: "In all these cases of extended franchise, …… the cost is that consumers located in the reserve area will not benefit from competition as quickly as they otherwise would." (Chisari et al 2001, page 16.))

In recent years the word "franchise" has acquired a specific meaning in the business environment, still however, in the context of a privilege or right granted. In this case the right is granted by a business entity, to a smaller entity, to use a business method or system. In return, the smaller entity pays fees to the larger. The assistance that the larger entity gives with the set-up of the smaller, and ongoing training and quality control, are usually also part of the business deal.

This type of franchising originated in the United States during the mid-1950s. Throughout the decades that followed, growth was rampant, so much so that "today about 50% of all United States retail sales are conducted through franchised networks. ….. [In the United States retail sector there are] 600 000-plus franchisees….. employing about 8 million people. During the same period, franchising has spread throughout the world, and although performance figures lag somewhat behind those achieved in the United States, several of the leading nations are rapidly catching up." (Parker 2003, page 167).

3.3 How franchising works

*(The author is largely indebted to Parker (*Parker 2003*, Chapter 9) and FASA (*FASA 2003*, Chapter 2) for much of the material of this Section 3.3.)*

3.3.1 Business format franchising

"Business format franchising" (to use its full name) is a business arrangement between a franchisor (the grantor of the franchise) and a franchisee (the recipient of the franchise). The two parties enter into an agreement with the intention to exploit the franchisor's **tried and tested blueprint of a successful business** for mutual benefit.

The agreement includes the knowledge and use of the franchisor's trade secrets and all the elements necessary to establish a previously untrained person in their own legally separate business. It usually (but not necessarily) grants license to the franchisee to use a brand name or trademark. In return, the franchisee agrees to be bound by the terms of the agreement, running the business strictly in accordance with the systems and procedures laid down by the franchisor (usually in terms of an operating manual drawn up by the franchisor).

Franchising can be summed up in the slogan: "Being in business <u>for</u> yourself but not <u>by</u> yourself."

3.3.2 Franchisor

A franchisor is an entrepreneur who has:

- Established a business in a clearly defined and growing market.
- Developed some unique product features or methods of delivery.
- Fine-tuned the systems and procedures necessary to facilitate ongoing customer satisfaction as well as the profitability of the business.
- Created a brand that enjoys some level of recognition and is well respected by suppliers and customers alike.

This entrepreneur is now ready to expand the business into a regional, national or even international network, but he knows that personalised service is the main reason for his success to date. As a result, he is somewhat reluctant to establish branches and entrust operational responsibility to employees. He wants to ensure that self-motivated individuals with a financial stake in the business take control of each new site.

He can select to become a franchisor in addition to, or in substitution for, any outlets that he personally runs.

If he chooses to become a franchisor, he must make sure that his business is of a type that can be franchised. It might be that it is not suitable. (See Section 3.4 below for discussion on this point.)

Following an in-depth review of all business processes, written guidelines for the optimal operation of the business must be drawn up and the necessary support infrastructure put in place, whereupon the process of franchising the business can commence.

3.3.3 Franchisee

A franchisee can best be described as an individual who wants to be in business but is reluctant to proceed on his or her own. The ideal franchisee:

- Should be a self-motivated individual who possesses the necessary drive to implement a proven system without requiring ongoing constant supervision, but also without questioning its merits at every turn;
- Must be a team player and prepared to co-operate in an enthusiastic, honest and pro-active manner with franchisor representatives and the other franchisees in the network; and
- Should literally "live the brand" and identify with the network's values.

People with a very high need to express their own individuality will generally not be happy as franchisees. Nor will franchising appeal to people who are expecting the franchisor to make all the decisions, do everything for them, and accept responsibility if things don't turn out the way they had hoped.

3.3.4 Financial considerations

Broadly speaking, these are the initial fee, the investment into the business, and ongoing fees. Other fees can become payable should specific additional services be rendered by the franchisor.

Initial fee
This fee is a lump sum that new franchisees are required to pay to the franchisor in exchange for the right to use its name and know-how, and receive initial training and support.

Investment into the business
This can be further broken down into:

- the capital expenditure needed to finance the start-up, for example, decor, shop fittings and equipment; and
- the working capital needed to finance operations until the cash flow of the business is sufficient to cover this.

Ongoing fees
Most franchisors levy two sets of fees under this heading, namely a "Management Services Fee" and a contribution to its Marketing Fund.

The former is a percentage of the franchisee's turnover, intended to pay for the costs the franchisor incurs in providing ongoing support services to franchisees, while allowing the franchisor to make a profit. In respect of the latter, most franchise networks operate a fund to pay for the cost of national and sometimes regional marketing drives. It is funded by contributions made by all franchisees within the network; should the franchisor himself continue to operate one or more outlets, these should contribute in equal measure.

Other fees
Some franchisors operate central services, for example a bookkeeping service, tax and financial advice or a central website; others arrange insurance plans, medical aid and pension cover for the benefit of all members of the network. Not unreasonably, they allocate the resulting costs on a pro rata basis. If given a choice, franchisees should, before agreeing to participate in any such schemes, make sure that they truly benefit from these other services, and that the resulting costs do not erode their profitability.

3.3.5 Financing a franchise

An essential element in franchising is invariably that the franchisee makes a significant (by his standards) capital contribution to the business. That this capital element is at risk is a substantial motivator to perform! (Not to mention the ongoing time and other commitments that he makes in order to ensure the success of the business.)

Which is not to preclude that the franchisee could not also resort to obtaining loan finance. Although in a franchise arrangement the onus will usually be on the franchisee to provide the necessary finance, franchisors sometimes assist by helping to arrange introductions to banks and so on. Bankers generally realise that franchisees of well-established franchisors stand a much better chance of success than lone rangers.

3.3.6 Franchisor services

Reputable franchisors will provide a wide range of services that have been carefully designed to improve the business performance of franchisees as well as the national standing of the network. More specifically, franchisors can be expected to:

- Evaluate prospective franchisees thoroughly to ensure a positive fit. (Under-performing franchisees can damage the reputation of the brand and cause a drain on resources, to the detriment of other franchisees.)
- Train new franchisees in all aspects of the successful operation of the business, both initially and on an ongoing basis.
- Monitor the market and provide feedback to franchisees regarding new trends and opportunities.
- Arrange bulk-buying opportunities as well as develop new products and services to enhance franchisees' competitive positions.
- Initiate and co-ordinate effective marketing campaigns.
- Actively maintain channels of communication with franchisees and be responsive to franchisees' needs. This includes visits to franchisees' premises as well as periodic regional and national meetings.
- Exercise reasonable control over franchisees' operations to ensure that franchisees are not left in the dark regarding shortcomings in their operations. Bad apples in the form of under-performing franchisees must be brought into line before the reputation of the network suffers.

- Investigate reasons for poor performance sympathetically and offer a reasonable amount of practical support. The dissolution of the franchise agreement should be considered only as a last resort.
- Use appropriate channels to air grievances and approach any such encounter in a spirit of co-operation. The overriding aim should always be the restoration of a win-win relationship.

3.3.7 Franchisor expectations

Franchisors expect their franchisees to:

- Assess themselves realistically and make comprehensive disclosure of their strengths and weaknesses at the interview stage;
- Fulfil their financial obligations, both initial and ongoing, timely and without the need for consistent prodding;
- Adopt the network's brand and vision as their own, and never criticise the franchisor or the brand in front of outsiders;
- Adhere strictly to the network's guidelines pertaining to all aspects of operations;
- Provide feedback on all operational issues, contribute ideas and make constructive suggestions;
- Attend training sessions, both initially and on an ongoing basis;
- Be pro-active and honest in their dealings with the network's representatives, fellow-franchisees and suppliers and ask for help when the need arises; and
- Use appropriate channels to air grievances and approach any such encounter in a spirit of co-operation. The overriding aim should always be the restoration of a win-win relationship.

3.3.8 The franchise agreement

The franchise relationship is governed by the franchise agreement. This should, with a minimum of legalese, clearly set out the rights and obligations of the franchisee and the franchisor.

Most franchisors have a standard franchise agreement that they are reluctant to change without very good reason. If a franchisor has multiple franchisees and a variety of franchise agreements, administration would become unwieldy.

3.3.9 The operations manual

This document is the blueprint for the effective operation of a franchise by the franchisee. It should be hands-on and contain answers to most operational queries franchisees may have. It and the franchise agreement complement each other: The franchise agreement lays down the basic principles of the relationship and cannot easily be changed, while the operations manual contains the tactics for systems implementation.

The operations manual will be frequently updated to reflect operational changes. It is customary, in terms of the franchise agreement, that amendments to the operations manual become binding on franchisees.

3.4 The franchising process, and success and failure factors

(The author is largely indebted to Davis (Davis pers comm 2002) and secondarily FASA (Parker in FASA 2003*, pages 21 and 22) for much of the material of this Section 3.4. Davis in turn acknowledges a retired franchising fund manager, the name of whom he keeps confidential.)*

3.4.1 The franchising process

The process of assessing if an existing business can be franchised, and how it should be franchised, can very simplistically be set out in sequence as follows:

- Assess a precondition for success: that a successful business already exists that is simple enough to be systematised and replicated.
- Assess a second precondition: that the market exists for numerous stores/outlets to be franchised elsewhere.
- Systematise every element of the business.
- Launch a new (non-franchise) store/outlet/service using the systems with new employees and test them.
- Select potential franchisees.
- Test potential franchisees in an existing store/outlet/service.
- Sign up and develop relationship.
- Train potential franchisees.
- Set short-term goals for establishment and performance reporting.
- Set longer-term goals for franchisee including retraining and new product launch.

At each stage (except the last) there must be an exit path. Sunk costs must not obstruct exit.

To illustrate the process by means of an example of a new product developed within an existing franchise business. (That is, the systems for the business and other products are already in place and functioning satisfactorily.)

Objective: To develop the chicken burger as a new product to vary the “fried chicken” menu.

- Analyse, break down and test every incremental step in the value chain from first principles. Thus: sourcing, source testing, ordering, purchasing, paying, delivering, storing, cleaning, sizing portions, cooking, cleaning, combining, packaging, presentation, charging, consumption, cleaning, disposing of waste.
- Analyse, break down and test every material element of input and the combinations of inputs. Thus: meat, oil, spices, buns, wrappers, side dishes, drinks, condiments, napkins, and containers.
- Test in-store – inventory withdrawal, production, consumption, customer reaction, disposal, etc.
- Systematise and package.
- Prepare training materials.
- Trial run training through “burger university” with typical franchisees and staff.
- Test graduates in the field.
- Correct any problems.
- Launch into the market with the established, better-performing prospective franchisees first.

3.4.2 Key success factors

These include, principally:

- Franchisor has an existing successful business to study, model and systematize.
- Clear definition and understanding of the product, the customers and the market.
- Simplicity and replicability through systems (i.e. personality cannot be replicated, but systems can).
- Local applicability of the concept. (Some concepts cannot be exported for a variety of reasons, including cultural reasons.)
- Training (and retraining) schemes.
- Franchisee understands franchising and his roles and functions, and can manage his expectations.
- Franchisee has some commercial background or a culture of trading.
- Franchisee puts some equity into the business.
- Franchisor invests in the franchisee.
- The franchisor/franchisee relationship is sustained for the planned franchise period.
- The local community accepts the franchise concept and this particular franchise.
- The local community accepts the franchisee, as a person.
- Continuous franchisor support of the franchisee: including redesign, market research and quality and performance audits.

Finally, a comment about the piloting of a newly established franchising concept or enterprise: This piloting must without question be done in the easiest of circumstances, where there is the greatest chance of success. If it is tried initially in circumstances where, for whatever reasons, any similar enterprise or alternative means of providing the same or similar service might have had some difficulty in achieving success, and the pilot struggles or even fails, then very little will have been learned from the piloting. That the pilot failed because the franchising concept was badly conceived, inappropriate to the product or service, or was poorly implemented or that it failed for reasons that were in no ways the "fault" of the franchising, will not have been learned from the piloting. (This point is reiterated in Section 7.2.2.)

3.4.3 Principal causes of failure

Principal causes of failure are usually one or more of the following:

- Wrong business:
  Not all businesses are automatically sound and attractive to investors and entrepreneurs. There must be sufficient income for the franchisee and franchisor, not only to live on, but also to justify the risk and extra hard work needed to get established in the first place. There will in any community be competition between business opportunities for entrepreneurs and investment. If the duration of the lease is to be short, there will be even greater pressure to make money while the lease is current.

- Unfranchisable business:
  Not all business types can be copied and systematised simply. The systems are the key to replication. In some instances the personality of the founder is a key. In others there may be an indefinable aspect of the business that makes a difference to the customers or investors.

- Unsuitable site or location:
  In property, “location, location, location” are the three key determinants of value. Many franchised businesses are no different.

- Wrong people:
  Entrepreneurs must have tenacity, commitment and zeal. Education alone is not a sufficient indicator of suitability. This applies equally to the franchisor and franchisee.

- Lack of understanding of the product and the market:
  Both franchisor and franchisee must fully understand the franchise systems, and these systems must be reflective of the business needs.

But there are certain problems associated with franchise relationships. These chiefly derive from the opportunities for exploitation, and may lead to franchise contract instability.

The scope for exploitation within franchise agreements is considerable. Franchisee may exploit franchisor, and vice versa. At the heart of the problem lies the question of monitoring. If the performance is imperfectly monitored, then payment between franchisor and franchisee imperfectly reflects performance, and "free-riding" may occur. For example, a franchisee may ride on the reputation of the franchise network of which he is part, and may be tempted to reduce the quality of his product or service. This then has ramifications for the reputation of the other franchisees, and of the franchisor. The franchisee might seek to justify the quality decline by pointing to local circumstances that affect his outlet, and only his outlet. It is unlikely that he will get away with this if he is selling fried chicken, but if he is selling water services or health services, for example, the benchmark comparisons are more difficult to make than for fried chicken. The franchisee could claim in the case of health services that since he has started his contract he has discovered that the people he is servicing were sicker to start with than are the people that any other franchisee is having to cope with, and therefore he is unable to meet some of the performance standards laid down in his contract.

"Obviously, franchisors as well as franchisees have a vested interest in avoiding this quality-reducing spiral. Their interest lies in the development of a monitoring mechanism which not only measures each franchisee's net revenue contribution, but also maintains a quality floor." (McMaster and Sawkins 1993, page 6, which also see for a more detailed discussion of contract instability and free-riding.)

3.4.4 Measures of success

The following are some of the more important measures of success:

- Customers are satisfied with the product or service, and consider that they are receiving value for money.
- Franchisee makes money consistently using the franchise.
- Turnover grows.
- Franchisee complies with all system requirements. No legal, quality, administration lapses.
- Loans are serviced on time.
- Suppliers are paid on time.
- Franchise relationship remains sound. No breakaways, no grey sales, no disciplinary action against franchisee.

It is claimed that franchising enjoys "proven success worldwide when compared to independent businesses. In the Philippines, 95% of franchise systems compared to 25% independent retailers survived the 1997 Asian economic crisis. In Australia, franchising is 2,5 times more successful than other small businesses. …. Perhaps the most important reason for the success of franchising is that entrepreneurs (franchisees) enter the SMME market by investing in a business that has a proven concept whilst enjoying support from the franchisor." (FASA 2003, page 55.)

3.5 The extent to which franchising can accommodate objectives, including providing a service, but without seeking a profit

(The author is largely indebted to FRAIN (FRAIN 2003a) for much of the material of this Section 3.5.)

3.5.1 Social format franchising

"Social format franchising" is a relatively new concept in franchising. Briefly, it entails the franchising of goods and services for social rather than commercial goals. To summarise, social franchises pursue social goals through the means of franchising as a concept for replication and distribution of their products and services.

"“First generation” social franchises were funded by USAID (The United States Agency for International Development) in Mexico in the early 1990s. The interest in social franchising is increasing around the world, as NGOs and social aid programmes are considering franchising as a mechanism to deliver services and products that have social goals. The benefits of franchising, including expansion with reduced capital and the replication of a proven business system, are attractive to practitioners in the not-for-profit sector. (FRAIN 2003a, page 2)) The definitions of social franchising mostly refer to it as franchising with social, rather than profit-making goals. Montagu (quoted in ibid, page 3) defines a social franchise as “…a franchise system, usually run by a non-governmental organization, which uses the structure of a commercial franchise to achieve social goals.”

Social franchising is not practical benevolence or charity, but the management of businesses with social goals in a manner that is business-like and efficient. Practitioners in this market refer to social enterprises as “profit making, not profit taking”. (Which might be less ambiguously phrased as "making a surplus, not taking a profit".) This implies that these enterprises make enough surpluses to be sustainable and to promote their social goals, but they do not take profit out of the community or distribute it to any other shareholders.

All the definitions of social franchising refer to the achievement of social goals. However, the pursuit of social goals does not negate the importance of running these businesses on commercial principles to ensure their continuity and longevity. Social franchises need to operate on commercial principles, but not for the attainment of commercial goals, and making a surplus only sufficient to sustain their operations.

3.5.2 The role-players in social franchising

In commercial franchising, there are two main role-players, viz. the franchisee and the franchisor. In social franchising, the roles of the franchisee and franchisor are based on similar principles, with the franchisor providing support and training and the franchisee operating according to standards prescribed by the franchisor. At a workshop quoted by

FRAIN (ibid, page 4), the roles of the franchisee and franchisor were defined as follows: "Social franchising is a process by which a developer of a successfully tested social concept, the franchisor,

- in order to scale up the coverage of target group
- and the quality of product [or services]

enables others, the franchisees,

- to replicate the concept
- using the tested system
- using the brand name

in return for,

- social results
- system development
- impact information".

Note that payment of fees has been omitted from this list! But payment has to be part of any agreement.

Therefore, as in commercial franchising, the franchisor is the developer of the concept, while the franchisee replicates the concept in his/her community along the lines prescribed by the franchisor for the purpose of achieving social goals. As in commercial franchising, it is easier to replicate a concept that has been tested and proven to work in terms of operational aspects and generation of revenue.

The franchisor is also responsible for training programmes, advertising, on-site support and negotiating in favour of the group. The franchisee must maintain prescribed levels of service quality, operate along the guidelines provided, and pay franchise fees. The franchisor should be a legal entity, while the franchisee could be a social enterprise with or without legal personality (quoted in FRAIN 2003a, page 5).

3.5.3 Comparison of commercial and social franchising

Social franchising usually has an additional significant role-player, viz. a donor, in recognition of the financial unviability (at least during the start-up phase, if not beyond that) that usually characterises the services provided, and/or in recognition that the services are being provided to people who cannot afford to purchase these in the usual marketplace, and/or in recognition that the private sector or the usual public sector mechanisms are not providing the service. The donor provides supplementary funding for the franchise, or all the necessary funding as the case may be, but would inevitably have its own agenda, and its funding may come conditionally.

The presence of this third party may complicate the relationship between the franchisee and franchisor or even affect it adversely. To minimise this effect, and depending upon how the franchisor and franchisee regard these conditions, they could try to pursue independence for the franchise by becoming as financially self-sustaining as they can, although the feasibility of this would depend on market forces and the ability to generate revenue.

Table 3.1 below shows the comparison of commercial and social franchising. (ibid page 5)

Table 3.1: Comparison of Commercial and Social Franchising

Commercial Franchising	**Social Franchising**
Role-players: Franchisee and franchisor	Role-players: Franchisee, franchisor and donor/s
Commercial goals: Profitability of franchisor, and profits for shareholders	Social goals: Sustainability of franchisor, and investment in community
Franchisees to make profits for individual wealth	Franchisees to generate surpluses and thereby be sustainable, while achieving social goals
Consumer demand	Consumer demand
For-profit sector	Non-profit sector
Mostly provides consumables and consumer products including food and services	Mostly provides social services including health and other related services
National marketing to promote brand awareness	National marketing with bias to social marketing to promote brand awareness and awareness of services
Market-related prices	Subsidised prices

3.5.4 Applications of social franchising

As with commercial franchising, the benefits of a franchise concept, i.e. principally those arising from the replication of a proven system, are attractive to the providers of social services also. The pursuit of economies of scale, standardisation and geographical dispersion makes franchising an attractive business concept for organisations with social goals.

Being a concept that is so new, available case study literature on the subject is very limited. FRAIN (ibid, page 6) gave the example of the provision of sexual reproductive health services, where the original author stated that the following conditions made franchising an appropriate strategy:

- unmet demand for services;
- customers who are prepared to pay for the service;
- limited access to services;
- availability of potential franchisees (in this case, trained practitioners);
- lack of supply from the private sector;
- existing capacity (in this case, medical facilities) that are under-utilised; and
- the difficulty that potential franchisees would have in raising the capital investment required.

FRAIN added that, while it is important to have a pool of potential franchisees, the existence of a sustainable franchisor is another condition for success of a social franchise. “It may seem blatantly obvious, but a problem that exists in commercial franchising is even more applicable in social franchising, namely the success and continuity of the franchisor. The franchise network cannot exist without the ongoing management and support from the franchisor. Should the franchisor fail, the survival of the network would be in jeopardy.” (ibid, page 6)

The ability of the end customer to pay may not be possible for all social services. The social need is often highest where income levels are very low. “However, the perception of value is important for the success of a programme, and charging a price for the service, no matter how low, will enhance the value perception of the end customer. Therefore, products and services should not be subsidised a hundred percent.” However, if the objective of the franchise is to become self-sustainable, charging customers for services and generating revenue becomes imperative. Franchising might be the wrong methodology if consumers are not willing to pay for a service. (ibid, page 6)

Social franchising has been applied in a variety of market segments, but it seems that most documented cases are from the health sector. Proposals have been made to franchise the supply of water services (Roche et al 2001, McMaster and Sawkins 1993) and business development services.

If the preconditions for successful social franchising exist as described above, it could in theory at least be applicable to a wide variety of sectors in both developing and developed countries. In developing countries, social franchising seems to be geared towards health services provision. In developed countries, the need seems to exist for job creation or facilitation, and to supplement social services traditionally provided by governments, including care-giving services traditionally provided by NGOs or charities, such as care for the elderly and care for AIDS patients.

“In the South African context, social franchising could have a wide scope of application. Social problems such as unemployment, lack of water and sanitation services in rural areas, AIDS care and education and a lack of health care could potentially be addressed by social franchise organisations. While donor funding is available, a lack of models for implementation is detracting from the optimal use of these funds.” (FRAIN 2003a, page 7)

3.5.5 Some problem areas specific to social franchising

FRAIN referred to what it described as "cultural and other managerial challenges".

“The idea that social enterprises can be run on a franchised basis still requires a paradigm shift from practitioners in traditional non-profit organisations. Profit is a profanity and there is an inherent tension and a conflict between the achievement of social objectives and earning money.

Another cultural difference may be the underlying assumptions of what is acceptable and desirable in an organisation. For instance, business culture encourages and rewards risk taking, whereas the non-profit sector prefers to minimise risk [because of] its lack of resources. Time is another factor: business regards time as money, while non-profits deal with complex issues and multiple stakeholders, which require a lot of time. Human relationships differ as well. There is often an arm's-length relationship with the end customer in business, whereas there is a closer relationship in the provision of social services.” (ibid, page 7)

The cultural differences are most relevant to the implementation of social franchising, as the role-players in a social franchise context will likely include both business and non-profit sector. Franchisees are likely to be from the social sector or from a disadvantaged background and hence without exposure to business culture. Inter alia, they will need to understand and accept the making of a profit or surplus as a means to achieve sustainability.

Understanding of organisational and personal motivations before embarking on a social franchise programme is essential. While cultural differences are not insurmountable, if not addressed they could detract from achievement of the programme objectives.

3.5.6 FRAIN’s list of critical factors

The FRAIN paper concluded that, based on its review of the available literature, "the following factors are critical in the implementation of a social franchise programme:

- Consumer demand is a prerequisite for the initiation of a social franchising programme. There must [in addition] be a demand for the specific product or service in different geographical areas to make franchising a suitable expansion mechanism.
- Consumers must be willing to pay for the product or service, even a nominal amount. This enhances its perceived value and therefore its longevity in the market.
- A pool of suitable potential franchisees must be available and they must be motivated by the apparent benefits provided by the franchisor of joining the network.
- A suitable franchisor must be available and willing to commit to the programme over a long-term period. Continuity and longevity of the franchisor is essential to the sustainability of a social franchise.
- The franchisor must be sustainable, and should aim to reduce his reliance on funding over time.
- The franchisee must have some risk in joining the franchise, even if the franchise fee or investment is relatively low, as this could affect the franchisee’s motivation to succeed.

- Piloting of the concept prior to franchising is critical. Only tried and tested concepts should be franchised, and the franchisor must ensure that franchising is applicable to the market conditions.
- Marketing is critical, as consumers must be aware of the product or service. The concept must earn the consumer's trust, especially if the service is sensitive by nature." (Ibid, page 12)

3.6 Chapter conclusions

The twin driving forces of the franchising concept as described above are:

- the profit motive on the part of both the franchisor and the franchisee (in social franchising, the motive to generate a surplus), and
- a successful business concept that can be copied widely.

Franchising, a way of reducing the barriers to start-up that face suitable businesses and accelerating its development, is based on tried and tested methodology. The franchise system firstly correlates and systematises the business, and then facilitates the setting up of the business, and supports and disciplines it thereafter.

The cardinal elements of a franchise can be summarised as:

- identifying a component of the value chain that is simple enough to systematise;
- discovering good practices;
- systematising the identified component;
- selecting franchisors and franchisees;
- identifying the financial risk to both the franchisors and the franchisees, and as far as practical reducing that risk;
- providing start up help, including initial training;
- preparation of operations manuals;
- ongoing research and development for the product or service and of the market dynamics; and
- continuing support, training, control and discipline of the ongoing business.

Social franchising, the pursuit of social goals through the means of franchising, and operating on commercial principles but not for the attainment of commercial goals, has thus far a very limited track record. However, it would appear to have significant potential to bridge the divide between the social and commercial sectors, for the good of society and of the communities that would be served by its programmes.

In the opinion of the current author, there should be no objection in principle to either or both of the franchisor or franchisee being profit-taking (rather than only surplus-making) entities, even in respect of the provision of the social services identified above. It is quite conceivable that, in a given situation, a service could better be provided by a for-profit entrepreneur franchisor or franchisee than by non-profits, whether the latter use franchise methods or not. It is even conceivable that, if a subsidy is normally paid from an outside source when the service is provided by a non-franchise method, it could be advisable for the subsidy to continue even if for-profits are involved. After all, choices of service provider must be made between alternatives, and it is in principle not impossible that the best alternative ("best" by whatever criteria, e.g. benefit-to-cost) or even the only alternative for provision of an essential service could involve subsidies and for-profits.

This point is returned to in the literature survey of Section 4.3 in the following chapter.

4. Franchising of water services: A review of overseas literature

4.1 Introduction

The concept of franchising has only very recently caught the attention of the water and sanitation sector internationally, in particular funding heavyweights such as the World Bank, and influential research organisations such as WEDC.

How recently, is shown in that even the standard published texts of the last few years on institutional aspects of water services delivery made no mention of franchising. These publications are nonetheless a valuable source of information very relevant to understanding the issues in water services delivery circumstances where franchising might in practice be considered.

The World Bank is the principal driver of much of the current research on and advocacy of water services franchising. However, no examples of the implementation of water services franchising could be found, and it is almost certain that none exist.

4.2 The literature on relevant issues in water services delivery

4.2.1 The chosen context

The literature shows a growing consensus on suitable concepts for service delivery to large urban centres and to rural communities. However, towns smaller than cities, and villages, fall between these two concepts, and there is no evidence that consensus has been reached on how best to provide service to customers in these areas. Quite the contrary, as a rule they have "fallen between the cracks" because they are neither an attractive market for the formal private sector, nor are they within the scope of interventions designed for rural communities.

However, interest in town and village water services has grown rapidly over the past several years, with organizations such as IRC (the International Research Centre, at Delft, in the Netherlands) and WEDC (the Water Engineering, and Development Centre, at Loughborough University, in the UK) in addition to the World Bank and the UNDP-World Bank Water and Sanitation Program, establishing their own town and village water services research programmes.

The current research study chose to focus on town and village water services as the most likely ground for franchise concepts. This focus is not defended other than to refer:

- to the trend in the international literature that franchising holds promise as an appropriate institutional concept for town and village water services, and
- to the easily defensible (see evidence in Chapter 2) opinion that, in South Africa, water services to towns and villages present more institutional problems than do water services to large urban areas or to rural communities, and is much more in need of research into viable institutional alternatives than either of these.

Which is not to say that franchise concepts are or are not inherently unsuitable in large urban areas or rural communities. But investigation of this can be the subject of a follow-up study.

4.2.2 Background to the most recent research initiatives internationally

Towns and villages are extremely important to policy makers and water services professionals for two main reasons, viz.:

- given increasing urbanisation worldwide, they account for a growing share of the people in the world who have no access to safe water and decent sanitation; and
- insufficient is known about how to meet their demand for improved water and sanitation services.

Water services systems for towns and villages can be characterised as follows :

- they are sufficiently large and dense to benefit from economies of scale (and, in many circumstances, from piped systems);
- "they are too large and complex to be operated by communities;
- they are too small and dispersed to be profitably managed by a conventional urban water utility;
- they can't go it alone, and need specialised professional support, in particular to train operators and to prepare and update business plans, expansion programmes and efficiency strategies." (World Bank 2002b, page 6)

A large part of the Millennium Development Goals for water and sanitation will have to be met in towns and villages, and sector professionals and national policy makers need more practical information on management concept and professional support options that have proved effective, and a better understanding of other key ingredients for successful town and village water services.

In 1999, the World Bank's Rural Water Supply and Sanitation Thematic Group, in collaboration with the Water and Sanitation Program, launched a global small towns initiative to study and document innovative management concepts that provide good quality, affordable services that are sustainable and can be expanded to meet demand. This effort led initially to e-conferences on the subject. These attracted a large number of participants from all over the world, who shared a wealth of information about local initiatives. Also, institutions and programmes such as IRC and WEDC established their own programmes and projects to learn more about small town and village water supply and sanitation.

The most significant single event since the 1999 start of this initiative has been the "International Conference on Water Supply and Sanitation for Small Towns and Multi-Village Schemes" held in Addis Ababa in June 2002. This identified the issues that deserve the earliest attention, and that it is planned by the World Bank (in particular) and others to give priority attention to.

4.2.3 Findings of the Addis Ababa conference

The conference found that successful institutional alternatives for water services delivery in small towns and multi-village schemes must have the seven key ingredients set out below (World Bank 2002b, pages 7 to 10).

Note that:

The first three ingredients for success deal essentially with management and operational responsibilities. "They apply to the whole range of management models although they are much more easily achieved and sustained in situations where the oversight function is clearly separated from day-to-day management [emphasis in original]. Hence the trend for delegating system management to private professional operators through contracts." Limitations to being able to achieve this separation include: (i) inability to attract competent operators; (ii) lack of capacity in drawing up and regulating the contract; and (iii) lack of customer confidence.

The next two ingredients for success deal with the enabling environment for water services in small towns.

The last two ingredients for success cover services and system development.

Note also that: "Access to services for poor households can be supported by:

- providing an element of grant for the initial investment so that tariffs remain affordable;
- pre-financing "social" connections; and
- ensuring the poor have a voice as stakeholders and customers."

More detail on each of these key ingredients, adapted from the conference report, follows.

1) Financial and managerial autonomy

Financial and managerial autonomy is essential to encourage entrepreneurship and investment.

Autonomy means:

- control of operations (staffing, connection and disconnection, billing)
- own bank account, ring fencing, no transfer to town budget;
- tariffs set in light of local conditions;
- the flexibility to adapt service level to demand; and
- ability to invest to adapt and develop the system.

Autonomy rests on: (i) financial viability; (ii) stakeholder support; (iii) through community oversight, protection from political interference.

2) Transparency and accountability

Transparency and accountability are critical to gain and maintain the trust of users and investors. They are founded on: (i) clear roles and responsibilities; (ii) independent audit and monitoring; and (iii) disclosure of information. They are particularly important in situations where there is a monopoly in service provision. Transparency and accountability are key to good governance but require good information flows and consultation. Customers must be aware of their rights, and oversight bodies need the capacity and the authority to exert their responsibilities.

3) Professional support.

The need for outside professional support for tasks beyond routine functions is a defining characteristic of small town/multi-village schemes. They need this support for:

– training staff in routine functions; and
– supporting non-routine functions: i.e. financial management, business planning, tariff setting, expansion planning, efficiency improvement, troubleshooting and communication, customer relations.

Professional support comes at a price. (A rejoinder from the current author to that is that it can be argued that the money spent can be more than worth it in terms of efficiency, cost saving, revenue increase and the like.) Sharing of professional resources between neighbouring areas results in economies of scale. Guidelines are needed for procurement, and for establishing and regulating professional standards.

4) Competition

Competition generally pushes prices down and quality up, fosters innovations, and builds capacity. Small towns offer opportunities for local entrepreneurs.

Competition <u>for the market</u> requires:

– supportive legal and regulatory environment (open entry and minimum restrictions on service areas);
– attractive contracts in scope, duration and size (through pooled procurement, clustering and aggregation); and
– a competitive procurement process.

Competition <u>in the market</u> can be fostered by:

– alternative services (tankers, vendors, private stand posts, reselling);
– limited contract duration and re-bidding;
– support to innovations; and
– benchmarking.

5) Legal framework and regulation

As far as small town and multi-village schemes are concerned, the central purpose of national laws and regulations should be to establish and enforce “rules of the game” that foster fair and sustainable relationships, including contractual relationships, between the role-players. A challenge is to translate policies into countrywide norms and regulations in such a way as to facilitate local initiative.

A supportive legal and regulatory framework is needed to:

– ensure stable access to water resources;
– establish cost recovery principles for water services, including setting out the process and guidelines for tariff setting and revisions (periodicity, information, consultations and recourse and arbitration);
– define guidelines for sound contract and business plans, and regulatory mechanisms; and
– protect the customers and uphold quality standards.

The build up of regulatory capacity, and the capacity for external auditing and benchmarking, should be approached with limited objectives and as a response to specific needs. The reasons for caution relate to the fact that: (i) regulation is costly and must ultimately be paid for by the users; and (ii) in most countries, the concept of independent regulation is not yet well established and would in any case be difficult to apply to a large number of small decentralized systems. Simple contracts between the authority and the operator, in which responsibilities, performance indicators, payment terms and incentives are clearly set out, underpin regulation.

***6)* Responding to the demand**

Approaching small town/multi-village water services with the basic goal of offering services that customers want and are ready to pay for is a powerful ingredient for success. At the system level, demand-responsive approaches lead to higher cost recovery and internal cash generation, ensuring sustainability and allowing further development. At the country / programme level, demand-responsiveness allows for more efficient use of public funds.

Interventions by governments/donors and NGOs can foster demand-responsiveness by introducing flexibility in:

- pricing;
- system design, technologies and service levels;
- empowering customers to make informed decisions (services levels, costs); and
- encouraging and competition.

***7)* Incentives for expansion**

The operators of a water services system in a small town or multi-village grouping might, if they are successful with that, be interested in developing their distribution network, thereby adding customers and increasing sales. Before they should be allowed to expand, it would be necessary to ensure that the proper prerequisites are in place; including:

- access to adequate water resources;
- stable institutional/legal framework allowing fair return on investment; and, in most situations
- basic production and storage facilities built (or rehabilitated) with sufficient capacity.

Incentives and facilitating factors for system expansion include:

- access to financing;
- limited administrative controls;
- reduction of administrative and financial barriers to making house connections; and
- incentives built into operator's contract.

4.2.4 The way forward, as identified in Addis Ababa

The conference noted (World Bank 2002b, pages 11 and 12) that governments and their development partners should recognize that small town and multi-village schemes represent a special challenge and opportunities that necessitate development or adaptation of supportive policy, legal and regulatory frameworks as well as programmes. Sector policies must be broad enough to allow a range of alternative management arrangements to emerge and evolve in response to local demands and capacity. Both of the following are needed:

- a sector-wide approach to institutional issues and financing mechanisms; and
- learning and piloting, which can be supported by retail water services projects in a limited number of towns.

The conference agreed that the following were the "priorities for further learning" with respect to water services for small town and multi-village schemes:

- Developing and improving services should be approached as a learning process at all levels: communities, country and global/regional, relying on case studies, models, good practices, tools and guidelines

- Further knowledge development and networking, with special attention to sanitation and to services for low-income groups and communities "which should be a guiding pre-occupation for all knowledge development activities".

- In order to support the development and the evolution of the water services systems, policy makers, planners as well as operators will need to develop their understanding of:

  - how best to structure the contractual relationships;
  - how to foster aggregation, and which aggregation models are best adapted to various situations;
  - how to approach capacity building of oversight boards and local operators; and
  - how to nurture the emergence of specialized water services enterprises.

- They also need to learn more about the following specific issues: (i) tariff setting and cross-subsidies, (ii) household connection policies, (iii) financing and risk mitigation, (iv) regulation, and (v) water resource management.

Conference participants identified the following themes of particular interest:

- poor communities;
- gravity schemes;
- water user associations using professional management;
- rural entrepreneurship;
- franchising;
- incentives structure for community management models;
- public private partnerships in small towns;
- regulation in rural systems and small towns; and
- sustained sanitation promotion without government support. (World Bank 2002b, **Annexure 4.1**, which is included at the end of this chapter)

Various parties at the conference indicated their intention to pick up on some or a range of these priority areas. Among them was the Bank Netherlands Water Partnership (see Section 4.3.6 below for part of the outcome).

4.2.5 Independent of or in parallel to Addis Ababa

It is noted in Section 4.1 above that standard published texts of the last few years on institutional aspects of water services delivery are a valuable source of information very relevant to understanding the issues in water services delivery circumstances where franchising might in practice be considered. That is so even if they make no mention of franchising.

Understandably (it is seven years old) what was then (and in many ways still is) the most comprehensive text of all on water services contracting out, viz. the three volumes constituting "Toolkits for Private Participation in Water and Sanitation" (World Bank 1997) makes no mention of franchising.

Less understandable is that the word "franchise" appears only once (page 48) in the much more recent WEDC document "Contracting out water and sanitation services: Volume 1: Guidance notes for service and management contracts in developing countries", and then only in the context that tenderers should be assessed for their recent performance on "projects or franchises". (Sansom et al 2003) The same can be said for a 2001 IRC document on sustainable management of water supply systems in small towns in Africa. (Moriarty et al 2002) This extensively discusses small operators, and points to the need to support them (but is short on ideas as to how to do this). The word "franchise" does not appear at all.

In terms of case studies, reviews of achievement, and guidelines in respect of water services provision, there is a very extensive body of documentation to draw from, even when franchising is not mentioned. (For example Gariba 1998, Troyano 1999, Tynan 2000, Colligon and Vezina 2000 and World Bank 2001.) Some, but not all, focus on what are usually referred to as "independent water and sanitation providers".

These publications are valuable sources of information on, inter alia:

- the problems of the water services providers to towns and rural areas, and
- the potential of water services providers (both for-profit and not-for-profit) to supply small towns and rural areas, but the need to support them on an ongoing basis, and the difficulties attendant thereto.

That need for ongoing support and nurturing of the independent service providers is a common theme.

4.3 The literature on franchising of water services

4.3.1 Review

The earliest paper referring to franchising in the water services sector that the current author could find is that on the water industry in Scotland. (McMaster and Sawkins 1993.) Not much, if anything, was published after that until the initiative on small towns, described in Section 4.2.2 et seq above, started to result in documentation.

The World Bank and its immediate partners such as the Water and Sanitation Program and the Bank Netherlands Water Partnership are currently the repository of the bulk of the research on and advocacy of water services franchising. And indeed it is impressive how much has been researched and written in less than five years. However, it would appear that none of this has yet been tried out in pilot schemes. Certainly, no published case studies of implementation could be found.

This body of work on water services franchising is described below under the headings of:

- the Scottish paper;
- between 1998 and 2002 – referring to franchising, but not specifically about franchising;
- between 1998 and 2002 – specifically about franchising;
- the Addis Ababa conference of 2002; and
- in the year 2003.

4.3.2 The Scottish paper

A 1993 paper (McMaster and Sawkins 1993) picks up on the presence of franchising among the several options listed in a Scottish Office consultation paper for the restructuring of the Scottish water services industry.

The context of these times was that the Conservative Party government of the United Kingdom had in the previous decade privatised in one or other form (including franchising), or had subjected to competition, a number of services that had previously been the responsibility of the public sector, in respect of both capital and operation. Examples include rail, water services in England, some health services, and an array of local authority services.

The Scottish Office had put forward two alternative forms of franchising, the one in which a public body would retain ownership of the capital works, and would call for bids to operate the works; whereas the other involved the franchising of both operations and capital investment. The advantage (over the then current arrangements) offered for both was that franchisees (it is in the 1993 paper assumed that they would be from the private sector) would improve cost-efficiency from the point of view of the public body. This follows from the assumption that competition at bidding stage would give prices lower than the cost of public sector operation, inter alia, because the bidders would foresee that the incentives in the franchise agreement would encourage them to reduce water wastage (and introduce other cost-improvement measures) more stringently than a public sector operator would.

The competition would also provide "yardstick information" which could be used to benchmark costs and performance standards through both the public and private sectors.

The advantage, from the public sector point of view, offered by the alternative involving private sector capital investment was that the public sector chronically "during the last 50 years" made inadequate investment in infrastructure, and it was hoped that the private sector would be more forthcoming.

McMaster and Sawkins made the following points, among others:

- Economies of scale, potentially attractive to franchisees, generally exist in the operation of water services, in reticulation, and up to "or just above (treatment) plant level", but not higher than that.

- Tariff increases have to be subject to regulation, for obvious welfare and political reasons.

- Availability of the yardstick information reduces the chances of franchisees claiming that circumstances beyond their control prevent them from meeting their contracted performance standards; this is particularly important in situations of natural monopoly (as indeed water services are).

- Given that local water conditions may vary from place to place (e.g. colour, taste), franchisors must be highly competent and in particular knowledgeable of local conditions, and monitoring must be of the highest order. This is to guard against franchisees giving fraudulent reasons for any inability of theirs to achieve performance requirements.

- Performance indicators in the water industry can generally be relatively easily assessed compared with, for example, some health service activities that were already at the time in the United Kingdom subject to compulsory competitive tendering.

- Thus the relative ease of performance specification reduces uncertainty, which in turn both:

  - leads to more accurate pricing by bidders and thus (generally) lower prices, and
  - reduces the ability of the franchisor and the franchisee to manipulate performance indicators.

The authors concluded that:

- Merely opening up the delivery system to competition is unlikely to raise sufficient finance (Via efficiency savings or by any other means. Incentives would not appear to be sufficient for the private sector to invest, given the restrictions that would likely be placed on tariff increases). Thus the option involving private sector investment is not likely to be workable.

- "A scenario in which large public water authorities would appoint several franchisees for cities, towns and rural areas in their charge should generate a significant amount of information for the implementation of a system of yardstick competition. …. Quality thresholds would be easily established and policed in line with current EC and UK environmental legislation. However, the main drawback of this system lies in the requirement for capital funding to arrive through the public purse." And the chances are that adequate public sector financing will not be made available.

- " …. whilst water industry franchising in some form is viable, the two options may both be unworkable compromises." (McMaster and Sawkins 1993, page 12)

Sawkins is still of the opinion that there is scope for the Scottish water authority to enhance competitiveness and limit opportunistic behaviour were it to open up the delivery process through competitive tendering. This would be tendering for the operation of various aspects or of all aspects of delivery other than for new capital expenditure. He reports that the Scottish water authority is tackling the backlog of capital investment by forming joint venture vehicles with major contracting partners. (Sawkins and McMaster undated; Sawkins pers comm 2004)

Either way, the franchising idea hasn't been taken any further.

4.3.3 Between 1998 and 2002 - referring to franchising, but not specifically about franchising

From 1998, publications purporting to present a comprehensive range of institutional options began to mention, or even to describe, franchising. For example, Snell, in her paper on small-scale providers, referred all to the replication of Sulabh public toilets and bathing facilities in India as a franchising concept. (Snell 1998, page 4) (However this is not franchising, as the Sulabh organisation owns the facilities (in 12 000 cities and towns spread throughout India), and runs them using direct employees or contract workers (not, as far as the present author understands, local entrepreneurs, although there may be some exceptions). (Pathak 1996, page 13))

Plummer, in her "sourcebook" on municipal capacity building in public-private partnerships, wrote a neat summary of the franchising concept, albeit that her example is of solid waste collection. The comment in her last paragraph about more confidence in the private provider is apt. But her description glossed over some of the tensions, such as how a household can be prevented from dumping rather than pay for the service.

"Under franchise contracts, the municipality grants a private firm an exclusive right to provide a specific type of service within a specific area. Often used in solid waste, the franchise is similar to the lease but, instead of leasing facilities and infrastructure, the operator is only given the right to deliver a service. This is often confined to a specified zone and constitutes a zonal monopoly for a fixed period of time.

As with a lease, the operator pays the municipality for the franchise. The revenues for making such payments are generated by collecting the fees from customers in the specified zone or by selling materials (such as solid waste by-products) removed from the zone. The operator thus bears the commercial risk of non-payment. Government still retains overall responsibility and accountability to the public under the franchise contract. The municipality is responsible for setting performance standards, ensuring a competitive bidding process is established, letting the contracts, and ensuring the performance of the firm through adequate monitoring of performance standards.

Strengths and weaknesses: While it can be difficult for solid waste operators to collect user fees, in some countries where there is little confidence in government, there may be more confidence in paying the fee to the private sector than to the municipality, and residents may prefer the franchise method for collection services. Franchisees have sufficient incentive to meet the requirements of the customers or they simply will not pay, and evidence suggests that operators are usually responsive to demand. However, because a franchisee has a zonal monopoly, households have limited bargaining power with the franchisee and little influence over the quality of the service." (Plummer 2002, pages 196 and 197)

On the Water and Sanitation Program website (first seen there by the current author in 2002, but it is not known when it was initially placed there), in a description of "management models with the most potential" for "small towns and multi-village initiatives", the franchising "management model" is concisely described as follows:

"Under a franchise arrangement the franchisor develops an operating plan and procedures under a brand name or logo which becomes synonymous with high-quality service, and commits to ongoing support and guidance to small-scale private operators in critical areas of management and operation and maintenance, in exchange for a share of the revenue. Although composed of many independent units with relatively small revenue bases, a franchise network has the power and resources of a much larger enterprise. By introducing an individual with entrepreneurial flair as the operator/franchisee, there is also a built-in incentive to operate the water supply efficiently and in a businesslike way. Franchising also best leverages the skills of the limited number of experienced water managers and operators found in most countries." (World Bank 2002c)

This definition of franchising in the water services sector is wholly adequate. The only quibble could relate to "high-quality service". Is "high" quality necessary? Certainly not in South Africa, where it runs contrary to DWAF's oft-stated standpoint since 1994 of "Some for all, rather than all for some".

Hyperlinked to this website entry is a very concise but extremely informative "Project summary: franchising". (Reproduced as Annexure 4.1 to the current report.) On one page can be found:

- under "at a glance", brief descriptions of what franchising is, contract type and management, roles of the respective parties, and method of financing; and
- under "project features", brief descriptions of franchising advantages, of essential features of a franchise arrangement, and other key points and issues.

This summary acknowledges its source document, which is the report described in Section 4.3.4 below.

4.3.4 Between 1998 and 2002 - specifically about franchising

In 2001 the excellent report "Franchising in small town water supply" (Roche et al 2001) appeared.

The section "potential advantages of franchising in small town water supply" from the executive summary is worth quoting in full. As follows:

"Town-based operators can generally perform routine operations of small towns or water supplies well. However, what is often missing are the incentives to achieve efficiency and the professional support needed to maintain good service at a reasonable cost and to expand facilities to meet demand. Without technical, financial and commercial assistance, town water supply systems are destined to fail.

While it is widely acknowledged that private sector participation in water supply can improve service and efficiency, there are few models in small town water supply. The revenue base is generally too small to attract large-scale private operators, and those responsible for the service (e.g. elected municipal officials) may be reluctant to entrust such a vital service to small-scale operators. Franchising is particularly interesting in that it leverages the limited skill in the water sector in a country and builds many small operating companies at the town level, while introducing the benefits usually associated with private sector participation: entrepreneurship, professional operations and maintenance, and competition.

Entrepreneurship in local operation: By introducing an individual with entrepreneurial flair as the franchisee, there is an automatic, built-in incentive to operate the water supply efficiently and in a businesslike way. The franchisee will have a desire to increase the business by growing the system as fast and as widely as possible and, at the same time, will be supported by a franchisor who institutes and monitors quality standards and provides the systems that would produce effective water delivery management.

Local ownership and operation: The appointment of local people as franchisees provides for the application of local knowledge to development of an effective network, with the franchisor's support and technical expertise. Ideally the franchisee would be a person with a stake in the community, who has social as well as financial goals, and who would be responsive to the needs of all sectors of their market.

Professional operation and maintenance: A franchisor can ensure a professional and unified approach to the management of the water supply facility, quality control and technical help and advice on an as-needed basis. The franchisor is able to provide resources normally only available to larger systems at an affordable price because the costs are spread over a network of franchisees.

Competition: To ensure that the franchisor and franchisees continue to provide good, affordable water supply, and grow and improve the business, the franchise lease or management contract will be open to competition every ten years for the franchisor and every five years for the franchisees. This would allow sufficient time for both parties to recover their initial investment and also encourage them to perform well so that they would be re-awarded their lease or management contract for a further term. Clearly it is in the interest of all parties to maintain continuity where possible, but the option not to renew would bring a healthy "commercialism" into the equation."

The document went on to say that whereas there is sufficient similarity between one small town's water supply facilities and method of operation, and that of another, any system that provides for replication (such as a franchise system does) could be introduced with benefit. Even if a complete "classic" franchise system proved unworkable, some hybrid concept that introduced, at the very least, a business package that helped facility operators to run their businesses better, would be advantageous. (Roche et al 2001, unfortunately pages are not numbered)

The punch line of the report was: "While it is recognised that there will certainly be obstacles to developing and operating a franchise system, no better concept is currently being proposed. The principal challenge appears to come from problems inherent in small town water supply as a business, per se, and is not specific to a possible franchise solution."

The usefulness of this document is further enhanced by the short section on "Design of a pilot project" and the annexure "Financial viability of franchising for small town water supply in developing countries". Selected statements from each of these are worth reproducing in full, as follows:

"Franchising in small town water supply is a new and untested idea. There are no franchisors and franchisees currently operating in the sector in developing countries and no direct examples to follow from more developed countries. Questions naturally arise as to whether there will be an interest on the part of the private sector to engage in franchising, whether local entrepreneurs will be ready and willing to enter into agreements with franchises, whether the institutional framework can be worked out so that service is provided at a reasonable price. A pilot project could be developed as a means of testing franchising …"

The financial viability of the concept was tested in respect of a "typical small town in eastern and southern Africa with a population of approximately 10 000". The "financial condition and projected operating results" are calculated. In this hypothetical example, "the small town utility can yield positive cash flows after payment of operating expenses, franchise fees and transfer of funds to the government for expansion of the network and to cover debt service. Whether the cash flows are sufficient to attract entrepreneurs as franchisees is a determination that can be made only by the entrepreneurs themselves." (Roche et al 2001)

4.3.5 The Addis Ababa conference of 2002

Several papers at this conference described franchising of water services.

Tyler discussed franchising of small towns water services. His paper outlined concepts, models and alternative scenarios.

Colligon stated that the national bulk water supplier ONEP in Morocco is also the management contractor in 250 small towns, and is responsible for direct distribution in selected rural areas. The author described how, to assist it in managing the small towns and its rural areas, ONEP contracts many technical tasks to local entrepreneurs, for example, stand-post management, pumping station operation, leakage detection, field water analysis and water sample collection, and making house connections. These entrepreneurs employ anything up to 10 staff.

ONEP however, some years ago reached the conclusion that, whereas the only type of contract it has been outsourcing in the villages is stand-post management, the turnover from this single activity is not enough to keep a local enterprise alive. It has thus resorted in rural areas to contracting out the equivalent of all of the functions that it currently performs itself in the towns using contractors for specific functions. Thus the "local micro enterprise" manages stand-posts, connects new customers, runs all equipment and does metering and billing. The author pointed out that this is a franchise arrangement, because the local enterprise uses the ONEP trademark, manages all relationships with customers, and pays ONEP a fee according to water consumption; whereas ONEP, apart from providing the bulk amount of water, defines the standard of service, tariffs, and so on. (ONEP undertakes all initial capital investment.) (Colligon 2002)

This paper, inter alia, illustrated that the dividing line between what is labelled as franchising, and some forms of contracting out, can be quite narrow. What is the essential difference between, say:

- ONEP outsourcing in a town or village the full range of water services operational functions (including managing customer relationships) to a local entrepreneur, who pays it a fee according to water consumption; and
- its equivalent company SODECI in Ivory Coast, which outsources in a town or village the full range of water services operational functions etc. as above?

Given that in the first case the entrepreneur uses the franchisor's trademark, and in the second case the entrepreneur does not, in the eyes of the customers, there probably isn't any difference other than (if the use of a brand is noticed at all) the branding identification.

The essential difference is of course behind the scenes. SODECI only monitors compliance with quality standards, and does not necessarily give training or support, whereas ONEP actively promotes and protects a brand by ensuring that the franchisee is competent to do the work to the quality the franchisor expects. To ensure this, ONEP as the franchisor would have an operations manual and would be giving training. That SODECI might (but would not necessarily) also give training doesn't alter the great difference in sharing of responsibility that lies between the franchisor-franchisee type of relationship and the client-contractor type of relationship.

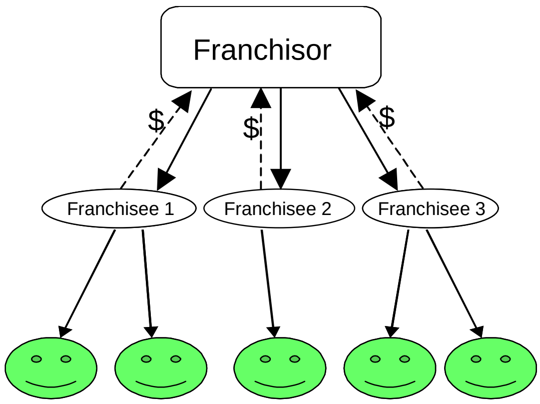
(Note as an important aside Colligon's comment that: "small towns are highly unprofitable (50% financial losses)".)

The conference itself concluded in respect of franchising that: "This innovative approach was welcomed, and it was considered that it was worthy of further study. While the model implies that the franchisor is private, the model could be developed with a public franchisor relying on capacity already in place in the public sector." (World Bank 2002b, page 32)

The illustration in **Figure 4.1** below accompanied the statement.

Figure 4.1: Franchising Overview

Franchising – Overview



- Under the franchise 'brand' Franchisees receive business 'know-how' from Franchisor and provides services / products to customers
- Franchisor monitors quality of product / service to customers
- Customers pay Franchisees for products and services and a % is passed back to the Franchisor as a royalty payment

Franchising – a business methodology, based on the duplication of success, between two or more separate legal business entities operating under the same brand name.

4.3.6 In the year 2003

Through the good offices of Cross, who the current author got to know when Cross was the Managing Director of the Mvula Trust, an introduction was in mid-2002 afforded to the prime movers in the World Bank and in the Bank Netherlands Water Partnership on water services franchising, and that e-mail contact has been maintained.

It is noted in Section 4.2.4 above that among the parties at the Addis Ababa conference that had indicated their intention to pick up on some or other of a range of the priority issues identified was the Bank Netherlands Water Partnership. This is an initiative funded by the World Bank and the Netherlands government.

Publications resulting from the work of the Partnership started appearing from mid-2003. That of interest is: "Can the principles of franchising be used to improve water supply and sanitation services? -- A preliminary analysis". (Van Ginneken et al 2003)

To answer the question posed in the title: "On a conceptual level, the authors have not found information that would preclude the effective application of franchising to the [water services] sector." (Ibid, page 14)

Note that the document did not confine itself to small towns and multi-village systems, but also considered ways in which the concept of franchising could extend to city level.

The document was only the first stage of intended further stages of study, and therefore did not go into much detail. Therefore, in the current report no further attention is paid to it (but, as noted above, contact is being maintained with the researchers, and the prospect of the receipt of further documentation is promising), except to note the caution that "a number of limitations" to the potential of franchising have been identified. These are:

– The applicability of franchising to the water supply and sanitation sector does not mimic franchise arrangements in retail sectors, where most often a franchisor can exert direct control over its franchisees through control over a key product. The legal provisions of (water services) franchise agreements are of fundamental importance and require careful study. The monopoly character of the sector complicates these provisions.

– The affordability of franchising for small and medium utilities in developing countries also needs further study. Even if the net benefits of being a franchisee exceed the cost of paying the franchisor, operators may not be able to pay the initial royalty fee. This limitation could be partly overcome by the use of subsidies or output based aid.

– Potential franchisors might be reluctant to enter into a franchise relationship because of the risk associated with the franchisees' potential mistakes or poor performance. This performance could impact negatively on the franchisor's reputation and the other franchisees using the same name.

– In addition, developing a franchising business has a high upfront cost. Only by having multiple franchisees can a franchisor generate enough income through royalty fees to cover its expenses and spread its risks. The start-up of a viable franchisor is an expensive and long-term process, involving significant risks." (Van Ginneken et al 2003, page 15)

4.4 Chapter conclusions

The literature review of relevant issues in water services delivery raises many themes. Not the least interesting of these is the need for ongoing support and nurturing of the independent service providers in small towns and rural areas.

There is every reason to accept that the Addis Ababa conference was spot-on when it identified the key ingredients for successful water services institutions in small towns and multi-village schemes. A question that this Chapter 4 must in its conclusions address is critical to the objectives of the current study. This question is:

- Does franchising of water services appear to have sufficient potential to be a significant institutional alternative, to be seriously considered in the appropriate circumstances?

The same question can alternatively be put as follows:

- Does franchising have the ingredients identified in Section 4.2.3 above?

This is most suitably done in a table:

Table 4.1: How franchising matches up with the key ingredients for successful water services delivery for small town and multi-village schemes.

Indicators for the third column are:

O = franchise "neutral" (i.e. these issues must be addressed irrespective of franchise or any other form of institutional arrangement, and a franchise would be no worse or no better than any other form)
A = franchise very suitable (which is not to say that other institutional arrangements might not also be very suitable)
B = franchise moderately suitable
C = franchise unsuitable

Where useful to do so, comparisons are made with matching, with the key ingredients, by a municipal WSP.

Ingredient #	The issue	How franchising Rates	How franchising does this
1 thro 3	Separation of oversight function from day-to-day management	A	Oversight function lies with others. As follows: Performance/service quality -- franchisor Operational standards performance -- WSP Legislation compliance -- WSA
1 thro 3	Lack of (local) capacity in drawing up and regulating the contract	A	Franchisor designs the contract with franchisee, WSP and WSA, probably using a national concept. Franchisor sets up monitoring and reporting regime, and enforces this
1	Autonomy: financial viability	B	Franchising ensures ring fencing of water services finances, and pays attention to viability. WSA should do this too, but may not in sufficient detail and frequency
1	Autonomy: stakeholder support	A	Franchisee must survive through good customer relations
1	Autonomy: protection from political interference through community oversight	A	The contract is a firewall. But franchisee can expect negative political attention if performance falls
2	Clear roles and responsibilities	O	Through the contract. WSP should have this also
2	Independent audit and monitoring	A	By all parties: WSA, WSP and franchisor. WSP might escape from audit impacts as this would be embarrassment to WSA, if found wanting
2	Disclosure of information	B	Through the contract. WSPs often do not have clear reporting systems and/or may not wish all details exposed
3	Professional support for tasks beyond routine functions	B	Franchisee receives some support from the franchisor, particularly in business matters. But in specialist technical matters both franchisee and municipal WSP would need external support
4	Competition for the market (3 requirements are listed)	A	Through the procurement process (assuming a franchise-supportive legal and regulatory environment is in place). Not only franchisees but franchisors could compete
4	Competition in the market (4 requirements are listed)	A	Through the procurement process and perhaps design of areas allocated to each franchisee. This supports innovations, but needs benchmarking.

5	Supportive legal and regulatory framework (4 needs are listed)	B	Franchising has an edge in "contract and business plans" and "auditing and benchmarking". WSPs, being public sector, might not be regulated properly
6	Demand-responsiveness	A	Franchise will attend to this as a way of retaining and expanding business
7	Incentives for expansion: access to adequate water resources	A	Some theft and leaks are preventable. The surest new water resource is reducing these losses, thus enabling the service to expand
7	Incentives for expansion: fair return on investment	B	Seeking higher sales on the same cost base leverages profits, i.e. return on investment. WSPs seldom evaluate investment return
7	Incentives for expansion: sufficient capacity in production and storage facilities	O	"O" in the sense that, for a franchisee, sufficient capacity has to be a given -- franchisor has to commence with the capital works being adequate for service delivery. (Vide franchise arrangements in other sectors.)
7	Incentives for expansion: access to financing	B	Investors are likely to be more willing to fund public sector capex if there is presence of a franchisor. And maybe less willing if for private sector capex
7	Incentives for expansion: incentives built into operator's contract	A	This can really be made part of a franchise agreement

The conclusion must be that franchising of water services to small town and multi-village schemes does indeed appear to have the potential to be an institutional alternative deserving of serious consideration. But it is by no means free of many of the issues that equally affect other alternatives, in particular the financial self-sustainability, or not, of the town or village water services system.

Finally:

- Whereas franchising has only in very recent years received the attention of researchers overseas, and implementation even at pilot scale is yet to take place, indications from the review of literature are promising.
- Whereas thus far minimal attention has in South Africa been given to the topic, it would be remiss not to commence without delay to investigate, more rigorously than the current study has, the suitability of water services franchising for South African circumstances. This investigation should in its first phase focus only on towns and groupings of villages.
- The South African research programme must, as the overseas research programmes have, commence by learning from other water services institutional arrangements in towns and villages, and from franchising experience in skills other than water, before it contemplates implementation, even at pilot scale.

Annexure 4.1:

Small Towns and Multivillage Network

Project Summary: FRANCHISING

AT A GLANCE

What is franchising?	Franchising is a method of distribution of a product or service, whereby the developer of a business concept – the "Franchisor" – licenses an individual or enterprise – the "Franchisee" – to operate that business concept, using the Franchisor's system and brand name.
Contract type and management	**Lease agreement or management contract:** Between asset owner and operator/franchisee. **Franchise agreement:** Between franchisor and operator/franchisee (subsidiary agreement to lease agreement to ensure professional support) Operator/franchisee is responsible for day-to-day management, with professional support from the franchisor.
Public Granting Authority	The asset holder of the facility, usually local or national government. Manages contracts.
Regulator	Provides licenses to franchisors, and monitors contracts. Audits performance. Approves tariffs in consultation with all stakeholders.
Franchisor	Develops strategic development plan for the region, and operations and financial management systems. Provides operators with management and technical support, and assistance in raising start-up capital. The franchisor could, for example, be a major utility, an existing operator, a local entrepreneur, an NGO or an international company.
Operator/ franchisee	Day to day management and operations. Revenue collection. Expansion.
User Association	Consults to ensure transparency in management.
Method of financing	The funding of capital costs would probably have to be on a partial or total grant basis, but a franchise arrangement is self-financing if the lease fee between owner and operator/franchisee includes debt service.

PROJECT FEATURES

Franchising is particularly interesting in that it leverages the limited skill in the water-sector in a country and builds many small operating companies at the town level, while introducing the benefits usually associated with private sector participation.

- **Entrepreneurship in local operation:** By introducing an individual with entrepreneurial flair as the franchisee, there is an automatic, built-in incentive to operate the water supply efficiently and in a business-like way. The franchisee will have a desire to increase the business and, at the same time, will be supported by a franchisor who institutes and monitors quality standards.
- **Local ownership and operation:** Ideally the franchisee would be a person with a stake in the community, who has social as well as financial goals, and who would be responsive to the needs of all sectors of their market. Financial autonomy for the franchisee is necessary so that profits can be reinvested to increase production and revenues.
- **Professional operation and maintenance:** A franchisor can ensure a professional and unified approach to the management of the water supply facility, quality control and technical help and advice on an as-needed basis. The franchisor is also able to provide resources normally only available to larger systems at an affordable price because the costs are spread over a network of franchisees. The franchisor commits to ongoing support and guidance and carries out research and development, thus freeing the franchisee to concentrate on operating a profitable business. The franchisor establishes beneficial relationships with suppliers for equipment and materials, from which the franchisee benefits.
- **Competition:** To ensure that the franchisor and franchisees continue to provide good quality, affordable services, and grow and improve the business, the franchise lease or management contract would be open to competition every ten years for the franchisor and every five years for the franchisees. This would allow sufficient time for both parties to recover their initial investment and also encourage them to perform well so that they would be re-awarded their lease or management contract for a further term.
- **Fees:** Cash flows must be sufficient to attract entrepreneurs as operator/franchisees. The typical fees in a franchise system are: (i) an initial "Franchise Fee" which is normally a lump sum paid by the franchisee for the right to operate and support services; (ii) an ongoing payment frequently called the "Royalty" or "Management Fee" (a percentage of the gross sales, paid monthly); (iii) a "Marketing Fee" (a percentage of gross sales, paid monthly), used by the franchisor to augment the central marketing budget. Revenue from water sales must cover: the lease fee, the franchise fee, royalty and marketing fee, the regulatory fee, operating and maintenance costs, replacement and expansion.
- **Key points and issues:**
  - Self-financing if the lease fee between owner and operator/franchisee covers debt service.
  - Franchise arrangement as a subsidiary to a lease or management contract ensures professional support, even when the revenue base from individual towns is otherwise too small to attract the private sector.
  - A minimum number of franchise agreements is needed to provide the franchisor with sufficient revenues.
  - Cash flows must be sufficient to attract entrepreneurs as franchisees

Source of information
Franchise Development for Small Town Water Supply. March 2001. The World Bank.

5. Franchising in South Africa: A well-developed industry, but not yet providing social goods nor water services

5.1 The size and extent of franchising in South Africa

The size of the South African franchise sector, compared to North America or Europe, it is in absolute terms still quite small, "but its vibrancy is beyond question. More importantly perhaps, our franchisors' operational practices compare favourably with those in use anywhere else in the world. Given the solid footing of franchising in South Africa, it is easy to see that the potential for future expansion is nothing short of phenomenal." (Parker 2003, page 168)

The first "Franchise Baseline Census" was carried out in 2002. Some of the statistics that follow are drawn from this census report (FRAIN and Franchising Plus 2002.)

"The survey identified 19 major industry groupings and several sub-sectors, spanning the gambit [sic] from the ubiquitous food outlets to information technology and travel." (Parker 2003, page 169) The survey did not only cover FASA members.

It emerged from the baseline census that over 400 franchised systems operated through more than 26 000 franchised outlets and generated retail sales in the 2001 financial year totalling R134 billion annually. (FRAIN and Franchising Plus 2002, page 5) 42% of this turnover was accounted for by petroleum sales. (Note however that no petroleum companies are listed as FASA members.) The remaining turnover of R80 billion, (it is understood) nearly all through FASA members, is still very substantial.

FASA lists approximately 135 of its members that are franchisors:

- Slightly more than one third are "fast food and restaurants", including such well-known brand names as House of Coffees, Debonair's Pizza, Juicy Lucy, Kentucky Fried Chicken, King Pie, McDonald's, Ocean Basket, Something Fishy and Butterfield Bread.
- The next largest group is "retailing and direct marketing", including BP Express, Cardies, Cash Converters, Pick 'n Pay Family Supermarkets and also Mini Markets, 7-Eleven and Vodashop.
- Other groupings are "automotive product and services" (including Battery Centre and PG Glass), "building, office and home services" (including Lumber City and The Drain Surgeon), "business to business services" (including Harvey World Travel, Minit Print and Postnet), "childcare, education and training" (including Academy of Learning and Master Maths), "entertainment and leisure activities" (including Blockbuster Video), "real estate services" (including Aida and Remax), "health and body culture" (including HealthPharm Family Value Pharmacies) and even one funeral franchisor (under the heading of "personal services" -- no doubt there because it didn't fit under any of the other headings!) (FASA 2003, page 7)

Some franchisors are owned by the same company. For example Famous Brands (the renamed (since February 2004) Steers Holdings) owns not just the Steers franchise but also Fishaways, Church Chicken, Debonair's Pizza, Blockbuster Video, House of Coffees and (since acquiring the franchisor Pleasure Foods in December 2004) Whistle Stop and Wimpy. (Lutge pers comm. 2003; Business Day 2004b)

Some franchisors directly own some of the outlets but franchise others. "Best practice in franchising is supposed to be a spread of outlets that are roughly 30% company-owned, 30% franchised and 30% owned in partnership." (Financial Mail 2002d, page 108) Of McDonald's 107 outlets, however, as many as 70 are directly owned. The reasons given by the marketing manager for this are "the business grew faster than the number of people available to be trained" and "the cost of opening a franchise, about R2 million". (Financial Mail 2002f, page 55) In contrast, all Mugg and Bean outlets are franchised. (Financial Mail 2002d, page 108)

Some franchisees hold several outlets from the same franchisor. The franchisors take the attitude that an existing franchisee has proved his ability and is therefore preferred for another franchised outlet, provided that he is not extending himself too far. Also, existing franchisees don't have to be trained again, saving time and cost.

Some closures notwithstanding, franchisors are generally buoyant and face the future with confidence. Over the next five years, the sector expects to open another 25 000 outlets, both within and outside South Africa. "Categories that have experienced strong growth over the past four years are education and training (52% growth), business to business services (52%), entertainment and leisure (26%), industrial (20%), automotive products and services (19%), real estate (12%), and building, office and home services (12%)." (Financial Mail 2003b, page 38)

While foreign brands operate in South Africa, some South African franchisors operate outside of the country. In some cases, a company is responsible locally for a foreign brand, while also franchising its brand elsewhere. An example is Famous Brands, which has the rights to the American Church Chicken brand in South Africa, while itself operating its own brand in 16 other African countries. (Business Day 2002) Cross-border activity is increasing. "56% of South African franchisors, across a variety of industries, have spread their wings beyond our borders, mainly in sub-Saharan Africa and to a lesser extent Australia and the UK." (Financial Mail 2003b, page 38). Mugg and Bean has outlets in two Gulf states, and during March 2004 opened its first outlet in the UK. (Moneyweb 2004)

5.2 The characteristics and track record of franchising in South Africa

5.2.1 Essential questions

The essential questions are:

- does franchising deliver a product or service that customers want and are prepared to pay for;
- do the business arrangements between franchisor and franchisee work as they are supposed to;
- are franchisor and franchisee businesses sustainable; and
- what effect does franchising have on local economic development?

These questions are more or less interrelated: for example, whether a business is financially self-sustaining depends largely on whether customers do or do not buy and pay for the product or service.

Thus the characteristics and track record of franchising in South Africa are described below under the headings of:

- business failures;
- franchise support of franchisees;
- financial requirements;
- jobs created; and
- empowerment.

5.2.2 Business failures

In South Africa, "failure rates are registered at 15% in franchised businesses as opposed to 80% in independent businesses". (FASA 2003, page 55) This relatively low rate is ascribed to the businesses being "proven" and to the support from the franchisor.

Sometimes franchise failures are ascribed to the franchisee. ""The selection process is paramount. We found that the success of a franchise rests almost solely on the capabilities of the operator." (Mugg and Bean has just had its first failure, in high profile Hyde Park Corner.)" (Financial Mail 2002d, page 108, quoting Mugg and Bean founder Ben Filmalter). Sometimes, however, the franchisor is at fault. "These days, Metcash admits that its Foodies convenience stores and IGA Supermarkets grew too fast. The company gave insufficient attention to franchisee vetting and had inadequate credit control systems." (Financial Mail 2002a, page 29) It is thought that the original franchisor of O'Hagan's went into liquidation because of misreading the market and inter alia, overpaying for the restaurants purchased. The new owner bought the franchisor business from the liquidators, and the business is growing. Franchise brands no longer seen include Porterhouse and Squires Loft.

On the other hand, some franchisors have had a long record of success, discounting the occasional franchisee failure. The Spur restaurant in Newlands, Cape Town, opened 36 years ago. The Spur chain now embraces 209 Spur and 45 Panarottis restaurants in 11 countries. (Financial Mail 2002e, page 57)

5.2.3 Franchisor support of franchisees

"It is in the area of franchisee support, however, where South Africa's franchisors truly excel. According to the survey,

- Over 92% of franchisors make a disclosure document available.
- Over 98% of franchisors provide initial and ongoing training.
- Over 96% of franchisors supply franchisees with operations manuals.
- Over 97% of franchisors visit their franchisees regularly.

These findings bode well for future development of the sector." (Parker 2003, page 169)

5.2.4 Financial requirements

Total capital required to set up a franchise is dependent on the size of the operation and other issues such as the cost of building modifications. It ranges from as little as R25 000, with very limited options available in this bracket, to R2 million and more. It appears, however, that the majority of opportunities require an investment of between R300 000 and R800 000. (Parker 2003, page 169)

As a rule of thumb, the prospective franchisee is expected by the franchisor to fund of the order of 20% of the start-up investment himself. This does not preclude him seeking loans to supplement the personal savings that he is able to invest. The franchisor puts up the balance of the start-up investment required, in the expectation that he will be repaid by the successful franchisee over an agreed period. (Lutge pers comm. 2003)

Most franchisors charge ongoing fees in the form of a management services fee (average 6,3% of franchisees' sales) and an advertising contribution (average 3,5% of franchisees' sales).

However specific examples show a wide range of financial arrangements:

- Martin's Funerals Franchising: "The cost of securing a franchise is R230 000, of which R90 000 is an upfront fee. The remainder is used to set up the business, including the necessary refrigeration and equipment. ……… The company is offering prospective franchisees the option of a joint venture if they do not have sufficient funds to start-up. Franchise royalties are quite high at 7% of turnover, but [Martin] Piek says these funds are used for training, setting up and subsidising new franchisors." (Financial Mail 2002b, page 20)

- "New Spur franchisees sign a 10-year agreement that does not impose kickbacks on plant and equipment, a practice that has hurt other local operators and tainted the franchise industry. "We make our money from a fixed (5%) royalty on turnover, so our business depends on our franchisees' success," says Ambor. Training reinforced by communication and monitoring is the key, he says." (Financial Mail 2002e, page 57)

- Mugg and Bean: Potential franchisees for their larger stores "must have a background in food service. "The cost is R65 000 and we also charge a royalty of 6% of turnover and a 2% marketing fee."" (Financial Mail 2002d, page 108)

- "In property franchising, the commission is shared either on a 50-50 basis or on a sliding scale that gives the franchisee up to 90%. In common with other kinds of franchise operations, property franchisees pay a one-off start-up capital cost. A percentage of gross income goes to a marketing fund and there is a monthly service fee." (Financial Mail 2002c, page 66)

5.2.5 Jobs created

While the baseline census reported that "accurate employment figures are not available, it stands to reason that the sector is a major provider of jobs", FASA noted that the franchised outlets employed an average of 15 people per outlet (FASA 2003, page 56). (This would be 15 "full-time equivalents" (Lutge pers comm. 2003)). Given 26 000 outlets, that is 400 000 people directly employed, in addition to which there would be large numbers of people indirectly employed, for example as suppliers of unprocessed goods to the franchises.

It is however one-sided to claim, as FASA does (FASA 2003, page 56), that all of these jobs have been "created", without acknowledging that some at least of the franchise operations have put conventional retailers out of business, and thereby other jobs have been destroyed.

5.2.6 BEE

Only 6,5 % of franchised outlets are owned by "Blacks" (is unclear if this means all who are not White) and 26,5% are owned by females. (Marissa du Toit pers comm 2002)

This is, however, rapidly changing. 40% of new franchisees during 2002 were PDIs. (Moyanga pers comm 2003)

Some franchisors have had more success in striking franchise deals with PDIs. -Some have deliberately sought prospective franchisees from this group. One of the most successful has been Butterfield Bread -- two thirds of its franchisees are PDIs (Lutge pers comm 2003). Scooters Pizza have earmarked for empowerment 25% of a recent R7,9 million loan. (Financial Mail 2003b, page 38)

5.3 Assistance to franchising in South Africa

Assistance available to franchisors and franchisees in South Africa is described below under the headings of:

- industry association;
- organisations for the promotion of franchising;
- consultancies; and
- assistance from the financial sector.

5.3.1 Industry association

The Franchising Association of South Africa (FASA) claims to be "one of the most advanced franchise associations in the world". Founded in 1979, it inter alia:

- promotes the concept of franchising;
- issues guidelines according to which sound franchise schemes should operate;
- applies that code of ethics to the industry, and acts against those who transgress the code;
- collects and disseminates information on franchising (for example through the publication of its annual "Franchise Book", and maintenance of a website www.fasa.co.za);
- promotes franchising in the small-business community. (FASA 2003, page 10)

5.3.2 Organisations for the promotion of franchising

The National Coordinating Office for Manufacturing Advisory Centres (NAMAC) is a SMME support agency within the grouping of the South African government Department of Trade and Industry. It has developed an extensive delivery structure (including regional offices) across South Africa that serves as a channel for the application of new tools, information, products and projects. The emphasis is on PDI-owned or managed businesses, with the aim of improving these businesses over time by enabling them to join the mainstream economy. Its target is small and medium-sized manufacturing enterprises which employ between five and 200 individuals.

In partnership with sister organisations within the Department of Trade and Industry group, and with the CSIR, NAMAC is developing and implementing targeted assistance projects to target groups in different sectors.

The NAMAC assistance project of specific interest is the Franchise Advice and Information Network (FRAIN), established at the beginning of 2002. This "strives to supply high-quality information and support services to individuals and small business (SMMEs) to ensure growth and improvement of new and existing franchise businesses in South Africa". This maintains a website with information on a wide range of franchising topics, through terminology, advantages and disadvantages, legal aspects, and a step-by-step description of the how to become a franchisee right up to developing a business plan and working out costs involved. FRAIN also presents franchise awareness training and, through its "franchise cadet project", guides young graduates in business science through franchises over a period of a year, to give them experience. (NAMAC 2003a, Business Day 2003c, FRAIN 2003b, and NAMAC (www.namac.co.za) and FRAIN (www.frain.org.za) web sites.)

FRAIN and a consultant issued a first "baseline census" in 2002. In view of the value that the industry has perceived from this census, it has been decided that this census will be a bi-annual event. Thus the next survey will be conducted during 2004.

5.3.3 Consultancies

The Franchise Book lists seven specialist "franchise consultants". These offer a range of services including strategic feasibility studies, franchise development plans, marketing plans, franchise support audits, and franchise and business management training for franchisors and franchisees.

Some of the finance houses (see below) also offer some of these services.

5.3.4 Assistance from the financial sector

All four of the major South African banks advertised in the Franchise Book, variously claiming to be "a part of the growing and exciting franchise sector" or to offer "a comprehensive range of commercial banking services for franchisors and franchisees". (FASA 2003, page 111)

South African bankers are generally well informed about franchising, and all major banks maintain a Franchise Desk or similar department at head office or even at regional level. Bankers' interest in financing franchises stems from the realisation that franchisees of well-established franchisors stand a much better chance of success than do lone rangers.

In addition to the finance offered by the banks, funding is offered by amongst others the Industrial Development Corporation (which targets franchisors), and Business Partners and Khula Enterprise Finance (both of which finance SMMEs and/or provide equity funding to retailers of SMME finance). The commercial banks will not loan a prospective franchisee more than 60% of his start-up finance unless they receive a guarantee. Khula sometimes provides this on a case-by-case assessment. It was recently reported that Scooters Pizza has signed a R7,9 million loan agreement with the Industrial Development Corporation, which will be used to increase the number of outlets and broaden the pool of franchisees. (Financial Mail 2003b, page 38)

5.4 Social format franchising in South Africa

5.4.1 Generic definitions and activities

The concept of social format franchising, as it is generally understood, is described in Section 3.4 above. The concept was not, it would appear, explored in South Africa until 2002 (in all fairness, that the concept is new anywhere in the world must again be pointed out). Whereas no proposals for social format franchises have got beyond the initial design stage (if that), NAMAC and FRAIN have become enthusiastic advocates, commissioning the first local publication on the subject (FRAIN 2003a) and hosting the first seminar (held in Pretoria 25 Jun 2003).

To quote: "Perhaps the most exciting development in FRAIN is their investigation into social franchising, already operational in the United Kingdom. This involves the state in using franchise mechanisms to employ people in socially useful areas. The state can either act as the franchisor and work directly with franchisees, or the state can simply contract with the franchisor that in turn deals with the franchisees." (NAMAC 2003a)

Ideas on the involvement of the state (i.e. national government) are still fluid, however. Fluid also are views on the nature of social format franchising. One alternative view is that social format franchising is not necessarily, if at all, to do with the delivery of "socially useful" products and services. Nor is the state necessarily involved. This view holds that social format franchising is primarily a means to empowerment. Social format franchising "is being developed to address the exclusive nature of business format franchising, [which is] mostly a seller's market, with high entry barriers in terms of cost and skills. ……… Social format franchising aims to address these imbalances. The essence of this form of franchising lies in a gradual transfer of ownership, which lessens the entry barriers and increases support for new franchisees. Transfer of ownership can take place where the franchisee buys shares in the franchised unit over time, a potential franchisee shadows an existing franchisee, [and/or there is] group/co-ownership of a franchise unit.

Social format franchising places the costs and risks involved in setting up a franchise system on the shoulders of the franchisor. Firstly, the nature and extent of franchisor support services will have to be increased. Secondly, the risk of opening a franchised unit lies with the franchisor. Thirdly, contractual obligations become more complex to accommodate the gradual transition of ownership/group ownership. …. A likely criticism of social format franchising would be that the motivation for success [of business format franchising] lies in the investment that franchisees make in their businesses, [and that] breaking this entry barrier down would therefore lead to greater failure." Support systems, such as that developed by NAMAC, would be needed. (Marissa du Toit pers comm. 2002)

The current report accepts only the definition of social format franchising as described in Section 3.4, which is the definition enjoying international currency, and not the interpretation of the two paragraphs immediately above.

5.4.2 Social franchising and the water services sector

The first two attempts to explore the application of social franchising principles in the water services sector have been independently driven, and were both initiated without knowledge of the social franchising movement described above. These two attempts are the Boutek CSIR research project, partly sponsored by the Water Research Commission (i.e. the current study), and the DWAF project, described in Chapter 7 below, that had at the time of writing not progressed to the stage of appointing the "Professional Service Provider" (to use DWAF terminology).

During 2003 discussions between NAMAC (Mr Lutge) and Boutek CSIR (Dr Wall), agreement was rapidly reached to co-operate on further understanding the common ground between the social franchising thrust and franchising in the water services sector. Late in 2003 these parties met jointly with DWAF, but nothing had by the end of 2003 eventuated beyond an informal acknowledgement by DWAF that NAMAC and Boutek could add value to what DWAF is attempting to achieve.

5.5 Chapter conclusions

Franchising of commercial goods and services in South Africa is extensive, generally viable, and growing rapidly. Certainly, there is evidence that, everything else being equal, franchised businesses have a far lower failure rate than do independent businesses. Net jobs have been created. A variety of organisations offer support of one sort or another, sometimes at a price.

In comparison, social format franchising is in its absolute infancy in South Africa.

6. Local economic development in South Africa

6.1 Introduction

In Chapter 2 it is suggested that there is a need for additional institutional concepts for the sustained delivery of water services at local level. For the purposes of discussion, refer to that need as a "push factor" to discover and develop additional institutional concepts.

Chapters 3 through 5 go into various aspects of the delivery of goods and services by franchise means. These chapters, inter alia, reveal a preponderance of evidence that franchising creates many more jobs than it destroys; and that in addition it creates many opportunities for local entrepreneurs.

Chapter 6 in part investigates the need for local economic development in South Africa. It concludes that there is an enormous need for local economic development in this country, and in particular for the creation and nurturing of more entrepreneurs.

For the purposes of discussion, that need may be referred to as a "pull factor", a major incentive to find additional means of local economic development, and in particular of local entrepreneur development.

The relationship between water services franchising and local economic and SMME development is introduced (this theme is taken further in Chapter 7). Also, engineering contractor development programmes are reviewed in search of useful pointers for a water services franchise development programme.

(What is meant by “local economic development” can be clarified as follows:

"Two approaches to LED can be identified. Firstly, it can be viewed as a business development approach, which aims at enabling local economies to adjust more successfully to macroeconomic conditions. The emphasis is on promoting individual self-reliance, entrepreneurship, expansion of the market, competitiveness, a reduction of unemployment, and sustainable growth. Secondly, it can be viewed as a more bottom-up approach of community development. Here the objectives are to achieve local self-reliance, empowerment, participation and co-operation, to redefine work and to achieve sustainability. …. [It is necessary to balance] the business development and community development approaches. This is important, as business-led growth that doesn't benefit poor people will become unsustainable, while poverty alleviation through community development won't achieve long-term success without growth." (DBSA 2000, page 103)

Local Economic Development (LED) means: “..local people working together to achieve sustainable economic growth that brings economic benefits and quality of life improvements for all in the community. “Community” is here defined as city, town, metropolitan area, or sub-national region.” (World Bank - www.worldbank.org/urban/led/defining)

Thus LED clearly should include elements of job creation, entrepreneurial creation and nurturing, and the provision of goods and services that are useful. And that the development must be sustainable would no doubt determine where would lie the balance referred to.)

6.2 A scan of selected local economic development programmes in South Africa

6.2.1 A "scan"

This Section 6.2 is not a comprehensive view of local economic development in South Africa, or even of a broad range of LED programmes. It is only an outline of LED and only the barest minimum of an outline to permit a judgement to be made if the LED element of water services franchising, although a side effect of the need for water services delivery, can nevertheless constitute an important additional incentive to choose the franchising option over alternative, less economically developmental, water service delivery institutional methods. If LED is badly enough needed, then a stronger-than-otherwise case can be made for the franchising option in water services.

Furthermore, if some at least of current LED programmes are not succeeding in their objectives as they should, then a strong case can be made for some of the effort (including some of the financial resources), up to now being put into those programmes, to be diverted to assist water services franchising, on the dual grounds that:

- spending the effort on water services franchising is more effective in achieving LED objectives than the programme that has been absorbing this effort has been; and furthermore
- the social benefits of water services delivery, from franchising, outweigh the benefits of the programme that has been absorbing this effort.

6.2.2 The need for LED and SMME development

The need in South Africa for less unemployment, for higher income to households below subsistence level, and for more entrepreneurs, is universally acknowledged. "Unemployment remains one of South Africa's serious challenges, and the creation of work opportunities is at the heart of government's comprehensive approach to poverty eradication." (GCIS 2002, page 49)

Although statistics of unemployment are often subject to dispute (often due to differences in interpretation, or definitions), there is no denying that to have of the order of 40% unemployed of those between 15 and 65 (Statistics SA 2003, page 54) is an intolerable situation.

Long-term sustainable employment will be an outcome of successful LED that is designed to take it into account as a supporting but secondary objective.

However, there is a pressing need for increase in business opportunities, and to facilitate access and participation in business for otherwise marginalised people, as entrepreneurs and as owners of the factors of production.

6.2.3 Review of a national LED programme

The programme reviewed is that of the flagship Local Economic Development Fund (LED Fund), housed in the national Department of Provincial and Local Government (DPLG). This programme was chosen by the current author for review because of its size and significance, and because a comprehensive evaluation has recently been completed. (MXA 2003a and MXA 2003b)

The programme emerged as a consequence of concerns that national government's macroeconomic policy was resulting in jobless growth and was unable to provide economic opportunities to the poorest sectors of the population.

The evaluation noted that the LED Fund has an agenda that is more "welfarist" than it is attempting to create comparative advantage. ("Comparative advantage": e.g. government acts as an enabler, creating an appropriate tax regime and promoting skills development.) DPLG advocates public sector-driven local economic growth through the promotion of skills, labour-intensive activities, the promotion of SMMEs, and BEE.

Spending by the Fund has been significant -- R295 million up to the end of financial year 2002/2003, with 275 projects funded, and 13 000 jobs created (some short term, some long term). A further R120 million is budgeted for the 2003/2004 financial year.

The Fund is intended to benefit the poor, although no definition of "the poor" is given. A maximum of 10% of the project value may be used for management and the employment of consultants, although this threshold has been exceeded at times. The Fund also permits a specialist LED appointment to be made to the staff of the municipality. People employed on the project must earn at least R70 per day. Municipalities may apply for funding up to R1,5 million per annum. They are required to show how the proposed initiative is linked to their IDP. Funding may be applied for new projects, upgrades, or refurbishment of existing facilities. Provincial LED committees adjudicate the applications received. DPLG disburses the funds in three tranches, contingent on project performance.

The evaluation concluded that: "….. while there are stark differences in the performance of the LED Fund across provinces, generally the Fund has been a conceptual and practical failure." (MXA 2003a, page 2)

The reasons for this finding are set out at length in the reports of the evaluation team. Additional documents describe the findings of case studies.

The evaluation team regarded the following as the principal characteristics of the LED Fund programme and the projects funded by it that have led to this poor performance. (Some additional comments by the team are incorporated in the very brief summary below.):

- The LED Fund has attempted to straddle different LED paradigms. On the one hand, it sees itself as an important contributor to poverty alleviation, while at times it adopts an entrepreneurial, business-oriented approach. There is a deep-seated ambiguity at the heart of the conceptualisation of LED as articulated through the LED Fund. As a result, the objectives of the programme are not clear, nor are they prioritised. This is manifested in the implementation of the programme: thus much of the funding went to projects that were predominantly, or exclusively, "infrastructure delivery" and/or "welfare", and were not designed to create sustainable economic development.

- The local government sector has struggled to define its role in LED Fund projects. In many instances, municipalities have taken up the role of the "driver" as opposed to the enabling role envisaged in DPLG policy. This has "contributed to the marginalisation of the private sector and NGOs". (MXA 2003a, page 4) Also, many projects tried to make entrepreneurs out of public sector officials (it is probably fair to state that most public sector officials do not have the necessary entrepreneurial spirit) and/or out of the very poor and usually did not try to make entrepreneurs out of those who had greater potential. (For example: "It is not clear that LED Fund has systematically sought out existing entrepreneurs and supported their efforts, in spite of clear suggestions that where funds are released in support of existing activities they have a greater impact. Too many LED Fund projects appear to have been formulated in response to the availability of grant funding ….. Cost effectiveness is not a concept that has informed the working of the Fund." (MXA 2003a, pages 14 and 15))

- The policy, and its implementation, does not link well with the policies of other national government departments ("other", that is, than DPLG).

- Many projects were poorly identified (e.g. had no relationship to other economic activities, or other supporting initiatives), poorly designed (e.g. counterproductive incentive structures built in), and/or poorly implemented. (For an example on "counterproductive incentives": "Currently there are disincentives for beneficiaries to show that they have become successful, as this would sever the flow of LED funds on which they are dependent. As a result, the programme tends to promote very expensive, overcapitalised, subsistence projects, without a hope of ever becoming financially self-sustaining." (MXA 2003a, page 15))

- Monitoring by national or provincial levels was usually deficient, and evaluation and corrective action almost totally absent.

- Few of the projects enjoyed external support beyond the short term. The evaluators noted that many a project enjoyed a subsidy and/or the assistance of a key personality or institution "from outside", and that there was a very real prospect of the project collapsing when these withdrew (as they would in due course).

In summary: "The practical failings of the Fund relate to the limited ability of the programme to promote competitive enterprises, job creation and financial independence among its beneficiaries, especially women and youth. Many LED Fund projects appear to be a form of welfare, without any linkages to the broader economic environment or any strategy to promote profitability. In their current incarnation, most projects will never enter the private sector, which truncates the potential for community-private sector partnerships." (MXA 2003a, page 13)

It is reported that DPLG did not dispute, but "generally accepted" these findings. (Cartwright pers comm. 2004)

To conclude this critique of the LEDF, it is useful to compare the LEDF programme with the following list of applicable programme options derived from a World Bank study. (World Bank 2003, p 12):

1. Improving the local business investment climate;
2. Investment in hard strategic infrastructure;
3. Investment in sites and premises for business;
4. Investment in soft infrastructure (i.e. skills);
5. Encouraging local business growth;
6. Encouraging new enterprise;
7. Promoting inwards investment;
8. Sector (and business cluster) development;
9. Area targeting/ regeneration strategies; and
10. Integrating low income and hard-to-employ workers.

The point is made in the World Bank study that any programme needs to prioritise these options, and will have to trade off between them in order to achieve the "balance" referred to in Section 6.1 above.

The LEDF programme possibly satisfied items 2., 9., and 10. to an extent, although this cannot be directly verified. However, it would seem clear that the definition and process (listed above in 6.1) were not followed due to the dominance of local government and the apparent exclusion of other factors of civil and commercial society. In essence, the LEDF programme attended almost exclusively to a single output of LED, viz. welfare level job creation, and also that it disregarded any considerations of building towards self-sustainability, choosing instead to rely upon a constant stream of external inputs to any project. Without the elements of sustainability having been built, the outputs would cease as soon as the external funding ceased.

6.2.4 Section 6.2 conclusion

The essential question is: Are there better ways of achieving LED than the ways the LEDF programme tried?

On the evidence reported in 6.2.3 above, the heavily funded LEDF programme has largely failed to achieve its apparent objective of sustained LED.

If intervention programmes to achieve sustained LED are considered in the future, it would be worthwhile to examine approaches and methods that have proven more successful elsewhere. Such interventions would be well advised to consider strategies and implementation plans that include business format franchising, due to the evident success of this method in bringing more people into the formal economy, and on a sustainable basis.

Without question, then, a strong case can be made for some of the future effort (including some of the financial resources) of such intervention programmes to be diverted to assist water services franchising, on the grounds that:

- spending the effort on water services franchising will be more effective in achieving LED objectives; and
- furthermore, the social benefits of water services that will be delivered by franchising will far outweigh the benefits that will be delivered by a continuation of much of the LEDF programme as it has been constituted up to now.

6.3 Local economic development, franchising, and engineering infrastructure contractor development programmes

6.3.1 Introduction

Section 6.3 reiterates the relationship between franchising and LED. It then comments on issues that need to be addressed in any programme for SMME development (generic issues, i.e. not specific to water services or to franchising).

Section 6.3 also describes how SMME development programmes for engineering infrastructure contractors have been and are structured in South Africa. The analogy for the franchise development programme that will be needed, if franchising of water services is to take off, is apparent. Useful pointers for the franchise development programme are found in the engineering infrastructure contractor development programmes.

6.3.2 Franchising and LED

Creating jobs and creating and nurturing entrepreneurs

The essential question is: does franchising create many more jobs than it destroys, and create and nurture many entrepreneurs?

Chapters 4 and 5 amply substantiate that franchising does indeed do this. (See in particular Sections 5.3.5 and 5.3.6.)

Black Economic Empowerment (BEE)

It is claimed that: " ….. the master franchise movement … holds employment benefits for South Africans but no scope for economic empowerment." Therefore franchising, and in particular social format franchising, must have a greater focus on emerging enterprises. "The employment implications …. far exceed [those of] the duplication/extension of an existing system." (Marissa du Toit 2002)

It was not within the scope of the current study to investigate the validity or otherwise of the statement that the franchise movement as currently implemented holds no scope for economic empowerment. That can be done in a future study. Undoubtedly, however, for practical reasons (inter alia, the likely small town and multi-village location of its focus), if not for political, economic and other reasons as well, a water services franchising programme must have a large, very large, emphasis on PDI enterprise.

This emphasis would be in accordance with national government's BEE objectives.

The programmes described in Section 6.3.4 below are also very strongly pursuing BEE goals (among other goals). Means that they have adopted to promote BEE could likely be adapted in order to pursue the same goals in a water services franchising programme.

6.3.3 Generic SMME development programme issues

The Small Business Project (a support and research unit, a Section 21 company, engaged in small business development) has drawn attention to:

- the need for SMME development;
- that SMME concepts must make financial sense; and
- that SMME creation and development needs systematic support.

Government has recognised that small business development is a key strategy in tackling poverty and promoting economic participation and job creation. "The Department [of Trade and Industry] is continuing to shift its focus from demand-driven to supply-side driven measures, and to increase its focus on SMME development." (GCIS 2002, page 163)

However, the Small Business Project notes that, "the lack of systematic support structures for the sector is inhibiting its development." (Other, that is, than in respect of public sector procurement strategy aimed at procuring goods and services from indigenous small firms to encourage BEE.) "Government-created SME support agencies like Ntsika and Khula are struggling to meet the development needs of their target groups." (For description of Ntsika and Khula, see GCIS 2002, page 169)

In the opinion of the Small Business Project, in order to boost private sector growth and job creation, the enabling environment must be made more favourable. "Government must set its sights on making this country a good place to do business, where it is relatively easy to register and set up a business, where investments are protected, [and] where laws and regulations are sensible and enforceable …." "International experience shows that an appropriate regulatory and institutional environment is the single most important element in an economic growth strategy. Only one other factor, a country's level of available skills, especially technical skills, is anywhere near as strongly correlated with per capita economic growth. However, interventions to improve the regulatory and institutional environment within which business operates, offer prospects for far more rapid impacts than inherently longer-term education and skills strategies."(Small Business Project 2002, pages 1 and 2)

The scope for SMMEs to create jobs is shown in that "… in Africa …. micro and small enterprises employ more than 40 per cent of all new entrants to the labour force". (Small Business Project 2002, page 3)

The small business sector needs to grow much faster than it has been. "The trade and industry minister has said that the small business sector is more than a decade away from where it should be". (Business Day 2003b)

The obstacles are substantial, and it would seem, not improving. A recent study showed that "South Africa has slipped three places to rank 22nd in a global entrepreneurship survey, indicating that the country has failed to create a competitive climate in which emerging businesses can grow and thrive. …. The 2003 Global Entrepreneurship Monitor, an annual survey published yesterday, showed SA had dropped from 19th place in 2002 to 22nd place [in 2003], out of 37 countries." (Business Day 2004c) "Problems in the education system, especially relating to the school curriculum and quality of teaching, contributed to lower levels of entrepreneurial ability and self-confidence among young people than in other developing countries. Poor financial management practices and reluctance from banks to grant entrepreneurs initial start-up capital were other factors that contributed to SA's dismal ranking."(Business Day 2004a)

To comment in conclusion: South Africa needs faster SMME development, but the barriers to entry and to growth for the smaller or start-up company are substantial.

Whereas measures such as those highlighted above are necessary anyway, franchising provides a means to overcome, or to mitigate the effects of, some of these barriers.

6.3.4 Development programmes for engineering infrastructure contractors in South Africa

The following development programmes in engineering infrastructure contracting are described below:

- the DBSA's "construction and development programme" of the first half of the 1990s; and
- the "Soweto contractor development programme" of the decade 1987 to 1998.

These are by no means the only two substantial infrastructure contractor development programmes of the last 15 years. They are, however, two of the largest and best documented.

A myriad of smaller programmes were run by others. Some have been documented, even if only partially. More or less the same findings are constantly reported, for example:

- "Without exception the contractors showed commitment, enthusiasm and an ability to learn rapidly the management and organisation techniques required …. They quickly grasped the profit potential, the long-term work continuity and the eventual ownership of useful equipment, as being in their best interest." (Bentall 1993, page 9)

- "It is acknowledged that the small contractor who would be willing and available to undertake the work envisaged is unlikely to possess all the necessary skills, and some level of support on the managerial, technical or financial level will undoubtedly be necessary." (Croswell 1993, page 11)

(For a more recent example, see Horak et al 2003)

DBSA's "construction and development programme"

The DBSA programme was founded on the philosophy that, whereas in the past ("then past", the programme was written up 10 years ago) development projects had generally been undertaken to meet only the physical needs of a community, South Africa's changing social and economic environment demanded that such projects be executed in a way that also addressed the other needs of the community. To achieve this, projects should be structured so that opportunities for employment and for the development of skills and entrepreneurial abilities are maximised. (Milne 1994, "Series preface". ("Series" refers to the set of documents that DBSA published to describe the programme.))

Furthermore, whereas the construction industry had up to that time achieved significant success in terms of recognising, promoting and implementing labour-based approaches, attempts to promote entrepreneurial development had proved "disappointing". "Some developmental institutions have small business support programmes for emerging entrepreneurs. Their efforts have primarily been directed at emerging builders in the housing sector. Emerging civil contractors, electrical contractors, plumbers, material/component manufacturers and suppliers are usually not considered by such organisations.

Emerging contractors have been supported with mixed success: shortcomings including inability to meet deadlines, unfinished work and abandonment of building or site, deviation from plans and specifications, poor workmanship and budget overruns. These are symptoms, the cause being the constraints faced by emerging contractors as they often have to operate in a system devised for established contracting.

Emerging entrepreneurs face two types of constraints:

- Internal constraints are factors which inhibit business efficiency and over which the entrepreneur has direct control, for example deficiencies in numeracy, literacy, managerial expertise and technical skills. These business limitations can be overcome through training and advice.

- External constraints are beyond an entrepreneur's control. They are due to market distortions and the prevailing socio-economic structure, for example laws, regulations, procurement procedures, perceptions, and access to training, finance and opportunities. Overcoming these constraints requires financial assistance, infrastructure, and appropriate developmental strategies.

The specific objective of entrepreneurial support is to assist emerging contractors to get the necessary technical, administrative, managerial and marketing expertise to operate in the industry; that is help them to overcome internal and external constraints.

Entrepreneurial support, which only improves the *supply* of contractors, through training, financial and management assistance, is not enough. Efforts should also be directed at increasing the *demand* for their services through labour-based approaches and by restructuring projects." (Milne 1994, pages 1 and 2)

Milne then set out a "framework for contractor development". "The elements of contractor development are:

- contractor classification, defining operating levels according to the managerial, technical and financial competencies expected of contractors;
- project or task classification defining the complexity of work that a contractor at a particular operating level can perform. It is vital to match the task with the contractor's competency;
- procurement and contractual arrangements defining the types of documentation, tender procedures and contract types that contractors at the various levels are comfortable with and that satisfy project and client needs;
- support services defining areas of support needed by contractors for overcoming their internal constraints; external constraints would be attended to at a higher level; and
- control measures, apportioning risk and providing cover similar to those in conventional approaches." (Milne 1994, page 4)

Milne in the rest of the document expanded on these elements, stressing how contractor development "is affected by:

- management (i.e. the client) choices that accord with and optimise entrepreneurial development;
- institutional roles; and
- project options that match the project with developmental objectives. " (Milne 1994, page 4)

The "Soweto contractor development programme"

The Soweto Contractor Development Programme (SCDP) was started in 1987 with a range of field experiments that included residential buildings renovation, new water mains, replumbing residential houses, new sewers, replacement of major stormwater drains, new road construction and surfacing, and laying of new kerbing. Over time, the most successful of these in the Soweto context was found to be new water mains, because that was the area of greatest need and therefore, of investment and experience-building. The other works would remain appropriate for application anywhere.

These experiments were born out of a strategic analysis that targeted the need for structural change in the ownership of the factors of production within this dormitory township. A key challenge at that time was the weak local economy. For this, and for other reasons (in particular the widespread boycott of rates and service charges, the then Soweto local authority had access to very inadequate operating budgets.

However, other factors from those times still apply today, such as the need to draw in marginalised components of society, to diversify ownership of the means of production in a community, and to bring quality services to serve areas that need regeneration.

One of the few opportunities available at that time to influence economic development was investment in urban engineering infrastructure, using funding made available by the Witwatersrand Regional Services Council.

The Soweto City Engineer's Department designed an appropriate programme (the SCDP) and assumed the responsibility of programme Sponsor.

The SCDP was designed to mobilise the intrinsic competitive advantages of the residents and did succeed in breaking an oligopoly stranglehold exercised by the large civil engineering companies that were active in the area at that time.

"To achieve success, a similar approach to business format franchising was adopted. A model of effective production delivery and administration was developed during these field experiments by the Sponsor's agents. Four professional engineering consultancies were briefed and appointed for this purpose. This model was then transferred, through training schemes and through contracts carried out, to the participants over a period of time.

Contract awards were kept small with short durations, partly to limit risk but also to ensure a higher than normal volume of new contract starts. An emerging contractor would be able to build experience of the tendering process, and the finalisation of contracts. The Sponsor could select the more proficient performers for further progress, whilst deselecting failures.

Analysis for the model identified disaggregated components of production and administration that could be simplified and systematised. Support for these were then provided by the Sponsor's agents on a reducing involvement basis, such that the end result of complete withdrawal of support could be achieved at some undetermined, but appropriate time in the future when support had become no longer necessary.

To gain the most effect and also to offer replication elsewhere in the country, linkages were created to other government agencies, DBSA, NGOs and the Soweto business community.

Job creation was in fact more of an outcome rather than an objective. Bearing in mind the low ratio of labour costs to materials costs and professional fees that can be achieved in capital intensive infrastructure, an emphasis on [job creation] would have detracted from the primary LED objective. But job creation was achieved by applying labour based construction methods, and it was a welcome outcome for many reasons including leveraging project spend.

But the labour-based construction methodology was principally used to simplify the construction supervision task for the trainee contractors, to reduce the cost of damage to existing unmapped services [were machinery to have been used], and to reduce the business risk of the contractors who were inexperienced in managing hired machinery. Above all, the task-based labour-only excavation work enhanced the comparative cost advantage of the local owner over the external construction company (which would have used conventional means of production)." (Davis pers comm. 2004)

Although the SCDP aimed to use infrastructure provision as the business opportunity for LED intervention, the same concepts that apply in LED and franchising were applied: viz. strategic analysis, market opportunity targeting, and delivery process disaggregation, simplification, and systematisation. This analytical and structured approach could be replicated where appropriate in an ongoing service delivery context such as water services provision.

To quote from the literature:

"The SCDP, while it increased the labour content of civil engineering construction projects in Soweto, "…. at the same time, trains local entrepreneurs in labour-based construction methods of installing services. In this way, technical, commercial, managerial and administrative skills are developed within the community with a concomitant increase in earning capacity. At the same time, the community retains and cycles a significant proportion of the money spent on a project. Local entrepreneurs who are, from the outset, employers in the community can, with sufficient technical, financial support and instruction, become fully-fledged contractors and, as such, provide greater earning opportunities for others in the community. Thus the project may be described as a job creation programme with the potential for sustainability through entrepreneurial development."(Watermeyer 1999, page 1)

"It was recognised [at the inception of the programme] that no Sowetan either owned, or operated, a civil engineering construction company." The barriers to entry, precluding local potential entrepreneurs from becoming contractors, "were identified as being:

- tendering and contractual requirements, such as the provision of facilities, the inclusion of penalty clauses, and the tendering of rates;
- the prevalence of plant-based construction practices;
- the lack of financial resources to purchase plant, hire plant and tools, and to pay wages;
- the lack of credibility in commercial circles;
- the lack of commercial, managerial and administrative skills; and
- the lack of technical competence." (Watermeyer 1999, page 2)

To address these barriers, the contractor development programme evolved five levels of contract, identifying the type of support required for each, the contractor responsibilities in respect of each, and the degree of developmental support that was required. The five levels of contract were:

- labour only;
- labour plus transport of materials to site (materials supplied by others);
- labour plus transport plus materials (assisted);
- labour plus transport plus materials (unassisted); and
- labour plus transport plus materials plus full surety.

The intention was that even if an entrepreneur entered at the lowest level of contract, he could be assisted to aim higher once he had proven his ability on the initial contracts.

"The project peaked with employment levels of about 900 people. Several contractors graduated from the programme and are operating fully-fledged civil engineering companies. They have purchased plant, have access to credit and finances, and have credibility in commercial circles. The project was replicated in several other towns, cities and rural areas in South Africa." (Watermeyer 1999, page 4)

(See also Watermeyer et al 1995.)

That these two approaches (viz. DBSA and SCDP) are broadly similar is no coincidence. They were developed through close co-operation between Milne and Davis (and also Croswell) during the early field experiments review and subsequent redesign phases, and the sharing of experience between these and others. (Davis pers comm 2004)

CIDB

It is understood that the contractor development programme of the Construction Industry Development Board will embrace the lessons from the DBSA and Soweto programmes. While it is currently still "under construction", early indications are that it will broadly incorporate the same five essential elements identified by Davis and Milne and referred to above. (Watermeyer et al 2001; Watermeyer pers comm 2004.) (But note some distinguishing features. For example, that in addition to "third party management support" to advise, assist and train on-the-job "fledgling" contractors, the concept of additional support from "mentors", who are to be "trusted and respected advisors", is introduced.)

Findings of Section 6.3.4

In summary, these programmes represent a useful body of knowledge, with practical experience stretching back more than a decade, to draw upon. The theoretical constructs, and also the practical programmes as implemented, to encourage the creation of SMMEs, to develop them, and to support them, provide much that will be of value to the programme of water services franchising entrepreneur development that will be needed. Given that these programmes are from the infrastructure sector, many of the analogies they hold for water services are much closer than are held in programmes for SMME and/or franchisee development in any other sector.

Unquestionably, the future drafters of a water services franchising entrepreneur development programme will find great value in closely studying these infrastructure contractor development programmes.

However, the analogy is not exact, and, if used as a basis, the contractor programmes would need extensive adaptation for the following two principal reasons:

- the contractor development programmes are development programmes for SMMEs in an environment that takes no particular account of franchising, whereas franchising has its own very special environment; and
- roads, water and sanitation contractors, and, even more so, building contractors, would expect at the level (size of contract etc) under discussion to undertake several contracts during the course of a year, whereas a water services franchisee (or, for that matter, a fast food franchisee) would expect to undertake far fewer contracts (or maybe only one), each of a much longer contract period.

The drafters of a water services franchising entrepreneur development programme would be well advised to take what is relevant from both the infrastructure contractor development programmes and the business format franchising franchisee development programmes, and to create a unique programme.

This new programme will however without doubt need to include the elements identified by Milne (Milne 1994, page 4), viz.:

- contractor classification;
- project or task classification;
- procurement and contractual arrangements;
- support services; and
- control measures.

The concepts of the SCDP could be amended and implemented along lines similar to franchising. This could be done by selecting small components of service delivery (after suitable unit process disaggregation analysis made by observing going concerns) and creating “Standard Operating Practices” for each of them. In fact developing Standard Operating Practices is done by commercial and public sector water utility operators as a matter of course. Some source materials may already exist ready for modification in some instances.

Single business processes, or logically grouped multiple processes, could then be let as entrepreneur development programme packages within a framework of a documented quality management system. Enabling competition and applying commercial rigour to this process would be important for cost control and healthy development.

In an ideal situation, the smallest package of business processes would be based on the minimum economic size of unit. In other words, the package of processes would be large enough to generate an attractive income for the Franchisee, but small enough to minimise the risk to all parties concerned (service customer, sponsor, investor, WSA, WSP, franchisor and franchisee)

Even in a pure development situation, with full support and mentoring assistance in place, the sponsor would expect to experience some failures, as indeed occurred in the SCDP described above. But by formatting the franchise development along similar incremental and progressive principles, the losses would be minimised, both in financial terms and in human terms. Thus operating manual documentation (Standard Operating Practices and administration etc.) and competitive bidding processes would be refined and improved by the sponsor’ agents and/or the franchisor.

6.4 Chapter conclusions

There is an enormous need for local economic development in South Africa, and in particular for the creation and nurturing of more entrepreneurs. This "pull factor" is a strong incentive to find and develop additional means of local economic development, and in particular local entrepreneur development.

Whereas franchising is shown in earlier chapters to increase employment and entrepreneur numbers and their development, the "pull factor" is a strong additional (to the "push factor") motivation for the franchising of water services, as opposed to the delivery of water services by other institutional models. Furthermore, resources on a programme for the franchising of water services would certainly be much better spent, in terms of achieving sustainable jobs and entrepreneurs, than were most of the resources spent between 1999 and 2003 by the Local Economic Development Fund, for example.

Many useful pointers for the water services franchisee development programme that will be needed, if franchising of water services is to take off, are found in engineering infrastructure contractor development programmes.

An important word of caution: A project to establish water services franchising in an area might find that an attempt to achieve too many objectives (especially if the project tries to achieve both business development and large scale job creation) will result in the achievement of only one, or of neither. The primary objective of a water services franchise programme must be sustainable water services delivery. All other objectives must be supportive of this primary objective. It cannot be allowed that they hinder its achievement.

Given that, and depending on local needs and circumstances, the next-ranking objective would probably be sustainable SMME formation. Job creation can be a possible outcome, but it is not a foregone conclusion, particularly during start-up. In fact, there may be some job losses initially if there is already a service being provided, and which the franchise service is replacing. Job creation must not be the primary objective, as the focus will then stray from providing the water services and getting the SMME up and running. The danger of too much attention being paid to job creation would probably be not enough attention being paid to the needs of the market, the business system development, and financial viability.

What is important is the assignment of the immediate responsibility for water services delivery, and the business risk, to an entrepreneur, and away from the WSA or municipal WSP.

7. Franchising of water services in South Africa

7.1 Outline of the water services franchising concept, and the possible format

7.1.1 Potential of water services franchising

Chapter 2 concludes that there is a strong "push factor" motivating the need to investigate water services delivery models alternative to those current.

Chapter 6 concludes that there is a strong "pull factor", viz. the desirability of local economic development, motivating the need to investigate franchising as a water services delivery concept alternative to the current models.

What form could such a franchise concept take?

In this chapter, the concept of water services franchising is discussed in more depth than hitherto in the current report, and a possible format is outlined. (Much can in this regard be learned from the experience reported in Chapters 3 through 5.)

The context is, for reasons stated in Chapter 4, currently confined to towns and to multi-village situations. This is not an inherent limitation to the concept, but is in the current report adopted for convenience only.

7.1.2 The case restated for investigating franchising in the water services sector in South Africa

Communities in South Africa that have been served with acceptable levels of service are those relatively easy to reach, whereas those that are unserved are generally communities in more marginal supply zones. These latter are the rural and peri-urban areas, and in particular the non-metropolitan towns which have a poor tax base and little capacity for cross-subsidy from those who use water in excess of the 6 kilolitres "free basic water" per household per month.

The capacity of municipalities in South Africa to adequately provide even basic levels of service to all their citizens is in question. Although the cities are more or less succeeding, it would seem that, generally, the less urbanised the municipality is the less the capacity it has. *Even prior to the 2000 new municipal demarcation, national government had put together a framework for private sector participation in municipal service delivery. There is no need here to go further than to note that, while partnerships with the private sector, and various forms of commercialisation of municipal services, have made headway in the cities, they have with very few exceptions not made headway elsewhere.*

The need for alternative water services provider systems is not disputed. Officials of both Rand Water and DWAF have for a number of years given their opinion that the potential for franchising in the water services industry water ought to be investigated. For various reasons this has never been done.

Since the twin driving forces of the franchising concept are the profit motive and the existence of a successful business model that can be copied widely, it is important that care be taken in launching a franchising endeavour. Neither of these two essentials for success is currently in evidence in the water services sector. Furthermore, there are many pitfalls when it comes to implementation even under the most favourable of circumstances.

The de facto obstacles to entry, and obstacles to medium term survival, for the smaller or start-up company are substantial. But if these obstacles could be overcome, perhaps through franchising, then there would be extensive opportunities that could be opened up for local economic development (LED), and that would also impact on Black economic empowerment (BEE) in many cases.

Any new system must at some stage be tested in the field. The piloting of any new alternative, such as franchising, should be done in the easiest of circumstances where the chances of success are the greatest. Piloting should not be done in an area of even average problems, let alone an area in which the problems are worse than average. The new idea will have difficulties unique to the fact that it is a new idea and it should not be further burdened with an attempt to implement it in a problematic area. (Applying this new concept will be a difficult enough task, without saddling the implementation team with the additional difficulties of, say, a problematic water supply or a demoralised and dirt-poor community.) If it were to fail in a problematic area, little will have been learned. Once it has succeeded in circumstances that are close to the most favourable that could be found, and has been shown to have a sound foundation, then it can be tested in progressively more problematic areas until its limitations are exposed in a fair trial.

As noted above, it is desirable to investigate means to facilitate the entry to the water services sector of emergent business enterprises. The emergent businesses will not have experience, nor will they have the time, given the urgency for development of their potential capacity in water services delivery, to develop this experience. Means to overcome this lack of experience thus need to be devised.

Franchising is a way of accelerating the development of a business, based on tried and tested methodology. The franchise system firstly correlates and systematises the business, and then facilitates the setting up of the business, and supports and disciplines it thereafter.

The business method elements of franchising most relevant are:

- identifying a component of the value chain that is simple enough to systematise;
- discovering good practices;
- systematising the identified component;
- selecting franchisors and franchisees;
- identifying the financial risk to both the franchisors and the franchisees, and as far as practical reducing that risk;
- providing start up help, including initial training;
- preparation of operations manuals;
- ongoing research and development for the product or service and of the market dynamics; and
- continuing support, training, control and discipline of the on-going business. (From Section 3.6.)

But it must be emphasised that a strong strategic planning base, followed by the design and determination and selection of clear and focused and prioritised objectives, must be laid down. This would be best practice for planning any complex multidisciplinary project, but it is critical for developing franchising in the water services sector because of the wide range of role-players that would be included into consultation processes and because of the essentially developmental nature of the enterprise.

There is no existing model to look to for experience in franchising water services, so implementation would be breaking new ground and as such would be inherently risky. Some risks would have to be taken and a medium to long-term view adopted, to ensure that initial experimental implementation was given sufficient time and opportunity to bear fruit.

Amongst the reasons why the franchise concept could achieve significant impact in South Africa is the potential for opening the water services industry to smaller companies in general and for black economic empowerment (BEE) in particular.

Thus through water services franchising there is potential to simultaneously:

- deliver water services, and
- promote LED, SMMEs and BEE.

7.1.3 Present relationships

Figure 7.1 schematically illustrates the relationships between, and reciprocal obligations of, WSA, WSP, DWAF and customers, as described in the Water Services Act. Note the important role of the funding partner, not described in the same Act, but who is adequately enough described elsewhere.

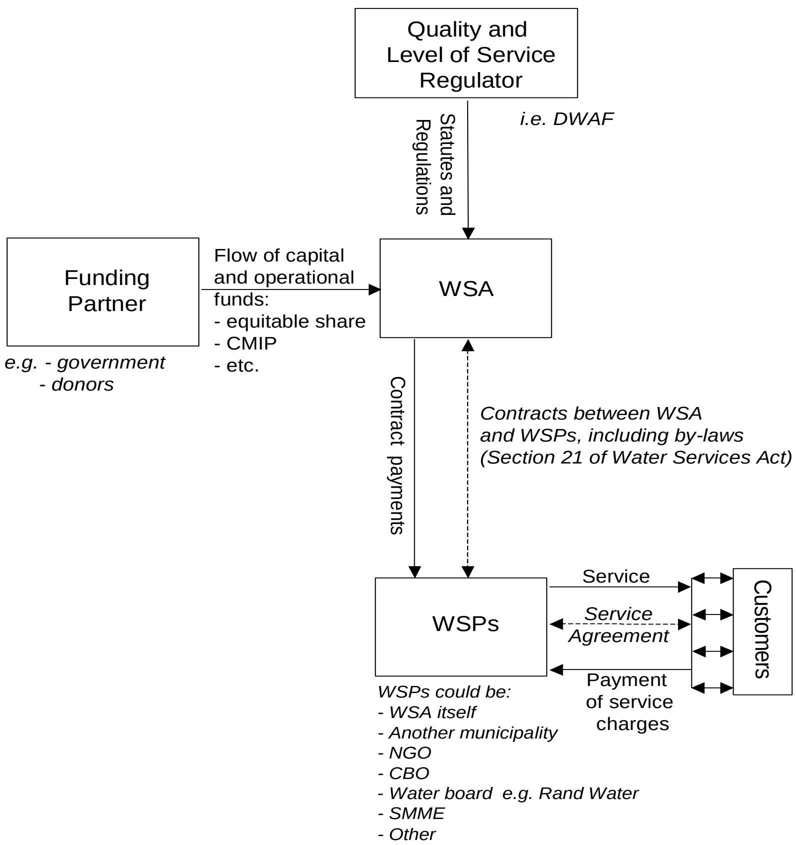


Figure 7.1: Present relationships between WSA, WSP, DWAF and Customers

7.1.4 Proposed institutional format for franchising in the water services sector

Specific formalised institutional arrangements would have to be made to ensure appropriate allocation of tasks and responsibilities.

This section discusses a preferred format.

Broadly, a franchise is “the granting of a right for a specific purpose" (see section 3.2 above). Thus, in respect of water services, who might be the franchisee, who the franchisor, and what is being granted?

In the first instance, the respective roles and responsibilities, and the interest groups or role-players must be mapped out, and the interrelationships and dependencies recognised.

The Water Services Authority (WSA)

The Water Services Authority (WSA) is responsible for providing water services to all in its area of jurisdiction.

In terms of national legislation and policies (see Section 2.3.3 above), a WSA may contract with one or more water service providers (WSPs) in its geographical area of responsibility. There is no barrier to WSPs, contracted to the same WSA, being of different types.

Bearing in mind the legal prohibition placed on private sector ownership of existing water assets, the WSA must retain ownership, at least of existing assets. If new assets are required for a part of the area, there remain complications and limitations in mobilising private sector investment, including lengthy selection processes, commercial unattractiveness and low financial returns in small or peri-urban communities. So it is assumed that the WSA must provide these infrastructure investments in the context of the franchising concept. The activity of the private sector WSP is therefore limited in this report to aspects of ongoing water services operations.

The Water Services Provider (WSP)

A WSP, or more than one WSP, will be needed to operate the water systems that are there already in the WSA area of jurisdiction, or those that are to be created to ensure full coverage services delivery. This unit may be the WSA’s existing internal WSP, or a utility, or a private sector operator retained under contract.

The central recommendation of this current study is that "franchisee" must be added to any list of possible WSP types.

The Franchisee

The Franchisee would be an entity that would be contracted, either directly by the WSA or by the WSP to provide a component of the service delivery function.

Bearing in mind that there is no such company or franchise structure currently available in this sector at the moment, the concept would have to be developed. The main objective of any appropriate programme would be the creation of viable WSPs. Identifying suitable beneficiaries of the programme would be part of the programme design and objective setting, more of which is mentioned below.

The Franchisor

There could be many candidates for the role of franchisor. But, starting with an exclusion, the WSA cannot be the franchisor. There is a compelling reason for this. The WSA-to-WSP contract binds the WSP to provide water services to specific levels, quality, etc., and with specific financial obligations. The WSA cannot both be the client, enforcing the contract (and penalising the WSP in the event of non-performance), and the franchisor. Given that the franchisor is responsible for helping the franchisee to meet standards, the franchisor will in many circumstances be at least partly responsible if the franchisee does not meet these standards. How can it, then, in its role of the client, penalise the WSP for non-performance?

Only municipalities are allowed to be WSAs. It is, however, fair to claim that too few municipalities are likely to have the mix of skills, and in particular entrepreneurial skills, that a franchisor must have.

Discussion

In the water legislation there is a clear difference and separation between the roles and functions of the WSA and WSP. This concept of separate roles, initially codified in the Water Services Act, was an important step forward in the industry for many reasons. The WSA is indeed an important role-player, but its role is one of contracting a WSP (which may or may not be a franchisee) to operate a water system in its area, subject to the authority and policies of the WSA. The franchisor could be a co-signatory to the contract or a guarantor of the performance of the franchisee.

The typical WSA will, as time passes, no doubt become more specialised in its Authority role. One probable result of that is that many of the water services provision skills, which may now reside in such organisations, will be downgraded or out-placed to WSP organisations. But to obtain greater leverage from the research and development investments that must be made in creating the franchise documentation and training programmes, these skills must become available in a much wider base of recipients than would be established in one WSA alone.

There is room for competition to be introduced later between franchisors and between franchisees, and further innovations and cost savings would be an eventual outcome. But this would be best achieved within the ambit of the private sector where competition is a way of life, rather than in the public sector where it is not.

Figure 7.2 shows how the franchise alternative does not disturb the present relationship structure. It simply supplements it, adding one more alternative to the array of possible WSPs. (Figure 7.2 is identical to Figure 7.1, but with “franchising” added in red.)

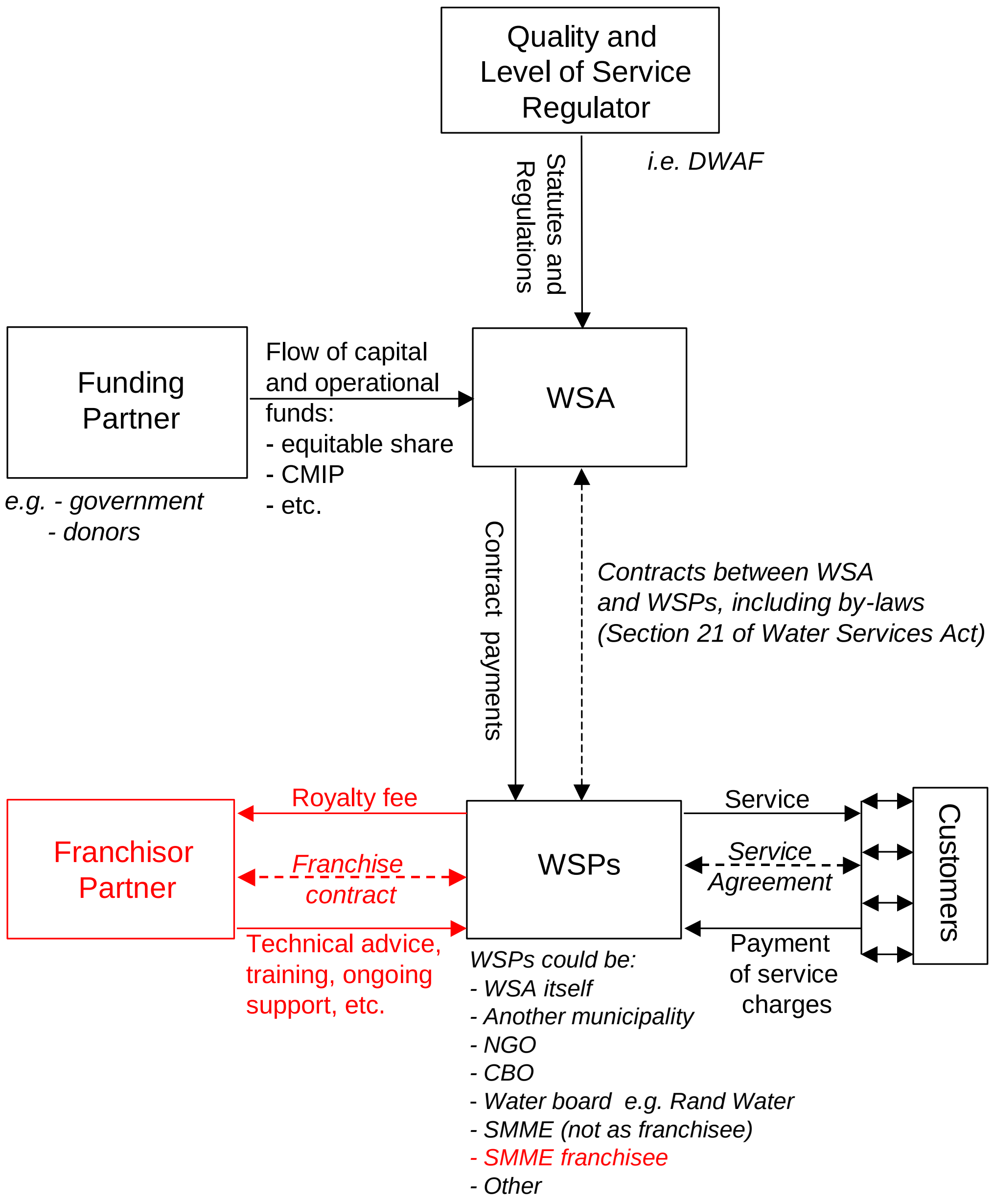


Figure 7.2: Present relationships with franchising alternative added

The franchisor could be any entity that chooses to offer the service and is able (if it desires, by contracting in required skills) to develop a package embracing the relevant business method elements listed at the end of Section 7.1.2.

There could in time be several water services franchisors in South Africa. Whether they would act in concert, or compete, is impossible to predict.

It is also difficult to predict which organisations would see the franchisor opportunity, and take it up.

Other important institutional players

In addition to franchisors per se, or what is provided by franchisors or by groups of them, there would need to be at least four other institutional groupings of skills and/or interest, viz. (the current author is indebted to Davis (pers comm 2003)):

- Industry sponsorship: An industry sponsor may give grants or concessionary loans, and/or give comfort to investors. (Conventional franchising does not have industry sponsors as such. The franchisors played that role in their start-up days, accepting the business risk (and of course some failed).) The sponsor could be a parastatal and /or a commercial sector body with specific interest in the development of the industry. If DWAF establishes a utility parastatal, it could play a role. The Association of Water Utilities could become involved. The commercial component could come from an Association of Pipe Manufacturers, for example. SMME support entities such as Khula may also have a role to play, as they do in the commercial franchise sector.

- Franchise package development: This could be by the franchisor or consultants (legal, management, operations, engineering, accounting, HR, training - in consortium) and/ or an experienced private sector operator. The British multinational water companies offer services similar to this and are less negative to the development concept than are the French multinationals, which tend to see this as giving away their commercial technologies and market advantages.

- Ongoing support and training (these two aspects could be housed separately): A structure is necessary to ensure continuous development and refinement of the product as well as auditing performance in conjunction with the industry sponsor. The CSIR could play a role here.

- Commercial support networks: Within targeted groupings and possibly also in the broader regional and national contexts, linkages with other commercial organisations would be desirable (for example with the relevant Chamber of Commerce).

7.1.5 Financing

Funding would be needed to nurture and grow the concept in its formative years. This funding would come from one or more of DWAF, DBSA, DFID or others, with possible contribution from the Water Research Commission, or the industry sponsor might have the resources.

DWAF would surely realise that financial support in the formative years (if not later as well) is money well spent. At the risk of labouring a point: choices are between alternatives, and the current study has sought to show that, although franchising may need sponsorship,

- in circumstances where the WSA cannot find an able WSP of another type, or enough WSPs to cover its area (a situation that it is expected will occur frequently), a franchise arrangement may be the best alternative or even the only option;
- in appropriate circumstances it will provide not just a more effective service, but also a more cost-effective service; and/or
- beneficial spin-offs include LED, SMME development and BEE.

DWAF has very strong motivation to play the role of the funding partner where such a partner is necessary. It is the only party that has the financial resources to make the financial contribution on a national scale that would ultimately be necessary. And it should perceive, and surely will perceive:

- that it is in its own interest that water services be provided, that it has the ultimate responsibility for water services to be provided, and/or that there are sufficiently compelling consequences that it will then have to deal with anyway should water services not be provided to all South Africans by some or other means; and
- that going the franchise route has in a significant number of circumstances at least as good as or maybe even a better chance of providing water services than has any other means.

Franchising would during this nurturing phase, and afterwards, of course benefit from the same funding streams (e.g. equitable share, CMIP) to the WSA as would any other type of WSP. It is not foreseen that the allocation of funds will in any way change compared to that for current institutional models.

To clarify in respect of the capital funding: Capital investment must be considered appropriately in the context of water services franchising, and not in the context of any other kind of franchising. The capital investment to deliver water services has its closest equivalent in commercial franchising in the building of the “KFC shop”, however, with the essential difference that the capital investment in the water services franchisors could well be much larger compared to annual turnover than in any fast food analogy. In network utilities generally, there are other dynamics relating to infrastructure investments that cannot be discussed here fully. In water services franchising, the business premises, office equipment and field equipment of the franchisee would be the significant investment to be made by the franchisor and franchisee, not the pipe networks. That they would have to invest in pipe networks would be a major barrier that no emergent entrepreneur would be able to scale.

Furthermore, in water services there is in South Africa significant socio-political controversy relating to the ownership of the assets that is best avoided by commercial interests at this stage. And, on a more pragmatic level, because of the capital intensity of pipe networks etc., the tendency for governments to subsidize investments and tariffs, as well as the context of water as a social rather than an economic good, there is very little possibility of obtaining returns on investment that could satisfy commercial loans.

In disaggregating the value chain to select an appropriate component of the service to deliver through a franchise structure, it is essential to eliminate capital investment in infrastructure from all of the options available for review and systematisation. Capital investment must remain the responsibility of government or, in specific circumstances only, of major private sector organisations.

7.1.6 Wrapping up Section 7.1

There are at least two possible variations to the Figure 7.2 concept. These could apply separately or together:

– that a franchisor contracts not to a WSP, but contracts to a WSA to provide elements of franchisor support to WSPs; and
– that a franchise is not in respect of an entire WSP service, but is of an aspect only, e.g. maintenance or billing.

It is at various points in the current report stated, or at least implied, that it is concerned only with water services, to towns and multi-village situations, and with delivery only other than by the public sector or the "big" private sector. Having notionally excluded the public sector in this way, the possibility must be admitted that one public sector institution could perform a role that is in many ways that of franchisor, and another public sector institution could perform a role that is in many ways of franchisee or either one of these could be private sector, NGO, CBO or of another form, or the franchisor could be "big" private sector. Indeed, the possibility should not just be "admitted", it should be welcomed. Many of the same principles apply, except that the public sector might not be as much concerned with the financial viability of the business aspects. Whether this is still "franchising", or not, is an important point that is returned to in Section 7.4.

At the end of the day, absolutely essential to the success in practice of water services franchising are, inter alia:

- that service to customers meets the specification in the franchise contract with the WSA;
- that suitable potential franchisors are willing and available;
- that local entrepreneurs are willing to take up water services franchise opportunities; and
- that franchising proves to be a viable business for franchisor and franchisee alike.

It is not inconceivable that a locally based organisation could offer a lower-cost yet more rapidly responding service than could a larger WSP that has to service dispersed locations from a central depot, and its employees incur substantial travel cost and travel time in order to respond to service calls. Given the huge geographic areas that many municipalities cover, this could be a distinct cost advantage to the locally based franchisee, and the customers would receive better service.

Finally, DWAF provided a useful summary of the statutory obligations to which franchising arrangements must conform. (DWAF 2002c, Annexure 2 of "Annexure A: Terms of reference"), referring very briefly to:

- tariff determination;
- bylaws;
- compulsory national standards;
- model contracts between WSA and WSP; and
- sanitation and health issues.

The same Annexure stated that the franchising concept "is considered to fit reasonably well within the framework of the Water Services Act although the Act does not specifically anticipate such water service provision arrangements."

7.2 Support Services Agents

The arrangement in the water and sanitation services sector in South Africa that is in its own way closest to franchising is that in which a WSA appoints a Support Services Agent (SSA) to support smaller locally based WSPs. With the fundamental difference that the SSA is generally a "not-for-profit" organisation, and that the WSPs supported are also generally "not-for-profit" organisations, such as CBOs.

An example is where the Alfred Nzo District Municipality, a WSA in the Eastern Cape, has opted for a process of developing community-based WSPs, supported by SSAs, one of which is the Mvula Trust. (Mvula 1999, Mvula 2001, Mvula 2002a, Mvula 2002b and Vapi 2002 provide a mine of information on the workings of SSAs.)

In terms of the Water Services Act, a WSA is expected to provide basic water services to communities within its jurisdiction and to ensure that such potable water supplies are functional and maintained. The Alfred Nzo District Municipality, as expected, assumed its role as a WSA and sought potential WSPs. Most of the municipality's area is rural; water schemes have in the past been managed and maintained by community-based project steering committees, which had neither adequate experience nor capacity to efficiently run these schemes. However, the municipality had no choice but to appoint CBOs as WSPs in most of its area, as no other alternatives presented themselves. (Which is not to imply that the municipality did not see some benefits in working with and building community organisations in this way.) In an effort to ensure proper service delivery, the municipality appointed the Mvula Trust as a SSA to equip community-based WSPs with skills and capacity to manage and maintain the water services schemes effectively and efficiently.

The Water Services Act does not in its institutional arrangements for water services delivery specifically make reference to SSAs. “However there is growing realization within the sector about the importance of setting up SSA arrangements in rural settings.” (Vapi 2002, page 5) It is acknowledged that considerable amounts of support are required to develop and build the capacity of CBOs to efficiently and effectively perform the WSP role. The thinking is that a municipality or an appointed agency can perform a SSA function, providing continued specialist support relating to major breakdowns, policy and systems development, as well as an initial mentoring role. “A study conducted by DWAF identified an urgent need” for SSAs to be appointed by WSAs that lacked the capacity to supervise and support all their contracted WSPs. "DWAF has also gone further to develop guidelines for WSAs to use when appointing SSAs to provide support services to CBO WSPs. These guidelines identify functions which can be executed by the SSA when providing support to the CBO WSPs." (Ibid page 5)

According to these DWAF guidelines, the roles of the SSA can include:

- major maintenance;
- operations mentoring;
- financial management support services;
- institutional and social development mentoring;
- procurement of goods and services (including bulk purchasing);
- health and hygiene promotion;
- pit emptying for VIP latrines;
- monitoring the CBO WSP;
- development of a support services implementation plan and support services budget for each CBO WSP;
- preparation of a support services annual comprehensive budget which reflects the total annual budget for all CBO WSPs services costs;
- provision of training and capacity building to CBO WSPs to ensure that they have the required capacity to fulfil their WSP functions: including the establishment of efficient administrative, financial and human resources systems, etc.;
- development of an asset register and operations manual for each CBO WSP; and
- development of an annual support services implementation plan for each CBO WSP.

To comment: This list is in principle very little distinguishable from many lists of the roles of franchisors. (Compare for example with the lists in Section 3.3.6 and 7.1.2 above.) In the WSA case described here, however, the SSA and all the WSPs are non-profit organisations.

(A major incentive to meet contracted performance standards, or to improve upon those, is therefore absent; however, the municipality's objective to build CBOs as WSPs has prevailed.) If both parties were for-profit organisations, then the SSA would to all intents and purposes be a franchisor.

With one further essential difference, however: that in the case described here, the WSA has contracted Mvula Trust to be the SSA, but also to be a type of " super-WSP", with CBOs contracted to it to perform a local WSP role. This is a device to get around the requirement of Section 78 of the Municipal Systems Act that lays down procurement procedure, including that tenders be called for. Following this procedure would severely complicate if not prevent the WSA in achieving its objective of empowering CBOs to perform the WSP role. (Rall pers comm 2003)

Were it not for this arrangement, there would no doubt be a contract between the WSA and the Mvula Trust to perform the SSA functions, and another set of contracts between the WSA and the CBO WSPs. In this situation, viz. of the WSA contracting with both WSPs and SSAs, in the event of non-performance the WSA would in theory have recourse to both of these. Confusion might reign as to where the greater fault lies and therefore as to which of the two should be penalised. However, an attitude on the part of the WSA that tried to penalise the WSP would be inappropriate, given that the WSP is a CBO, and the WSA is trying to be as supportive as possible of the CBO, even if service might suffer.

SSAs are not by any means all NGOs. Alfred Nzo divided its area into thirds, one of which was allocated to Mvula, but one of which was allocated to a private sector company (known as the "WASH consortium", led by Water and Sanitation Services South Africa (Pty) Ltd). The Chris Hani District Municipality has done the same. Again, one has been allocated to Mvula, and another to a private company, this time Amanz' abantu. (Rall pers comm. 2003)

7.3 Parties interested in the franchisor role

7.3.1 Sample of two

The crucial role of the franchisor is emphasised repeatedly in this report. Without the interest of organisations competent to play the role of franchisors, there can be no further thought of franchising. (For example, quoting FRAIN from Section 3.5.4 above: "The franchise network cannot exist without the ongoing management and support from the franchisor.")

For this report it is sufficient to show that there are at least two competent and substantial organisations that are interested.

Thus, key officials were interviewed in two "big" water services sector organisations that without doubt have the expertise and resources to play this role. The first of these is a private sector company, the second is a water board. Both expressed interest in playing a franchisor role.

7.3.2 Amanz' abantu

Amanz' abantu Services (Pty) Ltd is a private company whose shareholders include both well established and emerging companies. Amanz' abantu has extensive experience in partnering with NGOs. It has since 1996 been a Programme Implementation Agent for the Build-Operate-Train-Transfer programme of DWAF in the Eastern Cape, and more recently has been implementing DWAF and local government sanitation projects in that province.

Ive stated that one of the responsibilities intrinsic to the role of the Project Implementation Agent when implementing community-based operations and maintenance activities is in practice no different to that of a franchisor, except for the fundamental differences that the agreement period is much shorter than would be normal for a franchise agreement, and the "franchisee" is not a SMME but an individual or group of individuals (usually in, or shortly to be in, the employ of the municipality). That is, the Agent trains local people to operate the water services infrastructure that it has built, and for a number of years continues to support them and to check on and guarantee the quality of the work they deliver. (Ive pers comm 2003)

Based on the company's experience in this role since 1997, Ive has advocated "tri-sector partnerships", that is, between local government, NGO/civil society, and the private sector, for municipal services provision. The private sector brings financial and manpower resources, but also "competitive approach, risk management, technical knowledge, management and flexibility". (Ive 2002; University of the Witwatersrand 2000)

While the range of possibilities under the banner of this form of partnership is very wide, some of the characteristics of a franchise arrangement are approached, although the word "franchise" does not appear in the two publications referred to by Ive. For example, in that the private sector could in terms of the partnership agreement (which could have many characteristics in common with a franchise contract) provide typical franchisor skills such as business planning and quality control, and in that the three partners share responsibility for delivery. There is no question of this being the usual "client-contractor" relationship. (Ibid)

Ive indicated preference for for-profit local WSPs, and, on the grounds that they have no incentive higher than to provide basic quality of service, did not favour that CBOs acted as WSPs. A committee both representing consumers and running the service will, he stated, have no incentive to do more than will keep it out of trouble. For his part, "I want the guys who <u>want</u> that job", and whose jobs are on the line and who want to build a career in water services franchising. There still needs to be a committee representing consumers, but he felt that there was a conflict of interest when that same committee also delivered the water services on behalf of the local municipality.

Franchising, Ive pointed out, brings critical mass, which holds advantages such as the participants in the franchise being able to complement each other's skills, and to bulk buying.

7.3.3 Rand Water

As noted earlier, the long-established water board, Rand Water, has for some time had an interest in getting involved in franchising of water services. It is the opinion of their Retail Manager that there is much scope for this. (Duvel pers comm. 2003)

Rand Water is involved in working with a wide range of towns, mostly in Gauteng, the Free State and Mpumalanga. What it is doing covers a very wide range. At the one extreme, in Odi and Harrismith, Rand Water "runs everything". In respect of others, Rand Water commitment is only to give them (i.e. the municipalities) "pointers to assisting themselves". Range in between includes:

- running waste water treatment works for the municipality;
- billing and revenue collection for the municipality; and
- preparing a business plan for the municipality.

The major difference between some of these activities and franchising, is that the current commitment is specific and short term, and the "franchisee" is not a SMME but a municipality.

Duvel saw scope for Rand Water to play a franchisor role in respect of WSPs, or even WSAs for that matter, to which it is the bulk supplier of water. These could choose to perform the role of franchisee, to the franchisor of Rand Water, in respect of the full range of their responsibilities, or in respect only of some of these, for example, billing. For another example, a WSA might feel that it has capacity to be its own WSP in respect of only part of its geographical area of responsibility. It might prefer to appoint a third party as franchisee, with Rand Water being the franchisor.

7.4 Can and/or must water services franchising in South Africa be a for-profit activity?

There appear in some of the institutional arrangements for water services delivery in South Africa (and elsewhere) described in this current report to be only a few differences (albeit very important differences, such as the absence of the profit motive) between their business methods and those of what is generally regarded as "franchising". The most relevant (to water services) business method elements of franchising are listed towards the end of Section 7.1.2.

These actual circumstances could come closer to franchising if the following, among others, applied:

- separation of the "representing of consumers" function from the function of "delivering a service" (as there is for example (admittedly not entirely to the satisfaction of Johannesburg Water) between Johannesburg Water and Johannesburg Municipality); and
- more rigorous incentives for cost effectiveness.

On the other hand, what precisely is franchising? Apart from that it has to exhibit the business method elements of franchising of Section 7.1.2, the franchise (in the strict definition of "franchise") would have to have a SMME or its owner as the franchisee, and a private sector company as the franchisor. Also, the franchisor would have to fit the description noted in Section 3.3.2, to recall, that "a franchisor is an entrepreneur who has:

1. Established a business in a clearly defined and growing market.
2. Developed some unique product features or methods of delivery.
3. Fine-tuned the systems and procedures necessary to facilitate ongoing customer satisfaction as well as the profitability of the business.
4. Created a brand that enjoys some level of recognition and is well respected by suppliers and customers alike."

The business method elements noted in Section 7.1.2 are derived from a process such as that named immediately above as factor 3. ("fine-tuned the systems ….."), to which process water services delivery is readily amenable. With respect to the second factor, yes, product features or methods of delivery are sufficiently unique. With respect to the first factor, yes, it can be argued that water services delivery is clearly defined, and the "market" for its sustained delivery is growing. However it is questionable whether water supplied through a tap, or sanitation, can be branded (despite the best efforts of Rand Water and others).

So, although this study has already concluded that "franchisee" must be added to any list of WSP types, there is still scope for discussion as to what precisely is meant by franchising.

And it could with much justification be argued that restricting franchisor and franchisee to for-profit (profit-seeking) entrepreneurs is unnecessarily limiting in view of the great need for innovations aimed at improving access of the poor in South Africa to basic water services, and sustaining that improvement. Thus, the argument would continue, if it is insisted that by "franchising" is meant only what is described above as the strict definition, answering the question: "is franchising a feasible method for water services delivery in South Africa?" is of academic interest only.

To proceed further, it is necessary to break up the question, and to create from it two separate questions. As follows:

First question: "Is profit-seeking franchising in principle a feasible method for water services delivery in South Africa?" (By "in principle" is meant that there is no barrier to it being considered in specific circumstances, but it does not have to be considered in all circumstances.)

The conclusion of the current author is that, although the prospects for profit-seeking franchising look promising, the jury is still out. It all comes down to if profits can be made and if willing and competent entrepreneurs can be found, which is not yet known.

Second question: "Can a coherent package of the aspects of franchising (the package to include at least the business methods, but also the "clearly defined and growing market" and "unique product features or methods of delivery") be adopted by others, not profit-seeking entities, and be a feasible method for water services delivery in South Africa?"

The conclusion of the current author is that the answer is in the affirmative.

Factor 4., viz. "a brand that enjoys some level of recognition and is well respected by suppliers and customers alike", is left out of the second question. This issue requires further investigation, in particular:

- on the face of the recognition by almost all communities that "water is life" (to quote the DWAF slogan), and that they feel they must have it, it would seem that water enjoys some brand status;
- however, sanitation has undoubtedly a long way to catch up on water. Witness that it is still so often reported that the need for basic sanitation isn't perceived by many South Africans.

For-profits or not-for-profits, current water services funding streams to WSAs, must continue to flow. It cannot be expected that any entity wishing to supply this essential service should be compelled to supply it at less than cost, or even for free, without subsidies as currently provided for by national policies.

It is not unreasonable to allow the principle that entrepreneurs can be contracted to supply water services, and take the profits that their contracts permit. There should be no ideological barrier to this and given that there are currently not enough WSPs in South Africa, entrepreneurs should be offered the opportunity, to see if they can assist.

To counter any fears of excessive profit taking, it can be pointed out that:

- the prospect of profits will attract competition, which should, however imperfectly, counter excesses; and

– tariffs could be regulated by the WSA.

Finally, it must again be noted that the case for franchising does not depend on the case for or against the participation of for-profit organisations.

7.5 The DWAF/DFID water services franchising initiative

7.5.1 The proposal call

The original idea for the study that was later named "Local economic development through water services provision franchising" was reportedly put to DWAF by DFID Southern Africa, within the scope of the UK government's "Partners for water and sanitation" initiative. (Blakelock pers comm 2003) DFID undertook to provide the necessary funding.

Early in 2002 a request for proposals for a very ambitious project was issued by DWAF.
The objective was defined as:

– "to identify and evaluate the critical success factors, risks, incentive arrangements, participants and institutional structures required for the successful franchising of water and sanitation services on a <u>small</u> scale [the emphasis is in the original];
– to test these findings in an appropriate pilot project;
– to develop rules on how main role players can work together in achieving the overall objective of sustainable water and sanitation; and
– packaging the business concept and developing suitable management and administrative systems to enable its application on a wider basis." (DWAF 2002c, "Annexure A: "Terms of reference", page 3)

The pilot area chosen was the Albert Luthuli Municipality, in Mpumalanga, the municipality being a WSA. (For information: This municipality includes the towns of Carolina and Badplaas.)

Two phases were identified. Continuation to the second phase would be dependent on the successful completion of the first phase.

Briefly, the scope of Phase 1 consisted of:

- Conduct a desk study to collect information on existing franchise-type arrangements for water, sanitation and other utilities especially those operating in Southern Africa. Addressing, inter alia, economic and financial issues, selection and training of franchisees, design of contracts, role-players and their responsibilities, role of small business and legislative requirements. Undertaking a "detailed" appraisal of "relevant selected franchise projects". Also investigating the concept and application of franchising generally, and the applicability of the concept in South Africa in the water services sector in low-income rural and peri-urban areas.

- Develop criteria for the selection of a pilot area, and select the pilot area within the Albert Luthuli Municipality, undertake a detailed appraisal of the pilot area, and develop an appropriate specific franchise concept for the pilot area.

- Prepare a project report and pilot project implementation plan.

Briefly, the scope of Phase 2 consisted of:

- Advertise for and select a franchisee, and implement the pilot project, including providing training and support to the franchisee.

- Provide ongoing mentorship and support to the WSA and franchisee, monitor and evaluate the process and extract lessons, write a user-friendly guideline document of the process to be followed for successful franchising of water services provision, and prepare a final project report. (Ibid pages 3 through 5)

The timeframe allowed five months for the first phase and 13 months for the second. (Ibid page 6)

Proposals were only considered from partnerships between a franchise consultant ("preferably registered with" FASA) and an emerging consultant with prior experience in the water sector and based in Mpumalanga.

Three tenders were received. In May 2002, one was recommended by the appropriate DWAF committee, and the tenderer was advised accordingly. The contract price would have been R331 000 for the first phase only. However no contract was signed.

7.5.2 Comment

The contract price quoted above for the first phase would have been a bargain for DWAF if the contract had gone ahead and performance had been satisfactory. Especially as the area chosen is by all accounts not the simplest in which to try a new services provision concept.

7.5.3 Subsequent events

Opinions conflict to some extent as to why the project did not proceed. Certainly, a major contribution was made by the changes in the management structure and personnel of both DWAF and of DFID that occurred in 2002 and 2003.

Late in 2003 a meeting was held between the DWAF staff newly assigned to water services sector institutional development, and representatives of both NAMAC and Boutek CSIR. It was discovered that, in order to resurrect the project, DWAF will have to resubmit the project to DFID, identify a project to pilot (which might or might not be in the area previously chosen), and consider using its own funds for piloting.

The three organisations agreed to work together to develop a presentation on the project to resubmit the proposal to whomever necessary. It was also agreed that the Albert Luthuli area must be re-evaluated to ensure that it is indeed a viable area for piloting. The onus was left on DWAF to convene the necessary meetings.

Nothing further had by the time of writing (February 2004) eventuated.

7.6 Chapter conclusions

The need for alternative water services provider systems, and for LED, is indisputable. Through water services franchising there is potential to simultaneously:

- deliver water services, and
- promote LED, SMME development and BEE.

Thus the central recommendation of this current study was that "franchisee" must be added to the list of possible WSP types.

Some points:

- the WSA cannot be the franchisor;
- the franchise alternative does not disturb the present relationship structure between DWAF, WSA, and the funding partner(s). It supplements it, adding one more alternative to the array of possible WSPs; and
- groupings of skills and/or interest are required, only some of which might be provided by franchisors.

At the end of the day, absolutely essential to the success in practice of water services franchising are, inter alia:

- that service to customers meets the specification in the franchise contract with the WSA;
- that suitable potential franchisors are willing and available;
- that local entrepreneurs are willing to take up water services franchise opportunities;
- that the funding partners support water services franchising in just the same way as they support water services provision in comparable circumstances by any other institutional means; and
- that franchising proves to be a viable business for franchisor and franchisee alike.

There are currently some activities in the water services sector in South Africa that have parallels with franchising, but with differences, the most important of which is that the participants are generally not for-profits.

Some organisations have expressed interest in playing a franchisor role. Two, viz. Amanz' abantu and Rand Water, without doubt have the expertise and resources to play this role.

It is not unreasonable to allow the principle that entrepreneurs can be contracted to supply water services, and take the profits that their contracts permit. There should be no ideological barrier to this and given that there are currently not enough WSPs in South Africa, entrepreneurs should be offered the opportunity, to see if they can assist. However, the case for franchising does not depend on the case for or against the participation of for-profit organisations.

But a caution: No programme for implementing a water services franchise concept will be successful if it flies in the face of experience and logic. No programme will succeed without a holistic view, a strategic planning process, an analysis of market opportunities and obstacles, an approach that is long term developmental and progressive, and the creation of support structures (including documentation and procedures and the like).

In conclusion:

- the potential of water services franchising in South Africa is clearly demonstrated; and
- the circumstances are now most appropriate for a more in-depth investigation of water services franchising to be commenced than has been accomplished by the current study.

DWAF in 2002 issued a proposal call for study into water services franchising, to be followed by a pilot implementation. The project had a funding commitment from DFID. One tenderer was recommended. However, no contract was signed, and it would appear that DWAF has put the concept on ice. The DWAF initiative needs to be revived, but not necessarily in its previous form.

8. Conclusions and recommendations

8.1 Franchising of water services in South Africa: the case summarised

The capacity of many municipalities in South Africa to adequately and continuously provide even basic levels of water services to all their citizens is in question. An area of specific concern is in the context of long-term sustained operation and sound maintenance of the water services engineering infrastructure. There is a realisation that, in order to supplement current approaches, alternative concepts for services delivery (of all services, not just water services) need to be identified and investigated.

Chapters 2 through 7 sought to investigate if there is a case for exploring the use of franchising as an alternative water services delivery concept in South Africa.

It can now be stated that the answer is, yes, very definitely, there <u>is</u> a case for further investigation of this concept.

Chapter 2 concludes that there is a strong "push factor" motivating the need to investigate water services delivery institutional concepts as alternatives to those currently in use.

Chapters 3 and 5 respectively provide background on the principles and characteristics of delivery of goods and services by franchise, and describe the franchising industry in South Africa. Characteristics of franchising, the process, success and failure factors, and the extent to which franchising can achieve its delivery objectives without seeking a profit, are all explored, as is the very creditable track record of franchising in creating net jobs and in SMME development.

Chapter 4 concludes, from a survey of overseas literature (admitting that the topic is a very new one, and implementation even at a pilot scale is yet to take place) that water services franchising shows great promise. Especially this is so in respect of water services to towns and to multi-village schemes. However, franchising would by no means be free of many of the issues that equally affect other alternatives, in particular the financial self-sustainability (or not) of the system.

Chapter 4 also recommends that a South African research programme must commence by learning from the performance of other water services institutional arrangements, as overseas research programmes have. Experience must also be derived from franchising experience in business sectors other than water services. Subsequently, implementation should proceed at pilot scale as field experiments, and subject to structured research methodology. Furthermore, initial piloting must be done only in the easiest of circumstances, where there is the greatest chance of success. If piloting is attempted in a problematic area, and if the pilot is not completely successful, not enough would have been learned from the pilot implementation to draw any worthwhile conclusions.

Chapter 6 concludes that there is a strong "pull factor", viz. the need for local economic development, and in particular the need for the creation and nurturing of SMMEs, that strongly supports the need to investigate franchising in South Africa as a water services delivery concept in addition to, and probably complementary to, the current models. Resources allocated to a programme for the franchising of water services would be well spent in terms of achieving sustainable jobs and entrepreneurs, not to mention the water services delivery that would ensue. The chapter also states that many useful pointers for the water services franchisee development programme that will be needed are to be found not only in business format franchising franchisee development programmes in other sectors, but also in engineering infrastructure contractor development programmes that already have a track record in South Africa.

Chapter 7 concludes that the great need for alternative water services provider systems, and for LED, is indisputable, and that through water services franchising there is potential to simultaneously:

- deliver water services, and
- promote LED, SMME development and BEE.

Thus "franchisee" must be added to the list of possible WSP types in South African water services delivery practice.

Chapter 7 also states that it is essential to the success of water services franchising, inter alia:

- that service to customers meets the specification in the franchise contract with the WSA;
- that suitable franchisors are willing and available;
- that local entrepreneurs are willing to take up water services franchise opportunities;
- that the funding partners support water services franchising in just the same way as they support in comparable circumstances water services provision by other institutional means; and
- that franchising proves to be a viable business for franchisor and franchisee alike.

Two organisations with the expertise and resources to play a franchisor role have expressed interest, and there is little doubt that others would follow this lead.

The overall conclusion of the current study was thus that:

- the potential of water services franchising in South Africa is clearly demonstrated; and
- the circumstances are now most appropriate for a more in-depth investigation of water services franchising to be commenced than has been accomplished by the current study.

8.2 The way forward

A more in-depth investigation of water services franchising should include all of the following, where applicable, in much greater depth than was covered in this report:

- background research of the literature, and of the environment;
- investigation of support structure for appropriate SMME and BEE development;
- definition of franchise structure in the water services context in South Africa;
- analysis of some selected delivery value chains for simple, replicable systems;
- definition and development of business and operations model(s);
- outline development of draft systems manuals;
- mobilisation of interested and appropriate funding and research organisations;
- mobilisation of interested and appropriate potential implementing agents; and
- preparation for pilot implementation of the concept.

Inter alia, consultation would be extended to include franchise specialists, established franchisees and franchisors in other service fields, small business development specialists, and local government and professional bodies such as SALGA, IMESA and IMFO.

In respect of “preparation for pilot implementation", the work that would be undertaken would be to draw up criteria and a work plan for, and to undertake:

- clarifying objectives and expectations of a pilot study;
- establishing the research method and measurement parameters;
- designing the franchisee support structures and research structure;
- determining criteria for selection of pilot areas;
- designing criteria for selection of franchisees;
- identifying possible pilot areas;
- choosing the pilot area; and
- designing the pilot project.

Care needs to be taken to select a pilot area that, while it needs the water services, at the same time appears to provide the circumstances most favourable to the success of the concept.

The pilot implementation of the concept in some suitable towns or regions could then be undertaken.

8.3 Reiteration of the main outputs and outcomes of a framework development process in its full realisation and beyond

The main <u>outputs</u> of a process to develop a framework for franchising in the water services sector in South Africa would be:

– a definition of a franchise structure (and, hopefully, preliminary identification of industry sponsors and other potential funders for the formative years and maybe later as well, franchise package developers, institution(s) responsible for ongoing support/training and auditing performance, and other key role-players);
– business and operations model(s);
– draft systems manuals; and
– a pilot scheme under way.

The longer term <u>outcome</u>, when the service delivery system is widely introduced, will be that in a significant number of locations in South Africa there will be water services delivery where there has not been before. In addition:

– for DWAF and local government, an alternative delivery concept will be available;
– employment opportunities will be created; and
– for potential entrepreneurs, and for BEE, a new business opportunity will be made accessible and viable.

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