Water services franchising partnerships: Overview of the concept of franchising and its relevance to water services

Kevin Wall & Oliver Ive

Report to the

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by

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Water Research Commission
Private Bag X03
Gezina, 0031
South Africa

orders@wrc.org.za

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This report forms part of a series of seven reports. The reports in the series are:

- Going with the franchise flow: An exploration of franchising partnerships for the operation and maintenance of water services infrastructure. **(Report TT 432/1/10)**
- Water services franchising partnerships: Overview of the concept of franchising and its relevance to water services. **(Report TT 432/2/10)**
- Water services franchising partnerships: Review of policy, regulation and legal aspects. **(Report TT 432/3/10)**
- Water services franchising partnerships: Modelling of selected water services operational elements. **(Report TT 432/4/10)**
- Water services franchising partnerships: Institutional review for the application of franchising. **(Report TT 432/5/10)**
- Water services franchising partnerships: Establishing criteria for the selection of water service franchisors, partnerships and franchisees. **(Report TT 432/6/10)**
- Water services franchising partnerships: Business analysis case study: schools sanitation O&M. **(Report TT 432/7/10)**

Report TT 432/1/10 (*Going with the franchise flow: An exploration of franchising partnerships for the operation and maintenance of water services infrastructure*) is the only one in the series that has been printed. The rest are available on the WRC web site (www.wrc.org.za) from where they can be downloaded.

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Executive summary

Background to the project

The rapid rate of construction and commissioning of new water services infrastructure is severely challenging the institutions responsible for operating and managing this infrastructure. Innovative approaches to water service delivery are required. But even if all the existing institutions were coping with the water services delivery responsibility, there would be good reason to investigate alternative institutional models on the grounds that it needs to be found out if alternatives:

- could be more cost-effective; and/or
- could allow existing role-players to focus on their other responsibilities; and/or
- could offer a range of other advantages (including greater local economic development).

There is an alternative service delivery institutional model that is suited more for the ongoing operation and maintenance of water services systems than for investment in new infrastructure, and that is, importantly, friendly to small business and local economic development. This alternative is the franchising of water services. However, there is little experience of this approach anywhere in the world, and no experience in South Africa, although some existing partnerships have some of the characteristics of the franchise partnerships approach.

The barriers to entry for the smaller or start-up company are substantial. But if these could be overcome – and franchising is a way to mitigate them – then there will be many opportunities for improved water services and for local economic development. The twin driving forces of the franchising concept are the existence of a successful business model that can be copied widely (there are currently no such models for the water sector) and the profit motive.

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 key is the incentive, to water services authority, franchisor and franchisee alike, to improve efficiency – and to provide improved service reliability and quality.

To investigate this, the Water Research Commission (WRC) initiated a study (completed in 2005) that explored the concept of franchising, its relevance to the water services sector, and its prospects as an institutional option for water services operations and management. The study found that the franchising concept, if applied to water services delivery, could in favourable circumstances both alleviate problems encountered in and raise the efficiency of water services delivery. At the same time, franchising would have the added advantage of stimulating small business activities. (Wall, 2005a)

The study described at a conceptual level how a water services franchise model could be made available to emerging entrepreneurs, and concluded that this could be the basis of a viable business. The franchise would be in respect of a component of the value chain that is suitable for small business because it can be readily systematised.

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

- more consistently deliver water services to specification;
- improve water services efficiency; and
- promote local economic development, small-, medium- and micro-enterprise (SMME) development and Black economic empowerment (BEE).

Objectives of the project

The objectives of the project were:

- To further explore the concept of franchising partnerships and its relevance to the water services delivery chain.
- To identify and determine those elements in the water services delivery chain which offer the greatest scope for franchising partnerships.
- To review the legal, technical, financial and regulatory aspects which impact on the concept of franchising.
- To develop franchising models for a selection of the areas identified by the research, with consideration for the legal, technical, financial and regulatory aspects.
- To conduct a case study of an element in a hypothetical situation, to see how the model will work.
- To set out the way forward to eventual pilot implementation of franchising partnerships, and inter alia recommend areas for further research.

In summary, the ultimate objective of the project was to identify the scope for franchising partnerships for the operation and maintenance of selected water services infrastructure, to establish the viability of franchising partnerships, and to make a case for outsourcing to franchises to be considered by water services authorities (WSAs) and water services providers (WSPs).

The context in all instances is South Africa.

Focus of this report

This report summarises the findings (referred to above) of the earlier WRC study.

Thereafter it:

- surveys water services provision that has like-franchising elements;
- discusses the relevance of franchising to water services delivery, and discusses the size of the potential market;
- reviews the existing service delivery mechanisms;
- reviews the funding streams;
- draws conclusions; and
- makes recommendations.

Each of these is summarised below.

Like-franchising survey

Several water sector-like franchises (and one franchise) and other forms of PPP are described in this report, outlining (at minimum) the circumstances under which they were established and are operating, the SMME (or franchise SMME) and the supporting institution (or franchisor), and the success or otherwise.

There are not many instances of franchising or like-franchising in the water sector, and their nature, circumstances and achievements are so varied, that it is not possible to draw conclusions other than:

- franchising's suitability for water services operations and maintenance;
- franchising's general unsuitability for capital investment;
- the need to diversify if at all possible; and
- if serving low-income areas, that small enterprises are seldom financially viable, and that they need to be subsidised.

Common to all of the small enterprises surveyed is that their purpose is the operation and/or maintenance of services. There seems to be an understanding that franchising is not suitable for investment in new infrastructure, or it is just regarded as too difficult.

Certainly, the amounts of funding required for investment in new infrastructure, or even just the reconditioning or refurbishing of it, would be beyond the means of all franchisees (SMMEs that they are, and generally at the "very small" and "micro" end (that is, turnover less than R1 million per annum)). Investing in new infrastructure would even be beyond the means of many franchisors. Over and above these concerns, there would be an understandable reluctance on the part of franchisees and franchisors to invest capital in infrastructure given what appears to be an environment of uncertainty as to whether they will be able to recoup the cost of that investment. (Limited capital investment is nonetheless occasionally made.)

Either way, it seems to be justifiable that, in the current climate, potential franchisors and franchisees regard capital investment as an option to be considered only in exceptional circumstances. With respect to the provision of public services infrastructure, franchising is almost invariably regarded as suitable only for the ongoing operation and maintenance of infrastructure.

Furthermore, in order to improve the size and especially the reliability of the revenue stream, it would invariably appear to be prudent for franchisors and franchisees to undertake forms of activity additional to operation and maintenance, for example, construction work, and/or materials supply.

Relevance and potential of franchising

The water services delivery model in common use (i.e. a heavy reliance on WSA's/ municipality's own in-house resources) is not intrinsically flawed. The reason why many of the owners of the water services infrastructure and/or their appointed water services providers are not able to deliver satisfactorily lies in the implementation, rather than in the model. (Evidence that it is not flawed can be seen in the many instances in which water services are being delivered satisfactorily, or more-or-less satisfactorily.)

Essential differences between water services authorities, using the common model, that deliver satisfactorily and those that do not deliver satisfactorily, are analysed in this report under the headings of "budget", "skills" and "incentives".

A franchising partnerships model for water services delivery cannot be expected to address a WSA's budget problems. The franchising concept has however undoubted potential to structure alternatives to current water services delivery institutions. Any measures that led to more reliable and sustainable water services would (for example through reducing wastage of water) result in cost savings to a WSA, thereby improving its financial situation.

Franchising can also assist with the resolution of skills and incentives problems that are encountered by or in many WSAs and WSPs. Franchisee water service providers, dependent for their livelihood on the success of their business, would have a strong incentive to perform, and would also enjoy the benefit of the franchisor's expert guidance and quality assurance. On this latter point, a franchisor can ensure a professional approach, and provide quality control, ongoing training, and well as advice and help when needed.

This help from the franchisor would be of particular value to WSAs away from the major urban centres, few of which can afford to employ sufficiently skilled staff, which shows in the state of their infrastructure. Significant improvements would soon be seen if the generally under-qualified or under-resourced water services staff in these WSAs could have this ongoing support, mentoring and quality control, or if the WSA could contract all or elements of its infrastructure operations and maintenance responsibility, entering into agreements with SMMEs that, through franchising partnerships agreements, enjoy the necessary ongoing support, mentoring and quality control.

Given that the costs of the franchisor's higher levels of specialist expertise are shared by several franchisees, the franchisor could afford to make this expertise available to each franchisee on an as-needed basis, and could provide other resources normally only available to larger water services providers. This holds significant benefits for WSAs.

There are many situations where the principles of franchising would be of great value to improving water services. Franchising appears to be advantageous in respect of some elements of water services delivery infrastructure, and in some circumstances, but not in respect of those same elements in other circumstances. Franchising should therefore be preferred in appropriate situations, but not all situations are appropriate. As just one example: given the huge geographic areas that many municipalities cover, a locally based institution would have a distinct cost advantage over an organisation more centrally based in the municipality, and therefore at a greater physical distance and the customers would receive better service.

A WSA client's competence to monitor performance and enforce contract compliance is key to it effectively using the SMME sector. However, if a client is short of skills, it would be putting these skills to more efficient use in managing the work of the contractor then in trying to cope with the operational issues itself.

Whereas franchisees, being SMMEs, are generally unable to assist with capital investment in infrastructure, a very strong case can be made for capital funding, whether for new infrastructure or for refurbishment or replacement, to be made available by national government.

The environment for emergent business in South Africa is not by any means what it should be, and for this reason alone, being part of a franchise network rather than a standalone business is hugely advantageous to both the SMME and its client.

It is impossible to quantify the potential of water services franchising, but undoubtedly there are many situations where the principles of franchising would be of great value. Franchising should, however, only be preferred in appropriate situations. It is not a panacea for widespread application.

The main obstacles foreseen lie in (i) the apparent reluctance of many WSAs to outsource operations and maintenance, (ii) assurance of funding for the service (i.e. will the franchisee be paid in terms of its contract with the WSA or WSP?), and (iii) whether sufficient numbers of existing or potential local entrepreneurs would perceive that water services franchising partnerships present them with viable business opportunities.

A three-step breakthrough is required. The first step is the breakthrough to acceptance by WSAs of outsourcing the operation and maintenance of infrastructure that they, the WSAs, own. (This outsourcing need not necessarily be to the private sector. It could be to non-governmental organisations (NGOs) or community-based organisations (CBOs) as well.) The second step is the acceptance that the institutions outsourced to could be SMMEs. The third step is the acceptance that these SMMEs could be franchisees. (The third should not be a problem once the second level of acceptance is in place. Franchised SMMEs should be a concept easier to sell to clients of any sort than the idea of SMMEs that are standalone.)

One of the reasons why the franchise concept could achieve significant impact is its potential for opening the water services industry to smaller companies in general and for BEE in particular.

Service delivery mechanisms

The great majority of water services providers are internal delivery mechanisms, namely internal WSA/ municipal departments or business units. Outsourcing parts of the service delivery chain can be complex, because in each case there must be compliance with the requirements of the Municipal Finance Management Act (MFMA) and the Municipal Systems Act (MSA). Where the WSA has already gone through the process of appointing an external WSP, it is much easier for the WSP to outsource certain portions of the service delivery chain than it is for the WSA to do so.

The national Department of Water Affairs and Forestry (DWAF) “Consolidated Guideline for Water Services Authorities” states that management and service contracts are not subject to Section 78 requirements of the MSA, as these contracts deal only with part of the water service. Thus there is nothing in the legislation to prohibit either internal or external WSPs from outsourcing well defined functions, which are not municipal services, but rather subsets thereof.

Nonetheless many factors militate against outsourcing parts of the water services chain. The lack of suitable role models, the inertia of many decades of doing it in-house, that councillors and officials may perceive outsourcing to be reducing their influence, and the resistance from communities who believe that government should provide the services, all contribute to a significant resistance to outsourcing.

In spite of this resistance, outsourcing to SMMEs and franchises provides many advantages which will benefit the WSA, the WSP and the communities.

It appears that in all cases, contracting with small franchisees will be a less risky option to a WSA than employing SMMEs directly. The disadvantage is the need to deal with a three-way relationship between the WSP/WSA, the franchisor and the franchisee, but, with the will, the difficulties can readily be overcome.

Franchising is best suited to only certain activities in the water services supply value chain. In the first instance the franchisees could operate as contractors or sub-contractors to the WSP directly, as community-based water service providers do. Secondly, the franchisees could operate under licence from the WSP or WSA, and contract directly with the consumers, providing services such as plumbing services, or septic tank emptying, or the operation and maintenance of on-site wastewater or water purification systems.

Funding streams

That a WSP, or a contractor to a WSP, is a franchisee rather than any other form of SMME or private sector partner, or a public sector entity, must not disturb institutional, financial and other relationships of the delivery model in common use. For example, in respect of funding, if equitable share is currently used to subsidise the water services to a set of households when the WSP is a municipal WSP, this must not change, and the same subsidy must flow, should the WSP be a SMME.

If improved service delivery results in cost savings to the WSA and/or to improved service, this should improve the financial situation of the WSA. However, in practice this financial improvement is not always realised, and for this or for other reasons the contractually obliged payments to the franchisee whose efforts have improved the service are not made, or are not made on time. Late payment, or non-payment, then threatens the financial viability of the franchisee. This problem is not easily resolved. Possible solutions, such as paying the franchisee directly from financial savings made as a direct result of the improved service, or the presence of a government financial guarantor of last resort, might not be feasible or acceptable. National government would do well to perceive that the franchise option has in a significant number of circumstances at least as good or maybe an even better chance of providing sustainable water services than any other option has. It would therefore be in government’s own best interests to facilitate the participation of franchised water services providers.

Certainty and reliability that they will be paid for their services should be prominent on any checklist of the issues that need to be weighed up by SMMEs (and their bankers and sponsors) when they consider contracting to supply operation and maintenance resources to a municipality in its role as a WSA or even when they consider subcontracting to a third party that is directly contracted to the WSA.

If the funding is promised, will it be budgeted? And if it is budgeted, could that budget be cut? Even if the budget as such remains firm, will the funds be paid? Could the client divert the funds to other purposes? Could payment be subject to delays? What would the consequences of these actions be? Why would these things happen and what can be done about them?

SMMEs offering operation and maintenance services to the public sector would often be dependent on a single client for their existence. If this client fails to pay on time and in full, that could be disastrous for the SMME. One client not paying it for 30 or even 60 or more days would be a nuisance to a large enterprise with a large spread of clients, but a micro enterprise's main or, worse, sole client not paying it for even 15 days could ruin it financially.

Small businesses unable to meet their obligations, because their clients do not pay them or for any other reason, close down, and the entrepreneurs move on. This sounds harsh, but it is reality. Larger businesses lay off workers and downsize.

These are well-known business risks. The corollary is this is also a good reason why the private sector can greatly improve the efficiency of local government, as it offers structural flexibility. If all the services are provided in-house, when the budget is frozen or the revenue stream dries up, the WSA/municipality must continue to pay an unproductive work force, and service quality drops. The flexibility of outsourcing constitutes another strong argument in favour of WSAs/municipalities considering outsourcing, but it threatens the viability of the small enterprises so contracted.

In these circumstances, two generic advantages of franchising in the water services sector (or any other sector, for that matter), and being part of a network as opposed to being standalone and therefore unsupported SMMEs, become very important. These are:

- the leverage that the franchisor can exert on behalf of the franchisees; and
- that the franchisor can, if necessary, step in and perform the duties of the franchisee, should the franchisee fail to perform in terms of its contractual obligations to deliver the water service.

Report conclusions

There is no doubt that water services franchising can in many instances improve water services operation and maintenance, and that it can also be an avenue for local economic development, and SMME and BEE development.

This must, however, be seen in the context of whether water services franchising could or could not become a viable business opportunity in many parts of South Africa. Despite the obvious advantages of franchising partnerships for water services operation and maintenance, problems, such as procurement and an assurance of ongoing funding, need to be overcome. The jury is still out on whether they can be overcome.

It is apparent that, even if franchising of elements of water services is a valid option, most WSAs and WSPs are likely to need a lot of convincing before they would be prepared to seriously contemplate outsourcing these elements. They need to be convinced that not only is outsourcing a valid option, and preferable to current delivery methods, but also that franchising will be simple to undertake and will also be in the interest of the officials and elected representatives responsible for motivating the change, making decisions on the change, and then supervising franchisees' performance.

Authorities may have a variety of reasons for not wishing to allow alternatives to in-house performance of operation and maintenance. Thus it is one thing to say that there might be nothing stopping authorities taking this route. But it must become as easy (or easier) for them to take this route rather than to each time opt for in-house operation and maintenance. Thus, inter alia, the following must at some stage be done:

- draw up model contracts;
- draw up a standard form of analysis of the finances, and draw up financial models;
- do case studies of successes; and
- disseminate all of the above – publicise their existence.

Contracts should by rights be simple, because they are for operations and management, and not for construction.

Note that the case for franchising partnerships does not depend on the participation of only for-profit organisations. Franchisors and franchisees could, with a minimal diversion from a purist definition of franchising, be NGOs – franchisees could be CBOs.

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- WRC, Pretoria: Jay Bhagwan.
- WRP, Pretoria: Ronnie McKenzie.

  and

- all the members of this project's reference group that are not among those listed above.

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Words or passages enclosed by square brackets [ ], within quotations from other texts, are the current researchers' interpolations.

Descriptions in Chapter 3 of actual institutional arrangements, and in Chapters 5 and 6 of service delivery mechanisms and funding streams respectively, are to the best understanding of the researchers up to date to October 2006. Developments (if any) since that time have not been captured.

Throughout the text "the researchers" or "the current researchers" or "the team" refers to the team appointed by WRC to undertake the current project.

Throughout the text "the project" or "the current project" refers to WRC Research Project K5/1610, the "Water Services Franchising Partnerships" project.

Throughout the text "the report" or "the current report" refers to "WRC Report TT 432/2/10: Overview of the concept of franchising and its relevance to water services".

Abbreviations and acronyms

Amanz' abantu	Amanz' abantu Services (Pty) Ltd
ASGISA	Accelerated and Shared Growth Initiative for South Africa
BBE	broad-based empowerment
BEE	Black economic empowerment
Biwater	Biwater UK
BOT	Build-Operate-Transfer
BOTT	Build-Operate-Train-Transfer
Cascal	A jointly owned company between Biwater UK and the Dutch company Nuon
CBO	community-based organisation
CC	close corporation
CEO	Chief Executive Officer
CHDM	Chris Hani District Municipality
CMIP	Consolidated Municipal Infrastructure Programme
CPPP	community public-private partnership
CSIR	Council for Scientific and Industrial Research
CSP	community service providers
DBSA	Development Bank of Southern Africa
DFI	development finance institutions
DFID	Department for International Development (of the UK government)
DM	District Municipality
DPLG	national Department of Provincial and Local Government
DPW	national Department of Public Works
DTI	national Department of Trade and Industry
DWAF	national Department of Water Affairs and Forestry
EIA	environmental impact assessment
EPWP	Expanded Public Works Programme
ERWAT	East Rand Water Care Company
EU	European Union
FASA	Franchise Association of Southern Africa
FNB	First National Bank
FRAIN	Franchise and Advice and Information Network (of NAMAC)
GDP	gross domestic product
GIAMA	Government Immovable Asset Management Bill
GNUC	Greater Nelspruit Utility Company
ICT	information and communication technology
IDC	Industrial Development Corporation
IMESA	Institution of Municipal Engineering of Southern Africa
JOWAM	joint venture between Suez, Northumbrian Water and WSSA
JSE	Johannesburg Stock Exchange
KFC	Kentucky Fried Chicken – a fast food franchise
KPA	key performance areas
KPI	key performance indicators
LED	local economic development
LGSETA	Local Government Sector Education and Training Authority
LM	Local Municipality
Map Water	Maluti-a-Phofung Water (Pty) Ltd
MCO	microcredit outlets
MFMA	Municipal Finance Management Act
MIIU	Municipal Infrastructure Investment Unit
MM	Metropolitan Municipality
MSA	Municipal Systems Act

MSP	municipal services partnership
NGO	non-governmental organisation
NQF	National Qualifications Framework
PAC	Project Application Category
PDI	previously disadvantaged individual
PFMA	Public Finance Management Act
PIA	Project Implementation Agent
PPP	public-private partnership or public-public partnership
PWMSA	Professional Water Management South Africa
ROMP	Refurbish, Operate and Maintain Programme
SA	South Africa
SAB	South African Breweries
SABS	South African Bureau of Standards
SAICE	South African Institution of Civil Engineering
SALGA	South African Local Government Association
SAMWU	South African Municipal Workers Union
SARS	South African Revenue Services
SAWEN	South African women entrepreneurs
SEDA	Small Enterprise Development Agency
SETA	Sector Education and Training Authority
SFWS	Strategic Framework for Water Services
SMME	small, medium and micro enterprise
SPV	special purpose vehicle
SSA	support services agent
SWE	Small Water Enterprises
UYF	Umsobomvu Youth Fund
Uzinzo	Uzinzo Water Services (a joint venture between Amanz' abantu and WSSA)
Waterbility	Waterbility Water and Sanitation Solutions (Pty) Ltd
WEDC	Water Engineering and Development Centre (at Loughborough University, UK)
WISA	The Water Institute of Southern Africa
WMS	Water Management Services
WRC	Water Research Commission
WRP	WRP Consulting Engineers
WSA	water services authority
WSP	water services provider
WSS	water services (including sanitation)
WSSA	Water & Sanitation Services SA (Pty) Ltd

Definitions used in this report

Frequent reference is made in literature to "**community-based**" or organisations that are "based in the community". It is often not clear if it is intended that these terms exclusively refer to non-profit organisations, or could include profit-seeking organisations. Is the intention of referring to an organisation as "based in the community", to indicate that it is geographically located in the community that it serves, and draws most if not all of its personnel (whether they be volunteers or paid) from that same community? The South African Local Government Association (SALGA) has in a recent document made its interpretation clear. A "community-based organisation (CBO)" is "a not-for-profit organisation within a specific community, with community representatives, that provides a service to that community with the community's mandate or is representing the overall interests of the community." (SALGA 2005:3).

For the purposes of this report, the term "small, medium and micro enterprise", or SMME, indicates a profit-seeking organisation that might or might not be based in a community, drawing personnel from that community, and serving that community. Usage by the researchers in this report of "CBO", is less rigid, but is generally intended to indicate a non-profit organisation. If, however, the reference to CBOs is a quotation or a paraphrasing from another document, then the meaning intended by the authors of that document is that which rules.

"**Delivery**" embraces not just the placing in service of infrastructure, but the appropriate operation, including maintenance, of that infrastructure for the whole of its designed life.

"**Maintenance**" is in this report used as a generic term to include repair of infrastructure, refurbishment and renewal, and provision for replacement of that infrastructure.

The following definitions are direct quotations from the Water Services Act (South Africa 1997:10).

- ""**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."

Note that whereas all WSAs are municipalities or groups of municipalities, not all municipalities are WSAs. Nonetheless, in this report the terms "WSA" and "municipality" are used interchangeably unless only one of "WSA" or "municipality" is intended and these specific instances are clearly indicated.

Similarly, in this report the terms "customer" and "end user" are used interchangeably unless only one or the other is particularly intended – these specific instances are clearly indicated.)

1. Introduction

1.1 The purpose of Chapter 1

The purpose of Chapter 1 is to:
- briefly motivate the research project;
- state the objectives and phasing of the project, and introduce the project team; and
- outline the objectives and structure of this report.

1.2 Background to and objective of the project

1.2.1 Rationale and motivation for the project

In the past decade local government, assisted by DWAF and other players, has been remarkably successful in answering the challenge of services provision. Large numbers of households are now supplied with water services of a wide variety as a result of massive investments in infrastructure and institutional development. Although there are many who are still not able to access services, this achievement is exemplary.

However, this very success provides the seedbed for future problems. As the number and complexity of water services systems increases, so the operations and maintenance workload escalates. The rising challenge now is to ensure that local government WSP organisations can manage all the new systems sustainably.

Conventional wisdom, supported by research, indicates that the capacity of many local governments in South Africa to adequately provide even basic levels of water services to all their citizens on a sustainable basis is in question. The challenge of exploring a range of options to support these organisations also represents an opportunity to selectively incubate innovations on an experimental basis, following a tradition of South African leadership in public sector-driven partnerships with the private sector, for optimum development impact.

Both Rand Water and DWAF have for a number of years considered that the potential for franchising in the water services industry water 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 the profit motive and the existence of a successful business model that can be copied widely. Neither of these is currently in evidence in the water services sector.

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 WRC and CSIR during the course of the 2003/2004 and 2004/2005 financial years undertook pioneering research into the concept of water services franchising in South Africa. (Wall, 2005a). The study explored the concepts of franchising and its relevance to the water services delivery process. The outcome indicated opportunities in the water services delivery chain, and recommended that these be further explored.

1.2.2 Objectives of the project

- To further explore the concept of franchising and its relevance to the water services delivery chain.
- To identify and determine those elements in the water services delivery chain which offer the greatest scope for franchising partnerships.
- To review the legal, technical, financial, regulatory etc. aspects which would impact on franchising partnerships.
- To develop franchising partnership models for a selection of the areas identified by the research, with consideration for the legal, regulatory etc. aspects.
- To conduct a case study of an element in a hypothetical situation, to see how the model will work.
- To set out the way forward to eventual pilot implementation of franchising partnerships, and inter alia recommend areas for further research.

In summary, **the ultimate objective of the project was to identify the scope for franchising partnerships for the operation and maintenance of selected water services infrastructure, to establish the viability of franchising partnerships, and to make a case for outsourcing to franchises to be considered by water services authorities (WSAs) and water services providers (WSPs).**

In this report, WRC Research Project K5/1610, the "Water Services Franchising Partnerships" project, is referred to as "the current project" or "this project".

1.2.3 Methodology

The WRC project was divided into two phases, in order to facilitate the achievement of the objectives of the research project in an ordered and logical way. (Refer also to "project schematic" (Figure 1.1) on the next page).

Phase 1 consisted, inter alia, of:

- review of policy, legal, regulatory and other aspects which impact on water services; and
- identifying those elements in the water services delivery value chain which offer the greatest scope for franchising partnerships for the operation and maintenance of their infrastructure, and setting out the results of the business analysis (i.e. modelling) of possible franchising of selected elements.

The second phase included:

- Definition of a franchise structure, and preliminary identification of potential franchisors and other key role-players; and
- A case study of an element in a hypothetical situation, to see how the models would work.

Note that a further two phases, not part of this project, would be needed in order to take the work into pilot implementation. These phases comprise pilot project preparation, and then pilot project implementation.

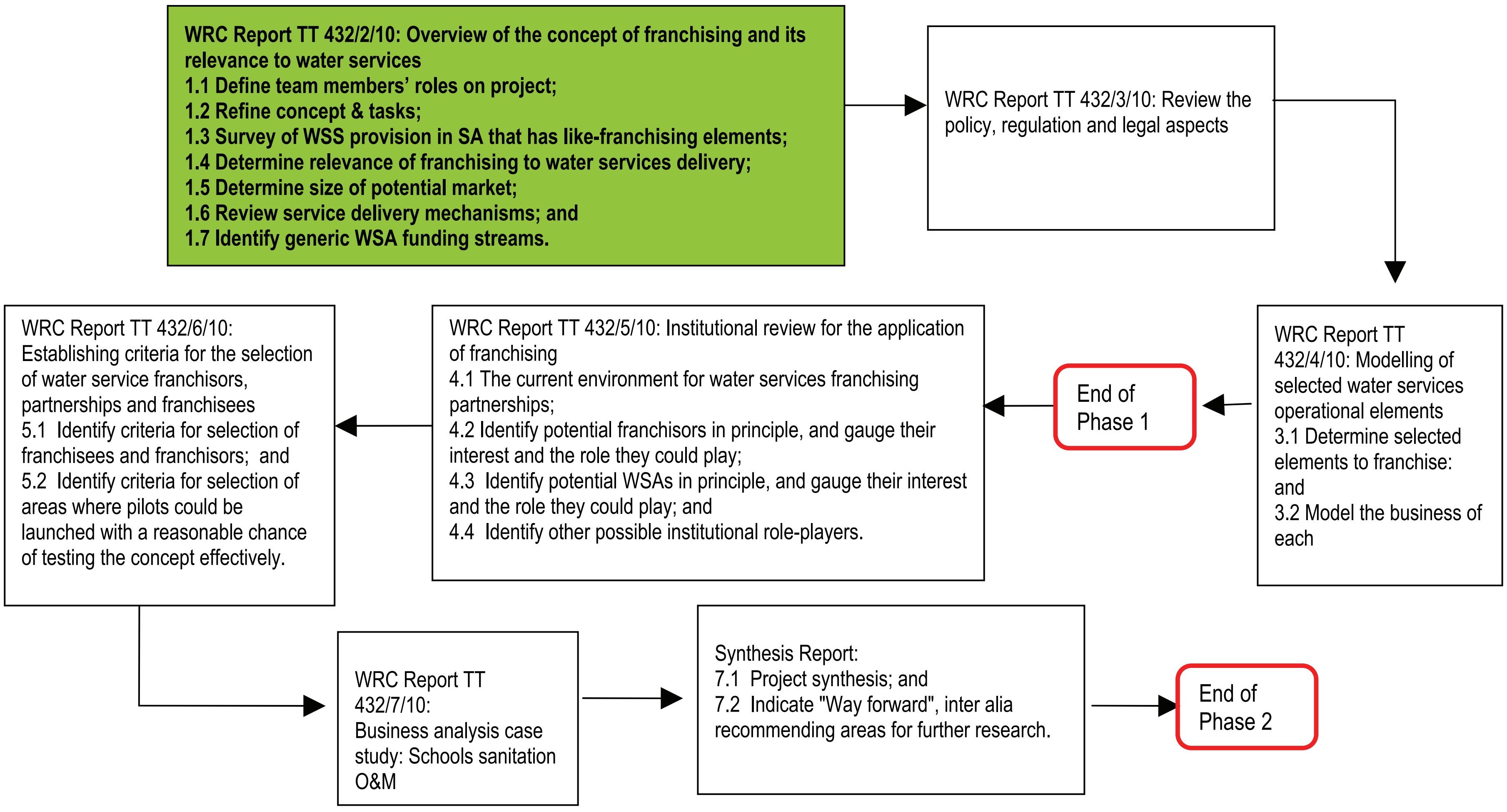

Figure 1:1 Water services franchising partnerships: project schematic

1.3 About this report

1.3.1 Specification

This report is to:

- Capture the concept of franchising; surveying water services provision in South Africa that has like-franchising elements; setting out for water services the size of the market, tasks, roles, and services delivery mechanisms; identifying WSA funding streams; and identifying the potential of franchising for water services delivery.

More specifically, that:

- Existing water services delivery mechanisms need to be reviewed in terms of their scope, effectiveness, friendliness towards SMME development, and other factors. The potential "market" for water services franchising would then be better understood in terms of opportunities to provide more effective or efficient service, to provide service when none currently exists, and/or to provide scope for SMME development while delivering water services.

This "WSRC Report TT 432/2/10: Overview of the concept of franchising and its relevance to water services" is hereinafter referred to as "the report" or "this report" or "the current report".

1.3.2 Purpose of this report

In a nutshell, the purpose of this report is:

- survey water services provision that has like-franchising elements;
- determine the relevance of franchising to water services delivery, and determine the size of the potential market;
- review existing service delivery mechanisms; and
- identify the generic funding streams for WSAs on the one hand and for SMMEs on the other.

The context in all instances is South Africa.

In a sense, this report is a scoping of the potential for water services franchising. After all, the ultimate objective of the project is to identify the scope for franchising, and to identify the viability of franchising and/or to make a case for franchising to be considered by WSAs and water services providers (WSPs).

1.4 Structure of this report

The structure of this report reflects its purpose (described in Section 1.3.2 above). Thus the report consists of an introduction (Chapter 1), a résumé of the first WRC report on franchising (Chapter 2), and four chapters (Chapters 3 through 6) which each deal with one of the objectives of the report. Chapter 7 draws conclusions and makes recommendations.

The middle five chapters thus respectively are:

- Chapter 2 which résumés the first report on franchising;
- Chapter 3 which surveys water services provision that has like-franchising elements;
- Chapter 4 which determines the relevance of franchising to water services delivery, and determines the size of the potential market; and
- Chapter 5 which reviews the service delivery mechanisms; and
- Chapter 6 which identifies the generic WSA and SMME funding streams.

1.5 Footnote on franchising

Should readers wish for generic background on franchising, they are referred to the first WRC report, and in particular to Chapter 3 "Delivery of goods and services by franchise: the generic view". Also to Parker (2003) Chapter 9 "Yes, there is an easier way!" and Illetschko (2005). Annexure A is a newspaper article that gives succinct general advice to a potential franchisee.

Annexure B is a brief history of franchising in South Africa.

2. Résumé of first WRC report on franchising

2.1 The purpose of Chapter 2

As noted in Section 1.2 above, this project builds on the findings of the earlier WRC study, described in "Development of a framework for franchising in the water services sector in South Africa," WRC Report No. KV 161/05. (Wall, 2005a).

It is useful therefore that at this point in the first report of the new project, the findings of that earlier study project be summarised. The text is taken directly from the Executive Summary of the earlier report.

2.2 Résumé of KV.161/05

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 partnership 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 described in the 2005 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 new 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, indicated that water services franchising partnerships show 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 concluded 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 (BEE).

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. “

3. Like-franchising survey

3.1 The purpose of Chapter 3

The purpose of Chapter 3 is to survey water services provision in South Africa that has like-franchising elements.

In order to discuss and describe "like-franchising", it is necessary first of all to reiterate what is meant by "franchising". This is done in Section 3.2.

Section 3.3 describes The Drain Surgeon, an oft-referred to example in franchising literature of business format franchising in the water services sector in South Africa.

Section 3.4 very briefly abstracts from studies of other kinds of partnerships, not in any sense or form franchising or even like-franchising partnerships. The purpose of this is not only to further reinforce what is in this project meant by franchising, but also to describe a number of features of these partnerships that could be of value to a better understanding of franchising.

Section 3.5 introduces "like-franchising", explaining what is for the purposes of this report regarded as "like-franchising", and hence which initiatives are selected for description.

Each of Section 3.6.1 through Section 3.6.8 describes one of the initiatives surveyed.

Section 3.7 draws conclusions.

This chapter does not aim to discover and describe all like-franchising instances in South Africa, not even those only in the water services sector. It aims only to describe a few, primarily in order to discover features of these partnerships that could be of value to a better understanding of franchising.

As an important aside: frequent reference is made in literature to "community-based" or organisations that are "based in the community". It is often not clear if it is intended that these terms exclusively refer to non-profit organisations, or could include profit-seeking organisations. Is the intention of referring to an organisation as "based in the community", to indicate that it is geographically located in the community that it serves, and draws most if not all of its personnel (whether they be volunteers or paid) from that same community? The South African Local Government Association (SALGA) has in a recent document made its interpretation clear. A " CBO" is "a not-for-profit organisation within a specific community, with community representatives, that provides a service to that community with the community's mandate or is representing the overall interests of the community." (SALGA 2005:3) (See also “Definitions” at the beginning of this report.)

For the purposes of the current report, the term "small, medium and micro enterprise", or SMME, unless otherwise made clear in the context, indicates a profit-seeking organisation that might or might not be based in a community, drawing personnel from that community, and serving that community. Usage by the researchers in this report of "CBO”, is less rigid, but is generally intended to indicate a non-profit organisation. If, however, the reference to CBOs is a quotation or a paraphrasing from another document, then the meaning intended by the researchers of that document is that which rules.

3.2 Reiteration of "franchising"

Prior to discovering, describing and discussing "like-franchising", it is necessary to reiterate what is meant by "franchising".

As briefly as possible:

The word "franchise" has meanings in several different contexts, but common to all these meanings is the concept of a privilege or right granted by an entity to another, smaller, entity. However, when the word is used in this report, "business format franchising" (to use its full name) is meant. This 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). (Wall, 2005a:17)

Thus franchising is a way of accelerating the development of a business, based on tried and tested methodology. The franchise system firstly systematises the business, and then facilitates the setting up of the business, the introduction of a franchisor that will thereafter support and discipline the franchisees, and the identification of potential franchisees. The cardinal elements of the franchise process are:

- identifying a component (or components) of the value chain that is simple enough to systematise;
- discovering good practice;
- systematising the "business" of delivery of that component;
- selecting franchisors and franchisees;
- identifying the financial risk to both the franchisors and franchisees, and as far as practical reducing that risk;
- providing start-up help, including initial training;
- preparing operations manuals;
- ongoing research and development; and
- continuing support, training, control and discipline of the on-going business. (Wall, 2005a:29)

To summarise, therefore, 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.

Illetschko went to some trouble to describe what franchises are not. The table below is his "summary of the different types of businesses that are often confused with franchises. It also contrasts them with the real thing. Each of the business formats in the table is briefly explained to make the differences between them quite clear." (Illetschko, 2005:11)

Table 3:1: Characteristics of franchise models and their look-alikes

Nature of the business format	Formal contract	Legal status	Principal's financial risk	Degree of operational control	Degree of support offered	Realistic success chances
The many look-alikes						
Basic business opportunity	Loose or non-existent	Independent owner	High	High	Low	Low
Multilevel marketing scheme	Loose or non-existent	Independent owner	Medium	Medium	Low	Medium
Agency agreement	Detailed regarding product	Independent owner	Low	Low	High	High
Distributorship	Loose, product-focused	Independent owner	Medium	High	Medium	Medium
Dealership	Detailed regarding product	Independent owner	High	Medium	Medium	Medium
Voluntary chain	Loose	Independent owner	High	High	Low	Low
Proper franchise arrangements						
Product/ trademark franchise	Detailed regarding product	Independent owner	Medium	Medium	Medium	Medium
Business format franchise	Detailed regarding all facets	Independent owner	Low	Low	High	High
Important note: It is clear from the above that the business format franchise model offers the greatest initial and ongoing support.						

(Illetschko, 2005:10)

3.3 A franchising example in the water services sector: The Drain Surgeon

3.3.1 About The Drain Surgeon

Section 3.3 describes The Drain Surgeon, which is, by all accounts, the most developed example of business format franchising in the water sector in South Africa, and is therefore worthwhile describing here at some length.

The following account is based on notes which have been submitted to Mr Pratt for his checking and approval, which approval has not to date been obtained.

A problem encountered when researching for this chapter any of the private sector initiatives, that is not just The Drain Surgeon, but also for example Professional Water Management SA (PWMSA), is the understandable reluctance of those interviewed to reveal aspects of their business, or their plans, that they feel gives them competitive advantage. Similarly their reluctance to discuss any financial issues except in the most general terms.

3.3.2 The way it operates

"The founder [more than two dozen years ago] of The Drain Surgeon, Glenn Pratt, is testimony to the fact that with clearly defined goals, an unshakeable belief in the power of marketing and an obsession with service excellence, one man can build real wealth within a lifetime. To top it all, the business was built within an industry sector that has a low barrier to entry and is seriously overcrowded. All this was achieved without access to grants or financial support from wealthy parents." (Parker, 2003:227)

Pratt, in an interview, jokingly stated that he would not contemplate a fried chicken franchise because he has never fried a piece of chicken. But, having trained as a plumber, served his apprenticeship, and then worked as an independent plumber before starting his franchising business, he knows plumbing backwards! He has learned through first-hand practical experience which plumbing operations are franchisable, and thanks to his day-to-day business dealings he is adding to that knowledge continuously. As he stated, his ideas for what can be franchised came, and still come, "through self-testing first". (Pratt personal communication 2006)

Pratt runs the Pretoria operation directly. All the staff, including those who go out to the visits, are direct employees.

There are 59 “The Drain Surgeon” franchises, that is, 59 separate companies. Some entrepreneurs own more than one company. The franchise is present in all the major urban areas of South Africa, in some cases, two or three, each covering a different area, in the same municipality. All are branded "The Drain Surgeon". Each has its own call centre and therefore customers in most other centres do not have to phone through to Pretoria.

"The Drain Surgeon’s marketing drives have become legendary. Glenn was among the first plumbers to introduce proper branding principles. In addition to Yellow Pages advertising, Glenn broke new ground within his industry sector by advertising on dustbins, hoardings at sports events and on the side of the road and any other place that lent itself to promoting the brand. The Drain Surgeon logo appeared in magazine adverts, on key rings, fridge magnets, pens and a multitude of other media. Radio and TV advertisements were also used." (Parker, 2003:229)

"While the core business gained momentum and established a national presence through franchising, an electrical repair service was added to maximise the utilisation of existing infrastructure." (Parker, 2003:229). There are now five electrical franchisees.

Some of the entrepreneurs started life as plumbers. Some had no previous knowledge of plumbing. One of Glenn Pratt’s rules for business success: “I’d rather hire a guy with a 65% skills level and a good attitude than an individual with perfect skills who has a bad attitude. It’s far easier to teach skills than attitude!" (Parker, 2003:230)

In order to keep control of the quality of service provided by the franchisees, Pratt does not do spot checks, visit the other franchises, or invite customers to complain to him. He is confident that if something was going wrong with the service rendered by one of his franchisees, he would get to hear about it sooner rather than later. He does call the franchise owners from time to time, to ask how they are getting along. He does insist that in all the franchises, top priority, over new business, is given to seeing to complaints of poor service. The plumber that did (or did not) do the job is sent back to sort out the problem.

If something were going wrong with one of his franchisees, he would offer assistance, up to a point. And if the franchisee will not accept his advice, there are ways that he can persuade the franchisee, for example he has influence with the national suppliers of plumbing materials.

If the franchisee sells the business (and this has happened), Pratt is heavily involved in approving the new franchisee. The franchisee is obliged to inform him even when the shareholding changes, e.g. the franchisee acquires a partner.

Figure 3:1: The Drain Surgeon at work

Sometimes the franchisee does not comply with the terms of the franchise agreement. For example, poor workmanship, poor payment of royalty fees, and not paying the supplier. If all else fails, the franchisor has to kick the franchisee out, and quickly source a new franchisee. Pratt has had to do this. And he has had a few complete failures, where the business had to be closed down altogether.

Apart from needing capital to purchase tools and equipment (which he then owns), the start-up franchisee needs capital to set up the call centre, and also needs working capital. The bank generally calls Pratt at some point in the negotiation with the franchisee, to verify that the franchisee has his support.

Pratt is hoping to soon set up a franchise that will primarily serve the formerly Black residential areas now part of the Emfuleni Local Municipality (LM). (This franchise would be in addition to the two existing franchises, in Vereeniging and Vanderbijlpark, within the LMs.) Whereas The Drain Surgeon's training institution is currently training 21 trainee plumbers from the Emfuleni area, the franchisee could be one of these, or could be someone from another field, it is too early to predict. (See also Sections 3.3.4 and 3.3.5.)

3.3.3 Ensuring adequate cash flow

The important principles are:

- that franchisees are not heavily dependent on a small number of their clients; and
- that franchisees offer more than one type of service, and that one of these can be relied upon to provide a steady income.

Each franchisee must have a number of clients. If a client does not budget sufficiently for operation and maintenance, or mismanages the budget, and is unable to pay its contractors, or pays them late, a contractor too much dependent on that client could go under.

Even much more so, given the reputation of unreliable payment to contractors that, rightly or wrongly, many public sector bodies (including municipalities, who are probable clients for the kind of service that The Drain Surgeon provides) have, Pratt advises "do not have too many eggs in public sector baskets".

In order to spread its client base, and to increase the reliability of its income stream, The Drain Surgeon has been bidding for installation contracts to add to the operations and maintenance service (principally drain cleaning and general plumbing) it has traditionally provided. For example, it has an arrangement with the retail materials supplier Cashbuild, so that when Cashbuild supplies materials to any institution of substance, The Drain Surgeon is the preferred installer.

Just lately, it has been taking this further, and tendering for "supply and install" contracts. It recently won such a contract in Sharpeville (which is part of Emfuleni LM).

As a further initiative: If a franchisee had, in terms of normal public sector procurement rules, to go out on tender for each task, that would not be a viable proposition for it. Accordingly, Pratt has proposed to a number of municipalities that they agree to an arrangement that would permit them to annually appoint a franchisee to undertake work during that year on an "as-and-when" basis. The first municipality has recently agreed to this on a trial basis.

3.3.4 The Training Academy

Pratt wants The Drain Surgeon to be "identified" as both:

- providing excellence in the training of plumbers, and
- having a great track record in setting up franchises.

The Drain Surgeon founded an offshoot in the form of "The Drain Surgeon Training Academy", also known as "Plumbtrain". This training academy, which has been going for four years, is located in the George Thabo Centre, in Dube, in Soweto. It is fully accredited with the Construction Sector Education and Training Authority (SETA), and is regarded by them as a "Centre for Excellence" for plumbing.

The Academy trains activities such as laying drains, fixing leaks, and clearing pipes. 90% of the training of these plumbers is on-the-job training. The Drain Surgeon supervises and quality controls the work that they do for customers while they are still being trained.

3.3.5 Franchises in the townships?

Pratt wants to create The Drain Surgeon franchises in the formerly Black residential townships.

As far as selecting suitable people is concerned, whether this be people to be plumbers or to be the franchisee entrepreneurs or both, based on the relatively small number of townships where he has commenced this initiative, he has been relying upon someone based in the township to pre-screen possible candidates. He is confident that he can train most of the people that he is sent, in the technical skills, anyway, and in some basic business skills also. Some will drop out, because they discover the work is not to their taste, or they have insufficient aptitude, or some other opportunities come up. That is expected, and not of undue concern.

In the case of his Emfuleni initiative (see above), he approached the ward council, and it selected the 21 people for training. Few of them had any previous knowledge of plumbing, so they are being trained from scratch. There was no vetting for their aptitude. But that does not worry him, they will "self-select". If they feel they are not making it, they will drop out of their own accord.

He is training them in activities such as laying drains, fixing leaks, and clearing pipes. Once they are trained, he will help the better prospects among them to set up as franchisees, if they want to be.

Some years ago, Pratt approached the Pretoria Metropolitan Municipality (MM), and offered to set up a system for them in the formerly Black residential townships. He made the offer not for social responsibility. He saw that, in addition to providing a service that largely was not being provided by the municipality, or was in provided only ineffectually, he could make money. His idea was that he would set up a container in a township, which would be the call centre and where spares were kept. Plumbers (which he would train) would be provided with the tools and a motorcycle with space to carry equipment, and would be dispatched by the call centre to deal with blockages. They would also, in order to provide
them with a source of income that was not dependent on the vagaries of blockages, be allocated an activity with a more regular source of income, such as the reading of water meters.

The proposal ended up with a senior official who said that clearing blocked drains in the townships was a profitable operation for the municipality, and it did not want to give up providing this service. However, Pratt did a costing that took into account not just marginal costs, but also overheads, petrol, capital, and proved to his own satisfaction that the municipality was far more expensive than the price he could provide the same service for.

3.3.6 Summing up the main strengths of the business

The main strengths of the current business are:

- the drive and business acumen of its founder, Glenn Pratt;
- his intimate knowledge of plumbing, and which elements are suitable for franchising;
- service quality;
- that the business is strictly for cash if the customers are individuals or households, and that commissions are accepted from institutions only if those institutions are creditworthy; and
- strong branding.

On Illetschko's table, reproduced in Section 3.2 above, The Drain Surgeon is undoubtedly "business format franchising".

3.4 Other partnerships

3.4.1 Section 3.4 objectives

Section 3.4 very briefly abstracts from selected studies of other kinds of partnerships that are not in any sense or form franchising or even like-franchising partnerships. The purpose of this exercise is not only to further reinforce what is in this project meant by franchising, but, more importantly, to describe a number of features of these partnerships that could be of value to better design of franchising relationships.

To reiterate, franchisees are SMMEs, but SMMEs that are "in business for themselves, but not by themselves". They have the assistance of a franchisor, but for that, they would be straightforward SMMEs. In order to point out the contrast between franchised SMMEs with non-franchised, i.e. standalone, SMMEs, Sections 3.4.2 and 3.4.3 looks very briefly at some studies of SMMEs, not franchisees, in the water services sector.

And much as franchise arrangements for the delivery of any public sector services are a particular form of public-private partnership (PPP), it's worth it to very briefly look at public-public and public-private partnerships, not involving SMMEs, in the water services sector. This is done in Sections 3.4.4 and 3.4.5. A couple of instances of public-public partnerships in the water services sector are, for good measure, described in Section 3.4.6. Another type of public-public partnership in the water services sector is described in Section 3.4.7.

3.4.2 SMMEs, not franchisees, in the water services sector: in South Africa

The national Department of Water Affairs and Forestry (DWAF) has stated that institutional reform of the water services sector "will result in the creation of a diverse range of institutional arrangements appropriate to the specific and diverse local and regional contexts within South Africa. Some possible arrangements are outlined below without any intention of being pre-emptive or prescriptive. The list is by no means exhaustive, and is indicative only. No expression of preference is intended in terms of the ordering (or any omissions) of the alternatives. Combinations of alternatives are also possible. The appropriate institutional arrangements will be defined on a case-by-case basis." (DWAF 2003c:20).

Having listed a number of these possible arrangements, DWAF went on to state that "government is committed to promoting the active involvement of civil society in the provision of sustainable and affordable water services", and that "this will be done through", inter alia, "engaging capacitated community-based organisations to manage water services projects at the local level, where appropriate". (Ibid:25).

Furthermore that: "Where water services are provided through smaller localized systems, it may be most appropriate for these services to be managed by the local community with support from the water services authority or water services agents. … DWAF will engage with other national government departments to secure the right of water services authorities to use community-based water services providers (as defined in this Strategic Framework) **without undertaking competitive tendering.**" (ibid:20). (emphasis added)

Despite that "the current policy environment of municipalities encourages local contracting of small service providers", "local authority initiatives that include community-based service providers remain scarce". And also despite advantages, such as that "local small service providers have an innate ability to respond to the dynamics of market need and demand that characterise informality". (Cousins, 2006:5). "Distinguishing between voluntary payment as beneficiaries or remunerated employment for providing services", Cousins identified a limited number of situations where SMMEs provided operation and maintenance services, invariably to undertake low-skilled tasks such as collection and emptying of buckets. (Ibid:6, 10). Mentoring, if any, of these emergent contractors, is invariably by the municipality.

All other instances that the researchers have come across of mentored SMME operation and maintenance of water services in South Africa have been at this low-skilled level.

There are, however, quite a number of instances of the profit-seeking SMME private sector operating and maintaining public sector water services infrastructure without mentorship, and not in terms of a franchise arrangement either. Some of these require high levels of skills. One example is that of PWMSA, which is described at some length in Section 3.6.8. It has now grown beyond being a small or micro enterprise, but it started small. Other examples may be found where a SMME has the contract to operate and maintain a treatment works. For example, operation and maintenance of the Zonderwater Prison’s wastewater treatment works has for several years been contracted out to the private sector, to a SMME. Given that the owner of this works, the Department of Correctional Services, does not have the technical expertise, it has also contracted out the client's responsibilities, and thus a consulting engineer performs "the Engineer" role set out in the operator’s contract. This example, while from the private sector, is not of a treatment works owned by a municipality.

Despite the moral lead given by DWAF, operation and maintenance of municipal water services by not only the private sector but also by non-governmental organisations (NGOs) and CBOs is very much the exception rather than the rule.

Jones et al. suggested reasons for "civil society groups and non-governmental organisations, although present, [being] relatively subdued members of the [water services operation and maintenance] partnership." Private sector consultants and contractors have been heavily involved in the design and construction of water services infrastructure, but not much in operation and maintenance. There is on the part of local government a "hostility to civil society in general (including NGOs and CBOs) that extends beyond the advocacy and "watchdog" roles to the service and "software" delivery functions that they have played in the past. Section 78 legislation makes it very difficult not only to engage the private sector, but any external provider including NGOs. …

Civil society itself is not particularly organised and is divided between taking up a service provision function or a stronger advocacy and watchdog role. A perceived lack of "professionalism" and low capacity also make them look bad (compared to professional "service providers) in the eyes of municipalities.

The private sector is not as large a player as one would expect, neither in service delivery nor in a support function to municipalities. Apparently "service providers" have been banned from several of the provincial fora largely as WSAs are hostile to their presence. Some NGOs have had to seek national intervention in order not to meet the same fate. Thus the scope of the sector is in fact much narrower than one would expect and heavily dominated by government or parastatals. This has several consequences, most significantly in reinforcing a top-down centralised approach and placing priority on expenditure and planning over the efficient and sustainable delivery of services." (Jones et al., 2005:29)

3.4.3 SMMEs, not franchisees, in the water services sector: WEDC publication on "small water enterprises"

As an exception to the rule elsewhere in this chapter that only South African instances be described, the team's attention was drawn by the WRC to a recent Water Engineering and

Development Centre (at Loughborough University, UK) (WEDC) publication on "small water enterprises" elsewhere in Africa. (McGranahan et al., 2006)

Small and micro business enterprises (i.e. the smaller-scale side of SMMEs) have since time immemorial provided many services that are nowadays more generally associated with provision by the public sector. These services included operation and maintenance of the means, including infrastructure, whereby the populace access water and waste services.

Today, "in many cities of Africa, Asia and South America, more than half the population of towns and cities obtain their water from suppliers other than the official water supply utility. Numerous terms have been used to describe the various different types of unofficial service providers Small Water Enterprises (SWEs). SWEs are private enterprises, usually operated by small-scale entrepreneurs (with a maximum of 50, and usually far fewer employees), which earn money from the sale of water. ..... They usually supply water to places that are unserved or inadequately served by the utility, or at times when the utility cannot. Customers are not necessarily the poor ….. . In many cities, however, it is low-income households that are worst served by the utility and most dependent on SWEs." Three broad categories of SWEs are wholesale vendors, distributing vendors and direct vendors (including operators of water kiosks). (McGranahan et al., 2006:2).

It is interesting to reflect that a frequent reason for lacklustre service delivery performance by a public sector utility, or for its disinterest in ensuring a reliable service, is "the operation and maintenance responsibilities in these organisations were usually regarded as "dead-end" positions". (Wall undated:52).

SWEs generally receive little support from governments, and "the incremental but critically important improvements they can provide tend to be overlooked by governments and international agencies." (McGranahan et al., 2006:1). Nonetheless, there are a number of examples of SWE creation being nurtured by governments and public sector agencies, or of SWEs being financially supported or being preferentially procured, or both, to the benefit of the SWEs, and resulting in improved service. (Wall, undated:61 and Section 4.3) and (World Bank 2005).

Whereas, internationally, "greater private sector participation has been widely promoted in the water sector in recent decades", "almost all of the attention has been devoted to large contracts open to international tender." (McGranahan et al., 2006:1)

Recognising the great impact that even marginal improvements in water services delivery through SWEs, if disseminated, would have on the many millions who depend on these water services providers, WEDC, with financial support from Department for International Development (of the UK government) (DFID), identified and tested ways of improvement. In each of four African cities, teams "have worked to identify constraints, opportunities and strategies for enabling small water-providing enterprises to deliver acceptable water services to low-income urban consumers. …. The accumulated evidence suggests that there are numerous opportunities for enhancing the role of SWEs in all of the cities." (ibid:3)

These opportunities lie in:

- the official attitudes to SWEs;
- the technology environment; and
- the financial environment.

The first of these has the greatest potential by far. The right kind of change in official attitudes would greatly improve the environments towards technological and financial strengthening of SWEs.

"Government agencies have long been inclined to ignore or suppress SWE. They have not traditionally been considered to be legitimate suppliers. … The goal of the utility has been assumed to be one of replacing rather than assisting the SWE. Often, the illegitimate character of SWEs has inhibited the investments that would improve the reliability or quality of supplies. This lack of investment applies to both the utilities, who fail to invest in servicing the SWEs, and to the SWEs themselves, who cannot secure finance at competitive rates." (Ibid:3-4)

Quite apart from the benefits to the SWEs and to the customers that they serve that would derive from governments (and their public sector utilities) and SWEs working in cooperation, the utilities can also expect to benefit from higher revenues, as SWEs become legitimate and reliable paying customers, and invest in better equipment.

The WEDC study identified measures in the following areas for the improvement of water services supply by SWEs:

- improvement of the quality and reliability of the sources from which the SWEs draw their supplies, and easing the access of SWEs to these sources (e.g. simple things like queuing facilities for water carts);
- official recognition, where appropriate, of the value of the service, and of the legitimacy of the SWEs;
- increased investment by SWEs (which investment, as the study points out, SWEs are more likely to get if they are legitimate than if they are not);
- technical support;
- regulations, and their enforcement, that improve quality and reliability, rather than regulations that simply harass the SWEs (as it is reported frequently happens); and
- measures that facilitate entry of new SWEs, in order to improve coverage, choice available to customers, and probably also price and quality competition (such measures would include subsidising fees for drawing from the water sources, and reducing bureaucracy and eliminating corruption in the granting of licences).

The WEDC study identified the following advantages, not directly to do with improving the quantity, quality and reliability of the water services, of growth in the SWEs sector:

- improved revenue to the owners of the sources (often the public sector utility); and
- employment creation, particularly in delivery of water from non-piped supply.

"To seize these opportunities, however, will require significant changes in relations between governments, SWEs, water utilities and in some cases other actors." (McGranahan et al., 2006:3).

As an aside: the study takes a swipe at governments and international organisations that "use targets as a guide to action. … The inherent problem is that targets based on single standards can be used to justify neglecting incremental improvements in the conditions for the worst off, in favour of improvements for those people whose water conditions are already close to acceptable." (McGranahan, 2006:23). It argues therefore that, rather than trying to develop public sector piped water supplies, and ignoring SWEs or even harassing them, given the difficulty in many circumstances of appreciably increasing access to private water supplies, it would benefit far more people, far sooner, and far cheaper, if governments worked to improve supply by SWEs.

<u>Commentary</u>

Interestingly, the WEDC study does not define SWEs in terms of the range of services typically provided, but there is an unstated obvious understanding that in the context of the book SWEs are small business entities that provide a range of "water distribution" (as opposed to sanitation or wastewater) services. However, the analogy with small business enterprises providing other elements of the water services value chain, as it is understood in the current report is obvious, for example, plumbing, drain cleaning, and the servicing of toilets. Note also that the study states that the customers of the SWEs that it investigated "are not necessarily the poor". More affluent customers can contract with SWEs to supply supplementary services (e.g. additional water supplies) or niche services.

And whereas in some instances studied, the official resistance to SWEs can at least partly spring from the fear that a well-functioning system of SWEs "can be taken to reflect the failure of the government to supply piped water", there should be no such resistance to small business enterprises supplying supplementary or niche services.

In conclusion: franchisees are all small business enterprises of a particular sort. Thus measures that open the door to SWEs, and/or improve service delivery by SWEs, and/or improve the viability of SWEs, are all measures that, everything else being equal, would do the same for water services franchisees.

3.4.4 Public-private partnerships, not SMMEs, in the water services sector: the project implementation agents

There have been a number of these partnerships over the years, some of them for construction of services, and some for operations and maintenance.

One particular type of partnership of significant size was begun with the appointment in 1997 of Project Implementation Agents (PIAs) for four provincial rural water supply and sanitation programmes. These accelerated Water Supply and Sanitation Programmes became known as the BOTT programmes.

Four PIAs were appointed by DWAF, one for each for the provinces of Mpumalanga, Limpopo, KwaZulu-Natal and the Eastern Cape. Private consortia tendered for appointment as PIAs, and each successful PIA formed a company to undertake these large-scale provincial implementation programmes. These programmes were notable for their turnkey approach to the planning, design and construction of water services infrastructure, and in addition, their contractual requirement to train the operational staff and to operate for a pre-determined period and then to transfer the schemes as going concerns to the local authorities. Following this transfer, the PIAs were required to provide mentorship for these operations for a pre-determined period.

As a result of the strong emphasis in the BOTT contract to follow community-based approaches prior to transferring operational responsibility to the LMs, the operational models developed for the BOTT schemes all included the recruitment and training of local community representatives. In many instances these new community-based SMMEs were then introduced to the receiving municipalities, who then either employed the operational staff directly or outsourced the work to them.

The BOTT programme concluded early in 2003.

The PIA for the Eastern Cape, Amanz' abantu, is the only PIA company that still continues to provide water services to its local municipal clients. It is active in rural water supply operations and in the implementation of household sanitation programmes.

The reason for its decision to continue was based on:

- the proven success of the partnership between the shareholders and in particular the BEE shareholders;
- the undertaking by government to continue rolling out its water supply and sanitation programme to the rural areas;
- the undertaking to follow labour-intensive and community-based approaches; and
- the opportunities related to the transfer of functions from national to local government.

These BEE shareholders today own 62% of Amanz’abantu.

A number of the SMME and individual shareholders of Amanz’ abantu are collectively represented through the Amanz’ abantu Investment Trust, which holds 30% (included in the 62% above) of the company. These trust members specialise in institutional and social development, and they act as trainers for training contracts that are secured by Amanz’ abantu . Amanz’ abantu is accredited by the Local Government Sector Education and Training Authority (LGSETA) to provide training related to community sanitation, environmental health and community development.

The relationship between Amanz'abantu and its SMMEs is in many ways similar to a franchise agreement, in particular in that Amanz'abantu trains them and supports them while they are assisting the delivery of rural water services to the municipal clients. While not business format franchising, it is also not outsourcing, in that they are Amanz'abantu’ preferred suppliers, and it trains and supports them. With the principal's financial risk being high, degree of operational control medium, and a high degree of support offered, the model does not fit any of the categories in Illetschko's table (Section 3 .2 above). They also do not only sell the "products and services" of Amanz'abantu, being free to pursue other business opportunities.

With the local government elections of December 2000, and the ending of the 5-year period of Transitional Local Government, another trend emerged in the Eastern Cape. Certain District Municipalities (DMs) which had been appointed as WSAs, in turn appointed “Support Services Agents” (SSAs) to assist them with overseeing the operation and maintenance of these rural schemes. This development is a natural progression to the operational phase of the BOTT programme, as it allows the DMs, despite having a limited pool of water service operating capacity, to assume direct responsibility for the operation and maintenance of their water schemes and to be in a position to receive the schemes being transferred to them by DWAF. (This concept is described in greater depth in the section on Alfred Nzo DM (Section 3.6.2).)

The SSAs and the community-based operators are both contracted directly to the DMs.

A major advantage of improving the capacity at local level in these rural areas is that locally-based organisations can better provide the day-to-day operational services than can organisations that are not locally based, for example, the staff of the municipality. (This topic is discussed further in Section 3.7.)

3.4.5 Public-private partnerships, not SMMEs, in the water services sector: other than the project implementation agents

There is also significant experience of PPPs, other than of the project implementation agent type, in the water sector, particularly in the Eastern Cape, where a number of municipalities entered into long-term contracts with a view to entrenching quality and level of service standards. For example, in 1991 the municipality of Queenstown entered into a 25-year contract with WSSA (Pty) Ltd to operate and maintain its water services, as well as to undertake certain infrastructure extensions and replacement. This contract is still in force, and with the Chris Hani DM having assumed the WSA function from December 2000, the original contract has been evolving into a broader range of services and service areas.

The contract signed in 1993 between WSSA and the town of Stutterheim was a 10-year “affermage” type contract, or lease. This contractual arrangement secured the services of an operator who was not responsible for making capital investment in infrastructure. Thus a shorter contract period was possible. Since 2003, this contract has been extended on a short-term basis to allow the municipality the time to complete its Section 78 process and to decide on its future approach to operation and maintenance.

The 10-year contract between WSSA and Fort Beaufort ended prematurely after seven years by mutual agreement, following the decision by the new Nkonkobe LM to assume the operation and maintenance functions directly.

Other water services PPPs include:

- The Dolphin Coast concession awarded to SAUR (now Siza Water) in 1998, and
- The Mbombela concession (Nelspruit) which was awarded to Biwater in 1998 (this latter is described in Section 3.6.4.)

It must be noted that generally these PPPs have come about through the identification of a need by the municipality followed by a period of consultation between the parties prior to the formulation of a terms of reference and the calling for tenders. Invariably the process has required a strong champion or champions. Influential municipal officials and politicians have in each case championed the approach, and their strength of leadership has been essential to the successful conclusion of the process. In cases where the private sector entity has tried to promote a PPP without the support of these champions inside the municipality, the initiative has not usually been successful. Also, while approaches from private sector entities can be instrumental in starting a process, it then has to go to public and open procurement and an entity would understandably have to weigh the effort involved in a difficult and protracted negotiation against its assessment of its chances of winning a contract.

The benefits which can accrue to the municipalities and consumers from these water service PPPs are dependent on the structuring and scope of the contracts.

The term “PPP” has generally referred only to those contracts where the private sector has assumed a shared financial exposure with its municipal client. However, the outsourcing of certain portions of the water service supply value chain to private sector service providers, without those providers sharing financial exposure provided that they deliver the operation and maintenance service that they are contracted to deliver, is not new. There have over the years been many instances where management and responsibility for operations and maintenance has been outsourced. These included:

- Zandvliet wastewater treatment works in the Western Cape;
- many of the water treatment and wastewater treatment works in the former self-governing areas, including KwaZulu, Kangwane, Ciskei and Bophuthatswana. Many of these contracts were extended after 1994; and
- Tongaat in KwaZulu-Natal.

Many municipalities continue to outsource portions of their operations and maintenance on a short-term basis. However, time and effort required to overcome the hurdles in the procurement processes have tended to discourage many other officials from embarking on the outsourcing approach.

In recent years, a number of appointments have been made of what are referred to as "strategic partners" to assist the municipalities with the structuring of new WSP entities. The Johannesburg MM initiated such a contract with JOWAM (a joint venture between Suez, Northumbrian Water and WSSA) in 2000. This 5-year strategic support contract was concluded successfully in June 2006, and all seconded staff have now left Johannesburg Water, which is a fully fledged and corporatised WSP in its own right. A similar, but smaller contract has been entered into by Maluti-a-Phofung LM in the Free State with Uzinzo Water Services (a joint venture between Amanz’ abantu and WSSA). This is described further in Section 3.6.6. Whilst these are not franchising or even “near-franchising” examples, they do highlight the need for private entities that can provide specialist operational and management support to municipalities in respect of their water services supply responsibilities.

3.4.6 Public-public partnerships in the water services sector (1)

Two of these partnerships are described, both involving Rand Water, which has a particularly long history of public-public partnering. Firstly, the Bushbuckridge case is described, and then that of Odi.

Rand Water is in Section 1 of the Water Services Act described as an "organ of state", and in the Public Finance Management Act (PFMA) is listed as a "national government business enterprise", along with the other water boards.

Bushbuckridge Water Board

In 1995 DWAF requested Rand Water to assist in setting up appropriate structures to undertake water services provision in the Bushbuckridge area. Between 1995 and 1999 Rand Water was responsible for establishing the Bushbuckridge Water Board on behalf of DWAF, providing operations and maintenance services and assisting with capacity building in the region. The primary objective of the support was the establishment of the new water board, and Rand Water withdrew from the area once this had been achieved.

Following the local government elections in 2000, Rand Water was once again requested by DWAF and the management of Bushbuckridge Water Board to provide technical assistance and capacity building. This project was focused on providing expertise in the following areas:

- internal audit;
- finance and investment policies;
- operations and maintenance;
- water quality and process control; and
- engineering and planning support.

Joint teams were set up for each of the areas above, and Rand Water seconded personnel who were able to assist their counterparts from Bushbuckridge Water through a process of training, coaching and mentoring. Bushbuckridge staff were thus able to gain experience while actually carrying out the work. Working together also allowed the Rand Water staff to find out first hand where the systems were inadequate, and to recommend changes or improvements in these systems.

The project objectives were described as:

- review current procedures and systems;
- design and implement appropriate systems and procedures;
- identify training and development needs of key staff;
- mentor the Bushbuckridge counterparts, so that by the end of the project they could demonstrate competence in their specific roles; and
- implement an effective performance management system for senior managers.

The project objectives were designed to ensure the following outcomes:

- implementation of efficient and effective procedures, processes and systems;
- effective utilisation of staff; and
- sustained improvement of the performance of Bushbuckridge Water.

The project outcomes were very ambitious, given a budget of less than R2 million over a two year period, and therefore it is not too surprising that they were only partially met by the end of the project.

The relevance of this work to the current research report is that it identifies additional areas in the water services chain where like-franchising or franchising opportunities may exist. It also highlights the need to be realistic in quantifying outcomes of capacity building projects, as the achievement of these are contingent on many factors, going well beyond the interaction of coach/mentor and counterpart. Perhaps the real lesson is that if Bushbuckridge Water had been part of a franchise network, where the franchisor was able to provide the systems, support and training that Bushbuckridge Water was lacking, it would have succeeded in achieving the outcomes more effectively.

Odi Retail Water

Rand Water was also involved in a much larger long-term exercise to develop a water services provider that would operate at the municipal or retail level in the North West province area of Mabopane, Ga-Rankuwa and Winterveldt.

From 1994, DWAF had to come to terms with the enormous responsibilities it had inherited when all of the homeland water supply schemes were put under its management and control. It rationalised a number of the water boards, resulting in new boundaries and responsibilities for the then Northwest Water Authority, and the Goudveld, Magalies and Rand Water Boards. Rand Water was in 1996 made responsible for the supply of water to the households in the Odi region, covering the three fledgling councils listed above.

This was the first time in its history that Rand Water had been made responsible for retail water services, as opposed to its core business of bulk service provision. It understood its mandate to be the provision of these retail services on behalf of the municipalities and not in its own right, and set about building a separate service provider which was called Odi Retail Water. The majority of the staff came from the Northwest Water Supply Authority who were more at home with performing day-to-day operational functions. One of the first tasks was to set up the systems to allow Odi Retail to operate as a standalone unit. This took place at a time while the non-payment culture was rife and still politically acceptable at a local level, despite which DWAF was insistent on reducing operational subsidies.

The agreement between DWAF and Rand Water, for the latter to take responsibility for the provision of retail water services in the Odi Region, was initially in the form only of an exchange of letters and not a formal contract. Political and legislative changes led, inter alia, to the Water Services Act of 1997. It then became possible in terms of that Act to appoint the local authorities as the water services authorities. This enabled two three-year contracts to be signed in 1999 between the Transitional Representative Councils of Mabopane, Ga-Rankuwa and Winterveldt, the Transitional Eastern District Council as the authorities and Rand Water as the Water Services Provider. After the local government elections in 2000 Tshwane MM and Madibeng LM became the Water Services Authorities, and they extended Rand Water's contracts to continue the water service provision role until June 2005.

Throughout this period the contracting provider was Rand Water, whereas Odi Retail was the business unit that undertook the actual service provision functions. The Odi Retail staff were employed by Rand Water on fixed term contracts which were linked to the term of Rand Water's contracts with the municipalities. The reason for this was that it was envisaged that at some point they would become the staff of the WSA.

Odi Retail provided a full service operation covering operations, maintenance, cost recovery, meter reading, billing, marketing and communications, It was responsible for purchasing water in bulk from Rand Water and distributing it to the end users, billing them for their consumption, collecting the revenue and following up on the non-payment on behalf of the municipalities. Rand Water provided the strategic direction, overall management, technical and financial skills that Odi Retail could not afford to hire full-time.

Rand Water and Odi Retail were successful in providing water services over almost a decade up to 2005. This corresponded to the most turbulent and dynamic period in the history of local government and thus in the water and sanitation sector. Both the coverage and the quality of services increased and more importantly cost recovery was improved from early lows of 25% to about 80%. Capacity building took place in all three of the WSAs and in Odi Retail. By the end of the period Odi Retail had been developed into a locally managed service provider, with all the competencies needed for running a full service operation.

Due in part to the success of the Odi Retail model, Tshwane MM decided in July 2005 to incorporate Odi Retail into its own Section 21 company, and to manage the water services provision through this entity. It has continued to make use of certain expertise from Rand Water. The decision by Tshwane MM effectively ended Rand Water's ability to provide retail services to Madibeng LM, bringing to a close Rand Water's role as a retail water services provider in the area.

In many ways Rand Water performed the role of financier of last resort, technical advisor, provider of systems and expertise and general support to Odi Retail Water. The views of the staff and management of Odi Retail were far less complimentary. They viewed Rand Water as not having sufficient understanding of local conditions, yet being overly strict and interfering in their operations. Much that could be learned from these tensions between the larger bulk provider and its retail business unit could be of value in franchising, in that these lessons could assist in designing a better relationship between franchiser and franchisee.

Whereas franchising in the water sector could be of delivery of the full-service or delivery only of individual elements in the water services value chain, the relationship between Rand Water and Odi Retail Water is a like-franchising example of the complete service delivery.

See also Ferreira 2001 for more historical background.

3.4.7 Public-public partnerships in the water services sector (2)

In addition to the kinds of PPPs, between Rand Water on the one hand and another water board or municipalities on the other, that are described in the preceding section, a number of the water boards and other public sector water services institutions offer to other public sector water services institutions a service that is aimed at one or other specific technical area of operation, rather than aimed at a broader combination of (usually) systems, procedures, training and technical improvement.

There is no particular reason for this report to case-study this, other than to provide a more complete picture of the nature of public-public partnerships, and to again raise issues around payment for the services provided by these partnerships.

Firstly Rand Water activities are described, then those of the East Rand Water Care Company (ERWAT).

It can be noted that a number of private sector water services institutions, e.g. WSSA, advertise that they offer similar services.

Rand Water

Rand Water has for a number of years been active in respect of a number of technical areas, including water demand measurement and management, and a programme to improve quality of the water in the watercourses supplying the Hartbeespoort Dam. Most of this activity is in the region that it supplies treated water to, but it has also been contracted by municipalities in at least two other provinces.

For example, it provides a substantial proportion of the water services technical expertise of two LMs on the West Rand, performing a range of services under contract. Included in this are community awareness, pressure management, and setting up a management information system.

Project management and the contribution of high-level technical expertise is by its own direct personnel, at no cost to the client, but for the greatest proportion of the activities, it uses subcontractors, at full cost to the client, under the supervision of its own employees. It does not and has never considered developing or assisting these subcontractors, and has never got beyond only considering possible franchising initiatives.

The record of payment on time by some of its municipal clients is not what it should be. Given its large turnover, it can carry this level of financial loss.

ERWAT

ERWAT is a Section 21 company established in the early 1990s by the approximately 20 LMs in the then East Rand. All bulk wastewater infrastructure of the LMs was transferred to ERWAT's ownership. Today it is a "municipal entity" jointly owned by the two MMs and the one DM whose areas it serves or partially serves, but more than 90% of the ownership is held by Ekurhuleni MM.

It advertises that it offers "tailored business solutions to your wastewater problems", and that possible services include operational management, advanced laboratory services, provision and maintenance of process control systems, training in both the scientific and operating fields, and project management. But this business has to date not been a significant proportion of its total activity. ERWAT operates under contract just a few water and wastewater treatment works for other, more rural, municipalities and also for industrial premises.

It realises the financial difficulties of the municipalities with which it contracts, and for that reason is not as insistent on on-time payment for services rendered as it is in terms of the contracts entitled to be. Some of its municipal clients are, however, habitual late payers for a variety of reasons, apparently including bureaucratic inefficiency. Given its large turnover, it can carry this level of financial loss. The bureaucracy has to be overcome by sheer persistence on the part of ERWAT's credit controllers and threats to stop service have never had to be carried out.

The work that it undertakes it performs using its own direct employees or subcontractors under the supervision of its own employees. It does not and has never considered developing or assisting these subcontractors, and has never considered franchising.

3.5 Introduction to "like-franchising"

This section introduces "like-franchising", explaining what is for the purposes of this report regarded as "like-franchising", and hence which initiatives are selected for description.

Each part of Section 3.6 describes one of the like-franchising initiatives in the water services sector in South Africa surveyed as part of this project.

To reiterate: the purpose of surveying these like-franchising initiatives is to discover what can be learned from them of ways to improve water services operation and maintenance. A purist "business format franchising" approach is not taken in this study. If better ways to operate and maintain water services infrastructure in appropriate circumstances can be learned from the initiatives, these ways must be reported, even if they are not "franchising".

Given the understanding of "business format franchising" summarised in Section 3.2 above, for the purposes of this report, like-franchising can loosely be regarded as having the design characteristics (using the phraseology of the table in Section 3.2) of business relationships:
- between a larger entity, which has the know-how and the business model; and
- a smaller entity, an "independent owner", that carries varying degrees of financial risk, has "low" to "medium" degrees of operational control, and receives "medium" to "high" support from the larger entity.

(Note that no comment is, or can be, made on "realistic success chances". That is after all hugely dependent on factors beyond the control of both entities, most certainly not part of the design of the relationship between the larger and the smaller entity.)

For the purposes of this project, in surveying the like-franchising instances, particular attention is paid to discovery of the "cardinal elements of the franchise process" listed in bullet point form in Section 3.2. Which of these elements are present? What role does each play? What can be learned for business format franchising of water services? What advantages, or disadvantages, do these like-franchising instances display compared to business format franchising?

3.6 Like-franchising in the water services sector in South Africa

3.6.1 Objectives, methodology and sequence of Section 3.6

Section 3.6 is the kernel of the project's contractual obligation to survey "water services sector provision in South Africa that has like-franchising elements" (1.3 of the "project schematic").

Seven like-franchising instances are described in Section 3.6. They are, in sequence:
- Alfred Nzo DM – support services agents (SSAs);
- Chris Hani DM – village water service operations and maintenance;
- Mbombela LM – urban and rural water service operations and maintenance by a concessionaire;
- eThekwini MM – VIP pit-emptying;
- Maluti-a-Phofung LM;
- Metsi-a-Lekoa – municipally-owned water company; and
- PWMSA – interest in being water services franchisors.

The reason for this order is:
- the need to start with Alfred Nzo DM, because that describes SSAs, and that description is needed for some of the others;
- the need to end with PWMSA because it is more the advancement of an argument than it is a description, and because it is the most blatantly private-sector driven – so in many ways it is the one end of a spectrum; whereas
- the order of the rest is not important, nor significant.

All of these involve outsourcing. None are strictly speaking franchising, in the sense of "business format franchising", at all. Whether some of these are even like-franchising, is debatable. But all are listed here, and are at least briefly described. The sole criterion for their inclusion is that they are in a relevant aspect of water services, they are South African, and from them a lot that is of value to our investigation can be learned.

Like-franchised water services can be either of:

- like-franchising offering a full range of water services, even if only for specific properties rather than for, say, a whole urban area; and/or
- like-franchising under contract to WSPs, offering selected elements of the full range of water services activities (e.g. domestic plumbing repair and/or refurbishment and/or upgrading, meter maintenance, billing).

For convenience, the first of these is in this chapter referred to as "Type 1", and the second as "Type 2".

The Chris Hani DM initiative, Mbombela LM, and the Alfred Nzo DM SSAs, appear to be Type 1. The other four, and also The Drain Surgeon (see Section 3.3 above), appear to be Type 2.

It would have been most useful to have been able to cover in the descriptions the points listed immediately below, or as close to them as might have been possible. The purpose of these brief case studies, to reiterate, is to learn from these experiences whatever it is useful to an improved understanding of the suitability of franchising in the water services sector in South Africa, and to assist in designing an institutional framework that, while not necessarily being strictly speaking tailored to franchising, could bring to the benefit of the sector those principles of franchising that would be most appropriate.

It was never going to be possible to cover more than a few of the points each time, for a number of reasons, including space constraints in this report, and the varied nature of the cases. Obviously, also, that none of them are actually franchising, and for that and for other reasons so much simply has not been considered, e.g. the undertaking is finding it difficult enough to keep its operation going, with the result that it has not found it possible to give thought to expansion.

Another reason is that major players in the case studies would not necessarily wish to give all the information required. This constraint would especially apply to private sector participants, who would not wish to reveal aspects of the businesses, or their plans, that they felt gave them competitive advantage.

Despite these limitations, the case studies do provide very useful information.

The points are:

- Something about the municipality or the company or NGO in general, e.g. nature of the area, or how the franchisor or franchisee started and who runs them or owns them;
- The way they operate with particular emphasis on the factors most pertinent to franchising, such as:
    - Who had the knowledge of the water services value chain, and in particular of the parts that have been franchised and how did they gain that knowledge, and know what is suitable for franchising?
    - Who is the franchisor? What does it do?
    - Who are the franchisees? What are they vetted for? How are they selected? What numbers of franchisees are involved, and how big are they? What do they do?
    - Setting up franchisees (or, more correctly in this section, the "near-franchisees"), what training and how, capital financing (and for what purposes?), etc. Who then owns what physical things, e.g. call centre, equipment, vehicles?
    - Ensuring quality control and what if not compliant with the franchise agreement? What can be done to improve compliance? What happens when the franchisee fails (and has this happened?) and how is the water service continued through any transition? How can the franchisor limit his liability if the franchisee messes up?

    - What are royalty payments based on (e.g. on franchisee's turnover?);
    - Are the franchisees branded? (i.e. common national logo, common name in the telephone directory);
- Financial viability, covering issues such as who pays for the service, subsidies if any, are there unreliable payers and what proportion are they and how threatening is this and what can be done about it (i.e. how to reduce the risk?). Also what about erratic demand for the service (is this the case?), and/or possible slowing down of demand for the service?;
- Replicating the model, and extending it (if it is not already there) to the lower income areas. How, where, what experience (and what plans)?. Another way to put this question is, if the business model has been tried and proven to work in a particular type of the area or socio-economic group, could it be replicated in other areas or among other groups? And what areas or groups? And what particular measures should be taken when replicating? (This question is partly prompted by The Drain Surgeon experience, i.e. this franchisor originated in and has its current customer base overwhelmingly in middle income areas where users of the service can afford to pay, but is now trying to replicate in lower income areas, and/or trying to convince a municipality is that it can provide service better and cheaper than the municipality can.);
- Assessment of which type it is on the table from Illetschko in Section 3.2 above;
- Lessons as to what has gone well, and why, and what has not, and why and how, with hindsight, it might have been done better, and why;
- A final section on summing up the main strengths and weaknesses of this outfit and the way it operates or conducts its business; and
- What can be learned for business format franchising of water services? What advantages, or disadvantages, do these like-franchising instances display compared to business format franchising?

Of the descriptions that follow, the description of PWMSA breaks the above pattern the most, because the value of Section 3.6.8 lies in the description of what this franchisor, experienced in parallel fields of water services provision, considers are the principal issues around franchising municipal water services or parts thereof.

3.6.2 Alfred Nzo DM – 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 SSA to support smaller locally based WSPs. With the fundamental difference that the small WSPs supported have thus far invariably been "not-for-profit" organisations, such as CBOs. (The SSAs have been a mixture of NGOs and private sector.)

An example is where the Alfred Nzo DM, a WSA in the Eastern Cape (the municipality that includes Matatiele LM, Mt Ayliff LM and Lady Frere LM), in 2001 opted for a process of developing community-based WSPs, supported by SSAs. Alfred Nzo DM divided its area into thirds, and awarded contracts for playing the SSA role in each area. Two contracts went to private sector companies and one to the NGO, Mvula Trust. (The two private sector companies were the "WASH consortium", led by Water and Sanitation Services South Africa (Pty) Ltd., and the consulting firm Maluti Water. (Vapi, 2002; Moat et al., 2003; Illing et al., 2005 and a long list of references given in Wall, 2005a provide a mine of information on the role of an SSA.)

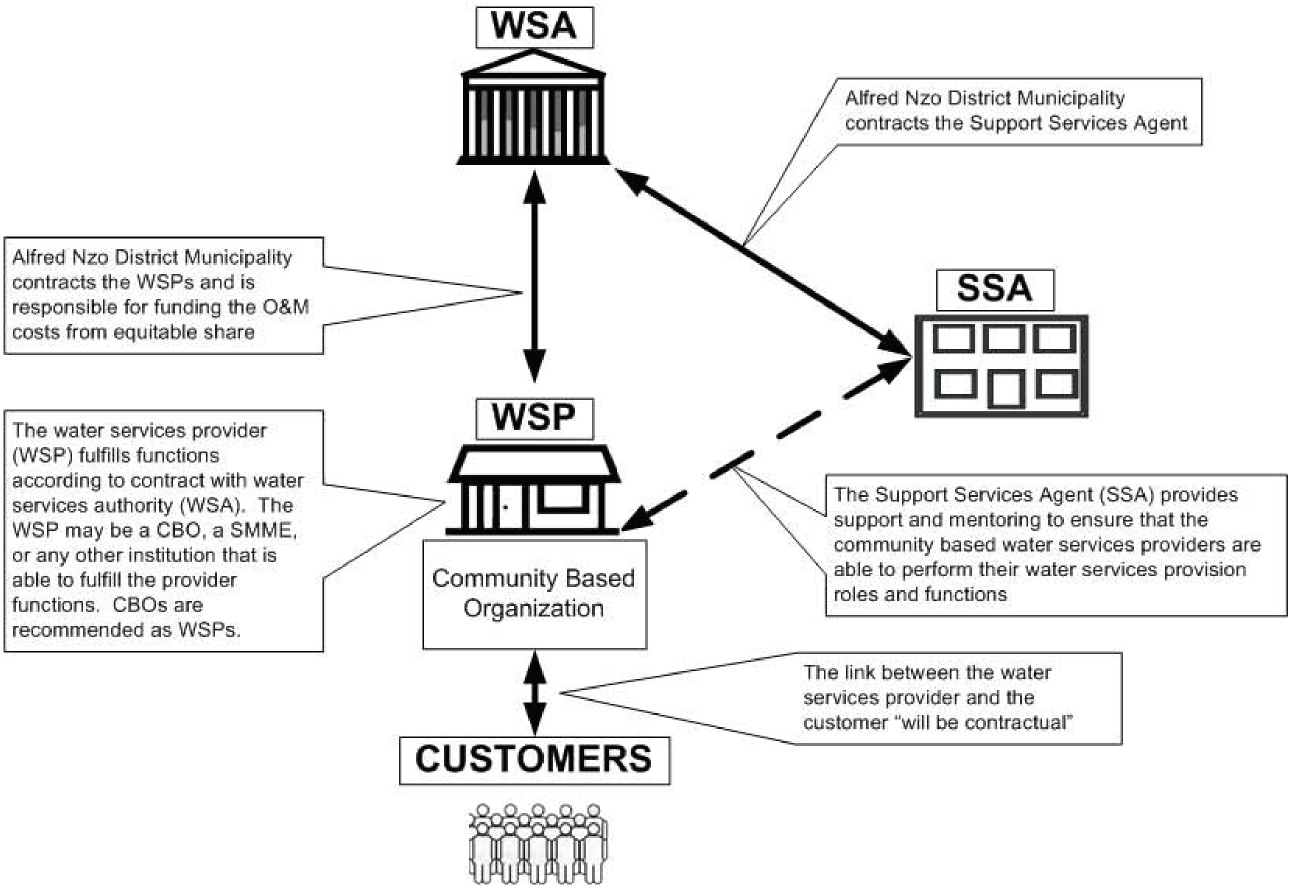

Figure 3:2: Alfred Nzo DM water services provision arrangements

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 these are maintained and are functional. The Alfred Nzo DM, 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 at the time felt that it 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 also see some benefits in working with and building community organisations in this way.) In an effort to ensure proper service delivery, the municipality appointed SSAs 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, 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." (Vapi, 2002:5).

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.

The current researchers 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 of Wall, 2005b.) So close, in fact, that if both SSA and WSP were for-profit organisations, then the SSA would to all intents and purposes be a franchisor. In the Mvula case described here, however, the SSA and all the WSPs are non-profit organisations.

From 2001 to 2005 Mvula provided SSA support to 35 water schemes benefiting 100 000 people in approximately 100 settlements in the Umzimvubu South (Mount Ayliff LM and Mount Frere LM) area. The SSA support to municipal officials and community-based structures included the provision of both technical and institutional support, and mentorship to community-based structures to ensure efficient and effective functioning of potable water supply schemes to mostly rural communities. Figure 3.2 (based on de la Harpe, 2003:6) captures these relationships in diagrammatic form.

Mvula's SSA activities in the 35 schemes included:

- household, institutional and technical surveys;
- minor repairs and refurbishment undertaken;
- emergency technical support;
- vandalism dealt with, very few cases are being reported;
- skills audits, training needs assessments and training for WSP board members and scheme operators;
- gender issues are mainstreamed. (In 2003, 60% of the WSP board members were women. Securing women operators remained a major challenge.);
- implementation of free basic water policies and procedures; and
- continued support and mentoring of the WSPs.

A 2003 review identified constraints and weaknesses within this CBO-based institutional model in terms of water services and local government legislation. Nevertheless the model is "successful" in providing basic water services to the Alfred Nzo DM's rural communities. (de la Harpe, 2003:4).

A 2006 review stated that "the project has convincingly demonstrated the ability of CBOs to ensure reliable water supply over time, provided that they are well empowered and provided with the necessary resources and support to carry out local operation and maintenance functions. They could therefore function as extensions of the WSA's preferred WSP arrangements." The project also demonstrated that municipalities stand to gain "a number of [other] advantages through CBO managed water supply" including "economic spin-offs, where funds remain in the community, and community members acquire entrepreneurial and development skills." (Mvula 2006:59).

About procurement:

The 2001 contract appointment stipulated that the SSAs work to develop and implement a process for selecting and empowering CBO WSPs, and thereafter to provide necessary institutional support to the WSA and the WSPs while ensuring that all schemes remained operational. (The appointment covered also refurbishing all infrastructure to its original status as first constructed.)

Following extensive workshopping in each selected village, each village community was requested to form a group or groups interested in becoming WSPs for their villages. These groups were then asked to submit expressions of interest. On average three to four expressions of interest per village scheme were received. An adjudication committee, on which the municipality, community and SSA were all represented, was established for each scheme. The committee advised the municipality, which then made the appointment. (Mvula 2002).

A 2003 review of the Alfred Nzo DM's SSA arrangement stated that the biggest constraints facing scaling up community management are the requirements of local government procurement legislation.

The review analysed the Alfred Nzo DM's SSA arrangement in terms of water services and local government legislation. South African policy identifies CBOs as one of the mechanisms for the delivery of municipal services. However, local government legislation requires municipalities to implement a competitive bidding process before appointing CBOs as service providers. Whilst the institutional arrangements successfully achieved community operation, and to a lesser extent, community management of the water services, the implementation of the Alfred Nzo DM model did not fully address various legislative requirements, particularly requirements related to the selection of CBO options. Increasingly the municipality and the SSAs have attempted to identify institutional models that address the various legislative requirements. However, these models were significant deviations from the CBO services provider model that was originally envisaged, and "which works in practice". In attempting to address legislative requirements, the municipality also became constrained in terms of formalising the existing community management arrangements. Consequently the institutional arrangements remained interim arrangements with complexities concerning responsibilities and the spread of risk between the different parties. (de la Harpe, 2003:34-51)

Thus, in addition to contracting Mvula Trust to be the SSA, the DM appointed it as a WSP, a type of "super-WSP", with CBOs contracted to it to perform a local WSP role. This was a device to get around the requirement of Section 78 of the MSA that lays down procurement procedure, including that all WSPs can only be appointed only after a competitive bidding process. Following this procedure would severely complicate if not prevent the WSA from achieving its objective of empowering CBOs to perform the WSP role. (Rall personal communication 2003).

Were it not for this arrangement, there would no doubt have been 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, namely, 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. Conflict could arise 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 have been inappropriate, given that the WSP is a CBO, and the WSA was trying to be as supportive as possible of the CBO, even if service might suffer.

Furthermore: “It is contradictory for a municipality to provide capacity support to a CBO on the one hand, whilst on the other hand a CBO becomes part of a competitive procurement process. Other parties tendering could argue that the procurement process is not equitable or fair, because the municipality has already “prepared” the CBO for the water services provision function.” (de la Harpe, 2003:16)

The competitive bidding requirement, it was felt, undermines “tried and tested approaches to establishing community management arrangements”. This case study questions “the extent to which municipalities should comply with [procurement] legislation that clearly slows down and impedes the delivery of basic services to poor communities in rural areas”. (de la Harpe, 2003:34-51).

Jones et al. agree that "CBOs, in particular, are prohibited from registering as formal bodies (Section 21 non-profit firms), and thereby face difficulties competing in open tender processes." (Jones et al., 2005:29).

Events in 2005:

Despite the prediction in 2002 that “…there is growing realization within the sector about the importance of setting up SSA arrangements in rural settings” (Vapi, 2002:5), in 2005, there was a "major political upheaval" in this DM. The DM's driver of the community-based WSP programme was placed in such a "difficult position" that he quit. The municipality dispensed with the services of all three of the support services agents. Their contracts were for 12 months at a time, annually renewable, and were not renewed during 2005.

The DM district municipality has now taken over as its own WSP. "We have not gone to look" to see how the new arrangement is getting on. Mvula does not know if water services provision is still as effective as it had become under the community-based WSP programme, it "may have" fallen apart. (Davids personal communication 2006).

3.6.3 Chris Hani DM – village water service operations and maintenance

The Chris Hani DM (CHDM), one of the six DMs in the Eastern Cape, is the appointed WSA for the eight LMs in the district. These LMs have varied characters. The Lukanji LM includes the towns of Queenstown and Whittlesea as well as a large rural population, and the Insika Yethu, Engcobo, Sakhisizwe and Emalahleni LMs comprise predominantly rural areas previously falling under the Transkei. The Inkwanca, Tsolwana and Inxuba Yethemba LMs are characterized by a sparse population in small farming settlements.

In 2003 the CHDM embarked on its “Refurbish, Operate and Maintain Programme” (ROMP) and appointed external service providers to assist it with its water service provider functions in the four of its LMs that consist mostly of the expansive rural settlements of the former Transkei and Ciskei:

- WSSA for the Insika Yethu LM;
- The Mvula Trust for Engcobo LM;
- Maluti Water for Sakhisizwe LM; and
- Amanz’ abantu for Emalahleni LM

All the above service providers (in effect SSAs) were appointed on the basis that they have the required experience in community-based approaches, and also that they have sufficient financial capacity to bridge-finance the working capital needed to fund the monthly wage bills and the monthly cost of procurement of goods and services. (Theoretically 30 days bridge-financing required, but in practice up to double that.) The service providers then each month claim back these costs, plus a management fee.

Important further qualifications for the ROMP service providers include being able to render the following services:

- project management;
- planning and budgeting;
- water quality and the management of water and wastewater treatment processes;
- training and development;
- procurement of goods and services; and
- mechanical / electrical repair and maintenance.

These contracts were short-term (2003-2006) support services contracts on a time-based and cost-plus approach. The reason for the short duration and flexible nature of these contracts was that CHDM was expecting to have to take transfer from DWAF of a number of schemes, and the contracts had to be able to accommodate the different nature and state of these schemes, together with a flexible timetable for their taking over.

Whilst the approach of the different service providers differs marginally, in general, the operational organizational structuring has been done utilizing community-based operators who are responsible for the daily village level operation and maintenance. These CBOs were selected on the basis of nomination by the village water committees for training and appointment as “Community Service Providers” (CSPs). These CSPs were formed into associations comprising a number of community-based members and were tasked with undertaking the ongoing day-to-day operations of the village schemes within a defined area (i.e. a group of villages). A typical CSP comprises a chairperson, secretary and treasurer, and a number of village caretakers who are responsible for overseeing the day-to-day operations in the villages in the area. The CSP functions include, in addition to their normal administration and operational functions, liaison with the village structures, traditional structures and municipal ward structures.

The CSPs were required to associate and open bank accounts (with a minimum of 3 signatories) and are paid monthly in accordance with the agreed monthly rates as verified by the ROMP service providers, who in turn include these CSP costs as part of the overall ROMP contract costs which are paid by the CHDM. The CSPs are approved by the CHDM in its capacity as the WSA, and are under the management and direction of the ROMP service providers who act as the agents of the CHDM. The ROMP support services agents are also responsible for undertaking the management and procurement of any repairs and/or refurbishment.

The function of each CSP is dependent on the scheme it operates, but typically it is responsible for switching on the pumps, checking and recording the water levels in the reservoirs and recording bulk meter readings, etc. A CSP is also responsible for ensuring the community standpipes are serviceable and that no household is tapping into the system illegally. Where major repairs are required, the operator contacts the ROMP service provider, who then sends out a repair team.

The ROMP programme has included recruitment and training as well as direct supervision of the former DWAF staff who were transferred from DWAF to the DM during 2005. With the DM’s Section 78 process now nearing completion, it is anticipated that in January 2007 a new tender/s will be issued, again calling for ROMP-type service providers.

This is speculation on the part of the team, but, given the success of the current arrangement, it is possible that an adaptation of the ROMP service provider model that brings it closer to franchising could be adopted. Should this be the case, a few like-franchisor service providers could be pre-qualified to undertake work in the area. Thereafter local entities would be invited to tender for the responsibility, supported by the pre-qualified franchisors, for the full range of water services provision functions in a small town or a rural area.

This approach would accommodate the local economic development (LED) policies of the CHDM whilst ensuring both the necessary capacity and quality of service for the delivery of the rural water services.

3.6.4 Mbombela LM – urban and rural water service operation and maintenance by a concessionaire

(The team is indebted to Gibson for the basis of the description that follows. Any interpretation is however the responsibility of the team.)

The winner of the contract was obliged to set up a special purpose vehicle (SPV), and there were various requirements pertinent to this SPV, including BEE requirements. The actual wording in the contract said that a “concession company" had to be established. This company had to be distinct from the operator although the operator was required to maintain a minimum shareholding of 25%.

The successful bidder was Biwater UK, which, several years after the contract was signed, struck a deal with the Dutch company Nuon, in terms of which contracts outside of Europe would be run by a new jointly owned company called Cascal.

Negotiations continued for two years after the closing of the bids before there was contract signing. Then another six months passed before financial closure and the start of operations (the end of 1999).

Finance (particularly the heavy capital investment that has been required, not to mention operating expenses) has had to come from the operator, who has in practice used own equity, a Development Bank of Southern Africa (DBSA) loan, and other loans.

The institutional setup at the time of writing (2006) is that Cascal is the "operating company". The "concession company" (this is using the language of the contract) is "Greater Nelspruit Utility Company" (GNUC), which is trading as "Silulumanzi". The concession company has a contract with Mbombela LM, which is the WSA.

Cascal is a shareholder in GNUC, and also has a contract with it, as the “operator” of the services. The shareholders of GNUC are Cascal, the BEE company (which is a company in turn owned by a number of other companies, as its shareholders) specially set up for the bid, and others.

Gibson, who was heavily involved in assisting the municipality with setting up the contract arrangements in the first place, and has recently completed the "five-year contract review", was unable to see how any of the institutional arrangements could be described as franchising. He pointed out that:

- Cascal has put its expertise into the GNUC. But that's not franchising; and
- GNUC makes use of local consultants and local contractors. But this is normal outsourcing, following the principles of normal municipal procurement rules (GNUC is obliged to use these rules), and also is not franchising. (GNUC is, in terms of its contract with the WSA, obliged to use municipal procurement rules, even though it is not a municipal entity, but a privately owned company.)

GNUC has trained local contractors, in particular plumbers, and then put them on a list of "approved contractors" that householders may use. But these are independent business entities, and not franchisees. It is no different to having an approved list of plumbers, as many municipalities have had for many years. (Gibson, personal communication)

3.6.5 eThekwini MM – VIP pit-emptying

(The team is indebted to Davis, and to documentation that he has provided, for the basis of the description that follows. Any interpretation is, however, the responsibility of the team.)

Background

It is estimated that there are between 100 000 and 120 000 pit latrines within the eThekwini boundaries. Assuming that each needs to be emptied on a five-year cycle, that means that 20 000 to 25 000 need to be emptied each year. The eThekwini MM has resolved to provide one free evacuation per pit latrine every five years until the backlog in other forms of sanitation have been addressed.

However, the terrain is so steep and rough in many parts of eThekwini MM that, aside of other considerations as to the physical and institutional method of emptying the pits, there are many instances where a pit cannot be emptied by a machine such as by a suction tanker. For example, steep and rough terrain, and not much space between dwellings results in the suction tanker not being able to get sufficiently close to the pit. For another example, many households put trash into the pit, including bottles and newspapers and so on, that clog up the suction hose. As a result manual digging can do the job whereas the tanker cannot. For a third example, the pit contents get very thick at the bottom and become like "toffee" which is very difficult to suction out, and the only practical way to get it out is to dig out by hand (of course it can be taken out by suction if the toffee is deliberately diluted with water, but that increases the volume of material that has to be disposed of). "We found that by hand is cheaper than suction tanker." (Martin personal communication 2005).

Currently, eThekwini MM empties the latrines or, more correctly, has the responsibility for emptying the latrines. However, emptying pit latrines has not yet become a major issue, because most of the latrines are still too new, but the task will escalate as the pits fill up.

Franchising the task

One of the stated objectives in the eThekwini MM IDP is that sustainable businesses be encouraged. The franchising initiative had been undertaken in that light, and also in that the municipality was generally looking at means of shedding non-core functions.

eThekwini MM realises that it has to make provision for the emptying of the pits, but would prefer not to have to do this departmentally, so it has been investigating alternative institutional arrangements. In the process of doing so, it conceived the idea of what it refers to as "franchising", although strictly speaking it is a management contractor arrangement with additions.

eThekwini MM has decided on a model that has elements of the Extended Public Works Programme (EPWP), franchising and management contracting, being support by main contractor of a group of emerging contractors (i.e. SMMEs). The main contractor would not be paid a straight fee, but would be incentivised through the fee in such a way that it is in his interests that the emerging contractors succeed.

eThekwini MM is calling it a "franchise" although it is not even close to being a franchise in the full sense (e.g. branding, longer term relationship than only five years, etc). eThekwini MM chose this name because it wished to make it clear that the institutional arrangement needed to be substantially different from the "management contract" image, and the boundaries to the skills needed that are usually implied by using that term.

The main contractor is envisaged to be an established company that possesses civil engineering and management contracting skills, but brings on board, if necessary by means of temporary alliances, a full range of the following skills:

- technical;
- financial;
- training (of the franchisees);
- community liaison; and
- project management.

The pilot project used a contract form closer to the management contract model than that which is envisaged for the full-scale rollout.

An objective is that the emerging contractors will after the end of this contract be capable of contracting on their own. Another, related, objective is that, in the long term, householders would be paying the contractor as a private arrangement.

The emerging contractor is seen as being in business for the long term. Emptying pits, but, also, he will have learned (through on-the-job and also formal off-site training) skills in business, and in organising labour. (He will have a qualification in terms of the National Qualifications Framework (NQF).) He will also have a R200 000 bakkie that has been paid for through the franchise contract, and hopefully would still be in working order. (eThekwini MM is buying the bakkies, and the franchisees will undertake to repay the municipality for these over the five years.) He will also have established a sound credit rating.

The labourers will also have a documented qualification for the on-the-job training that they will have received.

Other municipalities are taking a keen interest in this project, for the compelling reason that they are or will soon be facing a similar need to empty substantial numbers of pits. For example Msunduzi LM, which has 30 000 pit latrines, and similar terrain.

The pilot project

A pilot scheme (a 12-month contract, 2004-2005) preceded the process of calling for tenders that commenced in 2005. A number of improvements to the process were made as a result. For example, it was found cheaper (compared to transporting the product all the way to the nearest wastewater treatment works) to site a number of skips much closer than the treatment works. These will be located over sewer mains, so that the contractors will be able to empty into a skip with direct discharge into the sewer.

The first full-scale rollout

As the "Franchisee contract for the evacuation of pit latrines in the eThekwini area procurement document" (eThekwini 2005a:23) noted, “the eThekwini Municipality wishes to encourage the development of franchisees within the civil engineering sphere and to this end is prepared to enter into agreements with suitably selected persons to undertake certain engineering type contracts.”

> "…contracts will be granted for the hire of emerging franchisees, together with their labour teams and inclusive of the provision of an item, or items, of plant. This will qualify the emerging franchisees for access to financial resources not normally available to such persons. In view of the inherent financial risks involved by the financial institutions, it is deemed prudent to involve the services of a franchisor to assist and be part of the emerging franchisees' administration whilst providing the necessary advice and training in order to ensure the long term success of the venture.”

In selecting the contract philosophy contained in this document, the Employer has addressed 4 important issues, namely:

- To address the basic needs of the affected communities;
- To encourage the development of small businesses;
- To maximize the utilization of local labour; and
- To carry out the project in the most cost efficient manner." (eThekwini 2005a)

Not stated in the contract documentation is that eThekwini MM envisages that the contract may last as long as five years, and has set aside the funding for this (R70 million all-inclusive over five years).

Franchisors will pay the franchisees on a two-week cycle, but will themselves only be paid monthly. The turnover of each franchisee would typically be of the order of R1.2 million through R1.5 million per annum (based on the examples given in the annexures to eThekwini 2005a).

Between ten and 12 franchisees will be selected from eThekwini MM's database for learnerships under the EPWP. It is intended that, after their 3-5 year learnership, they will be fully trained SMMEs, with certain assets, a sound credit rating and the capability to tender on the open market.

Each franchisee will be allocated an area within which responsibility for emptying the pits is his. He will be required to hire local labour and to make use of community liaison officers to assist him with the smooth running of the project.

Progress

At the time of writing (October 2006, nearly a year after the invitation to tender), the contract had still not been let. Whereas all parties were in agreement that they wanted the franchising contract, letting of the franchisor contract was "still tied up with procurement processes". (Davis personal communication 2006)

3.6.6 Maluti-a-Phofung LM – setting up a municipal services entity

During the late 1990s, officials at the then Harrismith Transitional Local Council investigated using an external service provider for their water and sanitation services. Initially they tried to promote establishing a PPP, but the councillors were not prepared to take such a step, preferring to contract a public sector water services provider, and Rand Water was approached. The process was facilitated by the Municipal Infrastructure Investment Unit (MIIU), and a three year contract was signed shortly prior to the municipal elections in December 2000.

After these elections Harrismith was incorporated, along with Qwa-Qwa and Kestell, to form Maluti-a-Phofung LM. The new council inherited two water boards providing services in its jurisdiction, *viz.* Rand Water in Harrismith and Sedibeng Water in Qwa-Qwa. These contracts were monitored by a monitoring office, consisting of an external consultant and a municipal official. The contracts were managed through a coordinating committee constituted of Maluti-a-Phofung LM (the designated WSA), the two water board WSPs and the monitoring office.

The contracts with the WSPs due to end in June 2004 were extended to allow the municipality to complete its Section 78 process and to appoint a "strategic partner". Accordingly, in late 2004 Maluti-a-Phofung called for tenders for the appointment of a strategic partner to manage the formation and structuring of a new water entity, to be known as Maluti-a-Phofung Water (Pty) Ltd ("MAP Water"), that would become the water services provider for the entire Maluti-a-Phofung municipal area. A 6-year strategic support agreement was signed in November 2005 with Uzinzo Water Services (Pty) Ltd (Uzinzo), which is a joint venture between Amanz' abantu (80%) and

WSSA (20%). MAP Water, a municipal services entity wholly owned by the municipality, was incorporated at the same time, and in due course it entered into a service delivery agreement with the WSA, Maluti-a-Phofung LM.

In terms of the strategic support agreement, Uzinzo is required to appoint certain key managers of MAP Water, including the Chief Executive Officer (CEO), Financial Manager and Operations Manager. In addition, Uzinzo is to provide other support functions related to ensuring the start-up and structuring of the new water entity and undertaking the strategic and business planning which is presented to the WSA for its approval. The annual business plan includes a number of Key Performance Areas (KPAs) and their associated Key Performance Indicators (KPIs) against which both MAP Water and Uzinzo will be appraised. A Board of Directors comprising the MAP Water CEO as executive director along with two non-executive directors answerable directly to MAP Water, as the sole shareholder of the new water company, was appointed.

When Rand Water and Sedibeng Water were each originally appointed, the process of integration of the former municipal and homeland staff into a new WSA was started. With the incorporation of MAP Water, this process is now completed.

At the level described so far, this arrangement is clearly not a franchise or “like franchise” arrangement. The decision by the Maluti-a-Phofung LM to bring in specialist water sector partners to provide the strategic support for the 6-year start up is, however, recognition that all but a very few South African municipalities require external support, particularly technical support. The approach being taken recognizes that the provision of water services also requires a business approach. Hence the manner in which the new entity is being structured and run is clearly that of a separate business entity.

In terms of this business approach, generally the core functions are managed in-house. Opportunity would exist in respect of the non-core and ad-hoc functions, which are outsourced, for small business to provide services within the total value added chain. Services which MAP Water could outsource to SMMEs include:

- meter reading;
- leak detection and management;
- domestic plumbing services (although this is the responsibility of the consumer);
- pipe repairs and replacement;
- gardening and cleaning services;
- laboratory and water quality services;
- mechanical and electrical repairs and maintenance;
- information technology; and
- communications.

For more historical background, see van der Merwe et al., 2001; Smith et al., 2003; MIIU, 2006.

For lessons to be learned, see Smith et al., 2003:

- the problems caused by the turnover of municipal councillors "with experience in governing", even if they are all from the same party, (Smith et al., 2003:27);
- the "human resource scarcity" with which the "contract-monitoring role" of the municipality "is plagued", particularly in respect of engineering skills, (ibid:15);
- the importance of "a good outside consultant who is able to, through his independence, confront both Rand Water and city council when they have failed to fulfil their responsibilities", (ibid:14); and
- "the support by SAMWU at national and local levels [which] has created an environment conducive to improvements in the performative culture of the workplace". (ibid:2).

3.6.7 Metsi-a-Lekoa municipally-owned water company

According to DWAF, Emfuleni LM has, as a direct result of the rundown state of its water services infrastructure, been responsible during the last seven years for the spillage of raw sewage into the Vaal Barrage. (DWAF 2006a).

Responding to pressure from DWAF, its own citizens and concerned environmental groups, Emfuleni decided to change the manner in which it provided water services, moving away from the traditional municipal department.

Following a Section 78 assessment carried out in 2002, Emfuleni LM negotiated with Rand Water to establish a jointly owned WSP. This company, Metsi-a-Lekoa, was to be partly funded by Rand Water in return for a 29% equity stake, and Rand Water would have provided badly needed technical, financial and management skills. This initiative was, however, conditional on Emfuleni LM raising the balance of the funding, and as the funds were not raised timeously, the parties terminated the agreement in 2004. In addition it was understood that National Treasury had decided not to further support this institution, as a company jointly owned by a municipality and a water board would not be a permissible form of institution. (Ibid)

Instead, National Treasury approved a R130 million restructuring grant for Emfuleni LM, (all services, with about 50% earmarked for water and sanitation). Treasury, with the assistance of DWAF, would transfer the amount in stages, and progress against set KPIs would be monitored.

Emfuleni LM then proceeded with the establishment of Metsi-a-Lekoa, as a corporatised WSP for the municipality. DWAF initiated support activities for Metsi-a-Lekoa and the LM in the following areas:

- capacity building;
- tariff setting;
- free basic water policy implementation;
- credit control;
- communication/ consumer awareness campaign; and
- water conservation and demand.

In August 2004 Metsi-a-Lekoa appointed its own CEO and took over the staff and functions of the municipal water and sanitation departments. One of the benefits of the negotiation process with Rand Water was the development of business plans to improve the viability of the water services Metsi-a-Lekoa. It implemented initiatives, some of which are described below, to reduce water losses, control pressures in the distribution networks and increase revenue collection.

Most of the outsourcing has been in terms of normal outsourcing contracts between Metsi-a-Lekoa and external services providers. Metsi-a-Lekoa is, however, consciously trying to find ways to allow SMMEs and CBOs to benefit from its outsourcing, and it has made progress in this respect in the three areas described immediately below. The successes and failures of these three initiatives, and others that might be identified in the future, will in the course of time provide insight into franchising opportunities in the local government environment.

Meter reading services

Metsi-a-Lekoa is trying to involve community members and community businesses in meter reading. It has contracted a capacitated partner, Water Management Services (WMS), to assist it.

Pressure management

Metsi-a-Lekoa identified a need to reduce its huge water losses (in some areas, of the order of 80% of the water supplied to the area (McKenzie et al., 2006:1), and called for proposals to address this. One of the successful proposals was for a pressure management scheme. By controlling the pressures in the pipelines and lowering them during periods of low demand, such as late night and early morning, and increasing them again during periods of high demand, the amount of water lost through leaks etc. can be reduced substantially. (See also Section 4.3.5.)

Early in 2005, Metsi-a-Lekoa appointed WRP Consulting Engineers (WRP), the successful tenderer, to install a pressure management control point at the entrance to Sebokeng. The five year contract is notable in that it is based on a risk/reward model rather than a straightforward contract for services. WRP installed the pressure management infrastructure at their cost after agreeing a baseline of existing water supplies to the area for the previous twelve months with Metsi-a-Lekoa. Each month the actual volume of bulk water supplied to Sebokeng is measured, adjusted for extraneous factors, and finally approved by an independent assessor. WRP are then paid a percentage of any savings in the volume of water supplied.

The work is of a technical nature and the funding that WRP had to borrow is substantially beyond the capacity of most if not all SMMEs to raise. However, this project does indicate the benefits that could accrue to WSAs that are prepared to find innovative solutions and take a broad approach to utilising the private sector.

Leak repairs on private properties

Metsi-a-Lekoa contracted Rand Water and (separately) the Alliance to Save Energy to undertake repairs to leaking water infrastructure on individual, private properties in several areas of Sharpeville. The work is highly labour intensive and is an ideal opportunity for SMME development, both on the technical side and in the community interactions and communications arena.

The problem is that these tend to be intermittent projects and not continuous work.

Leaks in low income areas result in large water bills for the residents, who cannot afford to pay these amounts and so the costs end up being borne by the WSP or WSA. In many instances it has proven cheaper for the WSP to spend money on fixing these private leaks and reducing the amount of water that is used and not paid for. The business model is based on the considerable savings achieved if the leaks on individual properties are repaired.

Initially these projects were intended to be a once-off assistance to residents, after which they would be required to maintain their own toilets and pipes. Thus, although this type of work has a simple business model, the problem is that once a leakage reduction project is completed, the amount of this type of work reduces considerably, and those employed on the project would have to find other opportunities. However, it has been found that low income families do not spend money on maintenance and the level of water wastage soon climbs again. Thus there is a possibility in this field of ongoing opportunities for SMMEs, and perhaps for franchising.

3.6.8 PWMSA – interest in being water services franchisors

About PWMSA and the way it operates

PWMSA claims to be the "largest independent water treatment company in South Africa". (That is, in contrast to other water treatment companies, which they say are spin-offs of suppliers of chemicals, or spin-offs of construction companies.)

Their field is "anything where water is involved", but especially water and wastewater treatment. Their approach is to relieve the organisation that owns the water infrastructure of having to worry about the water side of its business. For example, for a manufacturer, PWMSA would take total responsibility for pre-treatment of effluent, ensuring its discharge to DWAF specification. Factory management, freed of concern about the water side, is thus able to focus on its core business i.e. manufacturing.

PWMSA prefers contracts where its reward is based on results, on meeting a specification. How PWMSA meets that specification is at its discretion. The means could be upgrading, they could be capital equipment, they could be chemicals, or they could be expertise or it could be more than one of these, in combination.

"We know exactly what business will make a small water treatment company sustainably successful." (Swanepoel personal communication)

PWMSA has categorised the types of work that they do into a couple of dozen "project application categories".

PWMSA has successfully applied technology which they have developed themselves, and technology that they have imported via their overseas links. But they are also discussing a relationship with the WRC, about applying technology that the WRC has developed.

PWMSA grew out of a niche supplier of chemicals and process technology to manufacturing industry that was founded in 1990. Following a series of expansions, it linked up with a European water treatment technology company, and PWMSA was formed in 1999. The core of the current PWMSA group is a holding company, a separate product manufacturing company, and eight franchisee companies each of which operates within a province (and Swaziland). Whereas the group as a whole is too large to be regarded as a medium-sized enterprise in terms of generally accepted definitions of SMME, PWMSA regards each of the separate companies to still be of SMME size.

Some of their franchisees cover a whole province in respect of a particular product application category. They could in theory have more than one franchisee in a province. The franchisees are branded. Thus, for example, a customer in Cape Town is served by the franchisee "PWM Cape Pty Ltd".

Most franchisees of PWMSA have more than one contract, generally are active in more than one product application category activity, and have more than one customer in each. But always using "the standard system", that is, the way of business remains standard, irrespective of the product application category. Franchisees cannot be exposed to only one customer (i.e. have only one contract) because franchisees dependent on one customer are too exposed to that customer defaulting on payment, or to a downturn in demand for service to that customer. It is far more preferable that each franchisee has a range of diversified customers and diversified activities.

Franchisees must be "hungry to get business", this is "fundamental". One way PWMSA keeps its franchisees hungry, is by "throwing them bait". For example, offering a new or additional technology to the franchisee. The franchisee must come back with a business plan, and show PWMSA how he can use this technology and why they must let him, and not someone else, have the licence to use this technology.

In respect of all product application categories other than water services provision in the sense of a WSP as defined in the Water Services Act (see below), the PWMSA business model is a straightforward business format franchise, and is viable. PWMSA customers are, with very few (if any) exceptions, from the private sector.

PWMSA will take on board as franchisees only individuals or companies that are already very competent in the appropriate technological field. Before anyone can be a franchisee, he "has to have the knowledge". Given the kinds of activities that they franchise, their franchisees are mostly chemical engineers or chemists. PWMSA then trains them in any additional technology, and in the business of being a franchisee.

Water services provision

In PWMSA terminology, "service provision", in the WSP sense, is the "project application category"", a category that PWMSA "has not really looked at".

The remainder of this section on PWMSA describes their own analysis, given their background of experience as franchisors in franchisors serving the private sector, of the issues that would surround offering services to the municipal sector.

PWMSA would like to take over a municipal water treatment or wastewater treatment works and offer to run it for the municipality at a fixed price. In other words, very much what they do for the private sector. The client focuses on the main reason why it is in business, and PWMSA operates the effluent or water supply to DWAF specification.

PWMSA’s interest in the WRC investigation of water services franchising arises from them perceiving that it might be able to create the space for them to get into the PAC 17 field. They would like the opportunity to put their ideas to the test. This could start by them being given responsibility for a couple of municipal water or wastewater treatment works. They are confident that within a matter of months they would have rectified these treatment works, and thereby established their credibility in this market. After which they could offer this service to many WSAs. Obviously, were PWMSA now to market to municipalities, they would be asked if they have made a success of municipal treatment works operation and maintenance. Hence it is essential that a breakthrough be made in terms of those first few treatment works.

PWMSA has identified that the procurement regime of WSAs is a big obstacle at present. PWMSA feels that it can try all it likes to convince WSAs of the good sense of their proposals, but they will not get through the procurement regime, irrespective of how sound their proposals are otherwise.

Their competition in terms of the services that they could offer to a WSA, includes, they state, WSSA, but of course WSSA‘s method of doing business is not a franchise arrangement, and furthermore WSSA seeks appointments from the public sector, whereas PWMSA’s clients up to now have almost all been private sector.

To sum up, PWMSA sees "three agendas" in possible PWMSA/CSIR/WRC cooperation, *viz*.:

- resolving the obstacles in the current contracting/procurement regime;
- proving that the concept is technically feasible and financially sustainable, and delivers value for money to the WSA; and
- putting together a set of requirements, regulations and guidelines, that will be conducive to outsourcing of this type of work.

Some important issues that according to PWMSA need to be resolved:

- Franchising is usually "retail", that is, the franchisee provides a service to the end user of the product or service. For example, Kentucky Fried Chicken (KFC) supplies chicken to the household that will eat it, or PWMSA (in respect of all the other PACs) supplies for example effluent treatment expertise to the factory that needs to have this in order to conform to regulations (e.g. from DWAF) imposed on it. The contract is with the end user. But the kind of franchising that we are talking about here would be different in that the contract would be with a body other than the end user, i.e. the end user is the household, but the contract is with the WSA. Therefore the existing PWMSA model would have to be adapted before it could be used for water services provision although much of existing PWMSA skills would be suitable.

- Income must be predictable within close limits. That is essential. A necessity would be guarantee of being paid, and being paid on time. Should a WSA reduce the operation and maintenance budget, the franchisee would be caught between end users who demand a service, and it receiving a reduced income from the WSA.

- A franchisee would need to have several contracts, in order to reduce the risks of all the eggs in one basket. And if one of those was with a WSA, the franchisee would need for safety's sake to have contracts with private sector organisations as well.

- Income must be predictable, yes, but conditional on the franchisee performing. The franchisee must be "hungry to get, and to keep, business". This is "fundamental". Franchising will not succeed if it is straightforward outsourcing. Also, from the franchisor's point of view, it is "impossible to manage a guy who is virtually guaranteed an income".

- Even if it can be shown that water services can be competently provided by franchising, and that any procurement obstacles have been removed, WSAs might still not wish to franchise out. What is the incentive to WSAs to do things differently? One possibility is that they can be convinced that they will save money on the water service and that the money thereby saved can be spent on other things (and win more votes for the councillors?). Another possibility is that national government or other funders instruct the WSA that grants or loans are subject to conditions – we give you the funding, but you must then do it <u>this</u> way. Or both.

- It's not just the WSA that must see the advantages, but it's the individuals in the WSA that must be incentivised. The head of the water department might perceive cost saving to the municipality, but his "empire" is reduced, and his salary gets reduced, so he will be negative towards franchising. How to resolve this?

Offering some hope is the fluidity in the total water services delivery regime in South Africa. For example, that DWAF used to be a direct provider of water services, but this will shortly come to an end.

Ringfencing of water services is an essential prior to any kind of outsourcing of any part of a municipal water service.

To sum up: PWMSA has not attempted or developed the water services PAC, because it is not comfortable that it or franchisees can make a viable business out of it. Non-payment by the WSA is the "biggest obstacle by far ". PWMSA has had bad experiences with several municipalities not paying for services rendered or for chemicals supplied to them.

3.7 Chapter 3 conclusions

3.7.1 Conclusions on the advantages in distant areas of locally based organisations

A major advantage of improving the capacity at local level in these rural areas is that locally-based organisations can better provide the day-to-day operational services than can organisations that are not locally based, for example, the staff of the municipality. This is for the following reasons:

- many rural schemes are very small and only require part-time operational staff to oversee the day-to-day operations;
- the distances of village schemes from the municipal centres are often far and to operate schemes from a remote location is not cost-effective;
- local operators are easily accessible to the local community for whom the services are provided; and
- due to the distant location of the schemes, the local staff work in a largely unsupervised environment, and therefore performance-driven contracts would generally be more suitable than the usual employment conditions would be.

Much of this would hold true also for small towns distant from main centres of the municipality, and would even hold true, but to a much diminished extent, closer to the main centres.

In many of the rural areas locally-based organisations are the only practical option to provide sustainable and cost-effective water services operation.

It is evident, however, that further structuring of these arrangements is both necessary and possible. The following need to be explored, and undoubtedly franchising has potential application to these issues:

- the creation of a contractual environment for village based operators where they are remunerated on a performance-based approach, rather than being municipal employees on full-time wages, would allow the WSA/WSPs to better control the operations of these rural schemes. (And also to better budget for them.); and
- the structuring of an arrangement whereby the skills of these operators can be supplemented when necessary, by bringing in outsiders on an "as-needed" basis, such as when a technical problem is presented that is beyond the skills of the local people to resolve.

3.7.2 Conclusions on non-profit and for-profit

Such locally-based organisations could be voluntary in various forms, and non-profit, or they could be staffed by people who are paid and yet the organisation is non-profit. Alternatively, the organisations could be for-profit, with paid staff.

Voluntary organisations, such as village water committees, have a proud history in South Africa. But their limitations have long been recognised. For example, "voluntary service", to some people, implies a high level of commitment, but not all people feel the same way. The reality is that most people expect to get paid for providing services, be it on a part time basis or full-time. The moment people are paid to do work, they are by definition no longer volunteers, but employees or contracted-in entities.

Put differently, could CBOs be franchisees? It would appear that provided that the relationship between the franchiser and the CBO is based on a proper franchise agreement, there should be no reason why a CBO cannot be a franchisee. However, as the franchise relationship is based on generating a profit, the differences in ideology would probably undermine the long term relationship between franchiser and franchisee. A similar argument would hold for an NGO. Having said this, it is still debatable whether in certain circumstances a NGO or a CBO might not be a candidate for a water services related franchise.

Whilst it is most likely that the community based franchisees would emerge from the local water services committees, these committees generally are associations of a voluntary nature and "not for gain". When a more formal structure is required, to facilitate contractual service provider agreements, which include for service level commitments and the need to develop and hold expertise, as well as the need to raise financing, hold assets and to act as an employer, these voluntary associations may not be able to sustain the rigorous requirements of doing business. In addition, the need for proper individual and collective accountability and corporate governance is more difficult to build into these voluntary association structures. Thus it could be argued that community based franchisee entities would be better structured as trading trusts, close corporations (CCs) or companies, all of which would fall under the more rigorous legal and statutory requirements for entities of this nature. In addition, the designated trustees, members or directors of these entities would have a fiduciary responsibility to act in the entities' interest, thereby improving their governance.

Franchisors would be more likely to accept registered CCs and companies as franchisors, as these would require more stringent external auditing, and thereby provide better security to the franchisor for their "investments" into the franchisees.

Yet there is no hard boundary between non-profit and for-profit organisations. In the Companies Act there is a clear definition of "incorporated association not for gain" (the well-established Section 21 companies) and of similar organisations. These organisations employ staff, and pay them, and charge for their services. Their charges for services rendered are set high enough to ensure that they are not simply paying out all their earnings, but are building up retained earnings so that they can become owners of capital resources, can look to expanding their range of activities or their area of coverage, and can build up reserves to assist them should there be lean periods in the future. They are not "for-profit" in the sense that a for-profit organisation might distribute earnings to shareholders, and they are not non-profit in the sense that they might not be building up retained earnings. But they are certainly accumulating what they generally refer to as a "surplus".

Some current attempts to build CBOs that need to train and retain staff, and pay them, and provide services for which a charge might be made, but insisting that they remain non-profit, and not allowing them to build up at least a small surplus, seem to the current researchers to be unnecessarily limiting. And once the "non-profit" label is discarded, the only difference between such an organisation and a small, medium or micro enterprise is the form of governance of the organisation. The enterprise is owned and managed by an individual or small number of people, whereas the non-profit is owned, if not also managed, by a larger number of people, with the attendant disadvantages of collective responsibility (not forgetting that there are advantages also).

It cannot be denied that in many cases the employment (and their development) of "career" staff, rather than volunteers, would improve the quality and long-term sustainability of the rural water services. And an organisation that is allowed to retain earnings and build for the future is more likely to favour employing career staff.

As an aside: if the career staff were ambitious, and sought more challenging and remunerative opportunities elsewhere, this would be true economic empowerment. The local operating entity would cope with this as any business entity would, i.e. by attracting suitable staff from elsewhere, or employing and training up new staff, probably from within the community.

3.7.3 Conclusions on franchising operation and/or maintenance of water services

Several water sector like-franchises (and one actual franchise, *viz*. The Drain Surgeon) and other forms of PPP are described in this chapter, outlining (at minimum) the circumstances under which they were established and are operating, the SMME (or franchise SMME) and the supporting institution (or franchisor), and their success or otherwise.

The team selected the instances reported in this chapter on the basis of reputed similarity of each, in some or other respect, to franchising. And indeed (with the exception of The Drain Surgeon) all have certain similarities. However, that the promoters of some call them "franchising", is taking liberties. For example, eThekwini's "franchising" that they are setting up for emptying of pit latrines is not really franchising, and is not a management contracting arrangement either, but is somewhere in between. Nonetheless, much can be learned from all of these near-franchising instances.

There are not many instances from which to draw experience, and their nature, circumstances and achievements are so varied, that it is not possible to come to conclusions other than:

- franchising's (and near-franchising's) significant potential for water services operations and maintenance;
- franchising's general unsuitability for capital investment;
- the need for franchisees to diversify if at all possible, and to be as little dependent on only one client as they can be; and
- if the franchisee (or any type of SMME, for that matter) serves low-income areas, it would need to be subsidised, because small enterprises engaged in water services operation and maintenance in low-income areas are seldom financially viable.

Common to all of the examples of franchising or near-franchising of water services surveyed in this chapter is that their purpose is the operation and/or maintenance of services. There seems to be an understanding, sometimes stated and sometimes implied, that franchising is not suitable for investment in new infrastructure, or it is just regarded as too difficult.

Certainly, the amounts of funding required for investment in new infrastructure, or even just the reconditioning or refurbishing of it, would be beyond the means of all franchisees (SMMEs that they are, and generally at the "very small" and "micro" end (that is, turnover less than R1 million per annum)). It would even be beyond the means of many franchisors. Over and above that, there would be an understandable reluctance on the part of franchisees and franchisors to invest capital in infrastructure given what appears to be an environment of uncertainty as to whether they will be able to recoup that investment. (Which is not to say that some, albeit limited, capital investment is never made. Refer to WRP's description, to come in Section 4.3, of their investment at Emfuleni LM, and their view of the risk to them of making that investment.)

Either way, it seems to be very justifiable that, in the current climate, potential franchisors and franchisees regard capital investment as an option to be considered only in exceptional circumstances and that, in respect of the provision of public services infrastructure, franchising is almost invariably regarded as suitable only for the ongoing operation and maintenance of infrastructure.

Furthermore, in order to improve both size and especially reliability of the revenue stream, it would invariably appear to be prudent for franchisees and even franchisors not to have all their eggs in one basket. They need different baskets, several clients and several types of activity if at all possible. Thus they need to undertake other forms (other than operation and maintenance) of activity, for example construction work, and/or materials supply.

This is easier for the franchisor to achieve, of course, than for a SMME franchisee, especially one at the micro enterprise end of the size and capacity spectrum, and especially if a start-up enterprise.

The Drain Surgeon is an excellent example of how a business can be built. Strongly led and focused, and with a sound business model, it has over more than 20 years diversified very competently, and today it:

- is a franchisor in a water services maintenance and repair niche;
- runs a business, with direct employees, in the same water services maintenance and repair niche;
- is a franchisor in an electrical services maintenance and repair niche;

- runs a business, with direct employees, in the same electrical services maintenance and repair niche;
- does some materials supply in water services;
- does some construction in water services; and
- has both public and private sector customers in many of these areas.

4. Relevance and potential of franchising

4.1 The purpose of Chapter 4

The purpose of Chapter 4 is to determine the relevance of franchising to water services delivery, and determine the size of the potential market in South Africa.

The first WRC report on franchising concluded:

- that there is a strong "push factor" motivating the need to investigate water services delivery models alternative to those current; and
- 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.

The "push factor" was further described as follows: "the capacity of municipalities in South Africa to adequately provide even basic levels of service to all the 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. 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 the opinion that the potential for franchising in the water services industry ought to be investigated. For various reasons this has never been done." (Wall, 2005a:70).

The report, however, outlined that, although franchising (and other forms of SMME) clearly had potential, extensive further investigation was required. For example, investigation of the probable difficulties that face SMMEs generically, and would face SMMEs in the water services sector. "The de facto obstacles to entry, and obstacles to medium-term survival, for the smaller or start-up company are substantial."

But, said the report, "if these obstacles could be overcome, perhaps through franchising, then there would be extensive opportunities that could be opened up for LED, and that would also impact on Black economic empowerment (BEE) in many cases." (Ibid:71).

To sum up: through water services franchising "there is potential to simultaneously:

- deliver water services; and
- promote LED, SMMEs and BEE." (Ibid:72).

The purpose of this Chapter 4, therefore, is:

- to determine the need for alternative water services provider systems in South Africa, to "deliver water services" ("push factor"), and, within that
- to determine the relevance of franchising to water services delivery, and the potential for water services franchising as a means of improving water services delivery ("push factor");
- while determining this potential for water services franchising, not forgetting the argument for franchising as a means of promoting LED, SMMEs and BEE ("pull factor").

Accordingly:

- Section 4.2 investigates the need for alternative water services provider systems;
- Section 4.3 investigates the relevance of franchising to water services delivery, and the potential for water services franchising as a means of improving water services delivery;
- (although this is not a significant focus of this report) Section 4.4 résumés and updates the argument for franchising as a means of promoting LED, SMMEs and BEE; and
- Section 4.5 draws conclusions.

Whereas there was discussion in the first WRC report of these same issues, the intention in Chapter 4 is not to repeat that discussion, but to extend it. The intention is also to update the research. For example, in respect of the state of water services management in South Africa, during the last couple of years there has been a substantial increase in documented research information.

4.2 The need for alternative water services delivery models

4.2.1 Sequence of Section 4.2

Section 4.2 investigates in the following sequence the need for alternative water services provider systems:

- Section 4.2.2 states that there are "two powerful and mutually supportive reasons for alternative water services delivery models to be investigated", defines "delivery" and "existing water services delivery models", and introduces a discussion on limits to private sector contributions to water services delivery;
- Section 4.2.3 résumés the findings, of the first WRC report, on how existing water services delivery models are doing;
- Section 4.2.4 suggests a replacement cost of the water services infrastructure, and describes recent and current national-level initiatives to improve the operation and maintenance of that infrastructure;
- Section 4.2.5 résumés recent findings on the state of infrastructure and the state of its operation and maintenance;
- Section 4.2.6 is a diagnosis of the state of infrastructure and the state of its operation and maintenance; and
- Section 4.2.7 draws conclusions for Section 4.2.

4.2.2 Is there a need?

In the first WRC report, the case was made that, even if all existing water services delivery models were functioning as they ought to, there were nevertheless good reasons to investigate alternative delivery models, "….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)." (Wall, 2005a:15).

The extent to which the existing institutional role-players were, however, coping was briefly discussed in that report (and is explored further, and updated, in Section 4.2.5 of the current report). It was concluded that:

> "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. … 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." (Wall, 2005a:15).

There are thus two powerful and mutually supportive reasons for alternative water services delivery models to be investigated.

"Models", as in "delivery models", is in the current report used somewhat loosely (and not always consistently) as a surrogate term for the way in which (or the mechanisms or the system of interrelationships whereby) institutional role-players (existing, or proposed) in the water services sector currently do, or could, attempt to deliver (or "provide", the terms "deliver" and "provide" are used interchangeably) water services.

Before proceeding any further, it is necessary to establish what is in the current report meant by:
- "delivery" of water services; and
- "existing water services delivery models".

Also, it is necessary to introduce a discussion on limits to private sector contributions to water services delivery.

"Delivery"

The existing institutional role-players in the water services sector, as indeed do those role-players in other infrastructure sectors such as water resources, transport, housing and electricity, to name just a few, manage huge infrastructure portfolios. This infrastructure is not an end in itself, but is a means to an end. It supports quality of life and the economy if it delivers the services that individuals and institutions need, and if it does this in such a way that they are able to access the services, and that the services are reliable. Access and reliability imply several issues, including that the service must be sustainable. If not, the infrastructure (water pipes, for example) may continue to exist, but the service will cease (the water will no longer flow). Clearly, in order to achieve its purpose, infrastructure must be effectively operated and maintained.

While there is a national drive to "deliver" infrastructure, “delivery” of services does not end with the commissioning of the infrastructure. Once the infrastructure has been commissioned, the activities necessary to ensure that it continues to perform must be carried out, such as the appointment of appropriate staff and the allocation of necessary budgets to maintain the infrastructure. “Delivery” needs to be universally understood as embracing not just the placing in service of infrastructure, but the appropriate operation, including maintenance, of that infrastructure for the whole of its designed life. (In this report, "maintenance" is used as a generic term to include repair of infrastructure, refurbishment and renewal, and provision for replacement of that infrastructure.)

Elements of water services infrastructure, just the same as other engineering infrastructure such as railway lines, water pipes, treatment works, roads, etc., and also buildings themselves, are designed to last for a minimum number of years (often in excess of thirty or forty years) and, during that time, to deliver the services intended of them. However, that the infrastructure delivers the intended services can only be expected if it is properly operated and maintained, and if it is not overloaded or otherwise abused.

"Existing water services delivery models"

Existing water services delivery models and mandates were described at some length in the first WRC report (Wall, 2005a:7-8), and are again discussed in Chapter 5 of the current report, and there is no need to repeat those descriptions here. It is sufficient to highlight that:
- the responsibility for water services delivery rests with municipalities, the Water Services Act (South Africa 1997) assigns to municipalities the 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;
- the most common forms of WSP are in-house, i.e. delivery is by departments of the WSA, or the WSA, if a DM, has appointed the LM as the WSP, and that then uses its in-house resources to deliver;
- less commonly, WSAs do contract municipal entities, water boards, CBOs, NGOs or private sector operations contractors to be their WSPs, or combinations of these;
- some of the above forms could, rather than acting as the WSP, be a subcontractor to the WSP (e.g. a CBO receiving local responsibility, contracted by a WSP that is a LM);

- often the water services delivery functions are disaggregated into components that are separately outsourced, for instance, for construction, for maintenance, or for billing and revenue collection; and
- components that are not regarded by a WSA as its responsibility, or are its responsibility, but are neglected, are sometimes delivered by one or other of the above forms, for example, private enterprise pipe maintenance services to middle- and upper-income households and to businesses.

DWAF is also directly delivering water services, but to a diminishing extent as its schemes (most of them in former homelands) are transferred to the appropriate water services authorities.

Limits to private sector contributions to water services delivery

It is necessary to outline some of the main limits to private sector contributions to water services delivery. Franchisees are after all SMMEs, and franchising is generally driven by the profit-seeking private sector.

The topic of "private sector alternative service providers", and DWAF opinion on the options of using these, was discussed at some length in the first WRC report (Wall, 2005a:13-15), and there is no need to repeat that discussion here. It is sufficient to highlight that:

- the Water Services Act states categorically that "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 1997: Section 19 (2));
- the "Strategic Framework for Water Services" states that "the role of the private sector in the provision of water services is welcomed, provided that consumer interests are protected" (DWAF 2003c:ii), and "we will 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:19); and
- a review of DWAF literature revealed that provision by SMMEs is not ruled out as an option, but it is simply not mentioned, suggesting that DWAF has given little thought to SMME options or to supporting SMME water services providers.

Of particular relevance to operation and maintenance of water services, 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." (DWAF 2003c:18).

In summary: "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." (Wall, 2005a:15).

More compelling than the DWAF Strategic Framework or the Water Services Act is the MSA (South Africa 2000), and in particular Section 78 of that Act. That Section sets out the procedure for a municipality when it has "to decide on a mechanism to provide a municipal service in the municipality or part of the municipality, or to review any existing mechanism."

This introductory discussion on the limits to private sector contributions to water services delivery is sufficient for the purposes of the current report. However, the topic is dealt with in depth in: " WRC Report TT 432/3/10: Review of policy, regulation and legal aspects: Review of the policy, statutory, legal, financial, regulatory, procurement issues that could affect water services franchising." That report:

- identifies policy, statutory, legal, financial, regulatory, procurement and similar non-technology issues that could affect water services franchising; and
- draws conclusions, and makes recommendations with respect to these topics in so far as they could (or do) affect formulation and implementation of the water services franchising concept in South Africa.

All discussion in this section on possible limits to the private sector contributions is irrespective of whether private sector contributions, and in particular the contribution of franchising, would or would not be suitable for water services delivery, which is of course the topic of the bulk of this report. (For example, the limits of franchising in respect of capital investment in water services infrastructure.)

4.2.3 How are existing water services delivery models doing? Brief résumé of the 2005 WRC report

Other than quoting a budget speech of the Minister of Water Affairs and Forestry, to the effect that a significant amount of the water services infrastructure has ceased to deliver for one or another reason, and that this would require one or another level of effort to bring back into service, the first WRC report did not investigate how adequately existing water services delivery models were operating and maintaining infrastructure. (Wall, 2005a:6). Nor did it investigate in any depth the underlying causes for these inadequacies. It confined itself to the general statements "under-funded maintenance budgets and inadequate maintenance practices" are "largely" responsible, and that, generally, infrastructure in the more urbanised areas is being better operated and maintained, and "the situation is worse in less well-resourced areas". (Wall, 2005a:6).

The first report also pointed out that, 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: "… 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 2004a, quoted in Wall, 2005a:9).

Also, the periods of transition in local government have not been conducive to consistent and adequately resourced operation and maintenance of infrastructure, and have in many cases contributed to the erosion of skills and institutional memory. There have since 1994 been two rounds of demarcation of municipal boundaries, in 1996 and again in 2000. Each of the rounds has seen major changes in political leadership, staff and systems. Many staff have left, or been assigned new duties or new areas, many new staff have joined, and staff profiles have changed. Responsibility for the administration of and provision of services to very large areas of deprivation has been assigned to unified administrations. Among these administrations that have struggled the most to provide services have been those responsible for geographical areas that had few resources even prior to 1996, and in which there was little existing local foundation upon which to build the new administration. New responsibilities have been assigned to municipalities. National government funding has enabled the acquisition of new infrastructure on a very large scale. Old funding sources have fallen away, and new ones have come in. It is not surprising therefore that for these reasons alone many municipalities have struggled to give the necessary attention to operation and maintenance of their infrastructure.

Hopefully, a long period of institutional stability can now be anticipated.

4.2.4 Replacement cost of the water services infrastructure, and recent and current national-level initiatives to improve operation and maintenance of that infrastructure

National government has made substantial progress on its promise to improve the lives of previously disadvantaged citizens. Since 1994 there has been:

- An increase of 80% (1994-2004) in the number of people with access to a basic level of water supply; and
- An increase of 56% (1994-2004) in the number of people with access to a basic level of sanitation service.

The investment in water services capital works has been considerable. The CSIR in 2006 estimated that the current replacement cost of the water services infrastructure that is the responsibility of the 170 water services authorities is at least R120 billion, and that the current replacement cost of the water services infrastructure that is the responsibility of the 15 water boards is of the order of R60 billion. At least a quarter (by current replacement cost) of that infrastructure has been constructed since 1994.

Municipalities, assisted by national government funding and other forms of assistance, and by donors, and through other initiatives, have in a sense become victims of their own success at rolling out new infrastructure. It is clear that an unintended consequence of constructing more infrastructure is in many municipalities resulting in a widening of the gap in ability to operate and maintain the infrastructure. Without concerted assistance, many already stressed municipalities will be unable to operate and maintain increasing amounts of infrastructure.

The replacement cost figures above represent an enormous amount of water services infrastructure that is in place and is delivering services (or should be delivering services), and has to be operated and maintained. In addition to which, 8.2 million people (2.1 million households) lack a basic water supply, and 15.3 million people (3.8 million households) lack basic sanitation (DWAF 2006b:19), and DWAF has set a tight timetable for the eradication of these backlogs (for example, "all households to have access to a functioning basic water supply by 2008" (ibid:20). From which it can be inferred that there will within the near future be a steep increase in the amount of water services infrastructure that will have to be operated and maintained.

The need to adequately operate and, in particular, adequately maintain the infrastructure in the ownership of the public sector (especially in the ownership of the municipal sector) has since the start of 2005 received unprecedented attention from national government. This attention has not been directed at water services infrastructure only, because addressing some of the obstacles in a municipality, say, to adequate maintenance, for example shortage of technical skills or the inadequacies of the income stream of the municipality, generally improves matters for all the infrastructure, not just for the infrastructure of one or other sector.

Indeed maintenance problems very often, if not more often than not, arise from poor operation of the infrastructure or from poor design (or inappropriate design) and construction, or overloading of the infrastructure, as well as all factors strongly related to those same obstacles, such as shortage of technical skills or the inadequacies of the income stream of the municipality.

To name the initiatives of greatest national significance, and/or the most important to water services infrastructure:

- The Deputy President, who is responsible for the blueprint for a new South African Economy, the Accelerated and Shared Growth Initiative for South Africa (ASGISA), set the scene by stating that: "…looking after both old and new infrastructure is a challenge and an opportunity… ..we have tended not to put maintenance high on the agenda…not only are we putting it high on the agenda now…we can launch it as an industry in its own right." (The Presidency 2006);

- ASGISA itself has identified six "binding constraints", which, if removed or mitigated, would have a considerable effect on accelerating and sharing growth in the short to medium term. One of these is the provision of infrastructure. ASGISA recognises that the impact of increased infrastructure investment would be negated should that infrastructure fail to deliver services, and therefore it has highlighted the need to simultaneously address backlogs for investment in both maintenance and new infrastructure. (The Presidency 2006);

- This is also recognised in "Government's Programme of Action for 2006" – one of the actions is to complete a national "plan" for maintenance of general public infrastructure;

- Of wider importance than programmes targeted at individual sectors, the Government Immovable Asset Management Bill (GIAMA) is before Parliament, and guidelines for asset management planning are being drafted. The Act will be binding on national, provincial and local government and will guide improved public sector infrastructure asset management;

- The initiative most directly pertinent to water service infrastructure is the current formulation process by DWAF of a national water services infrastructure asset management strategy. Commenced in 2005, this is scheduled to deliver by the end of 2006 a "plan" of the actions required to radically improve the maintenance of water services infrastructure in the ownership of municipalities and water boards;

- Several authorities have drawn specific attention to the shortage of skills, particularly technical skills, appropriate to infrastructure operation and maintenance, for example, the research by the South African Institution of Civil Engineering (SAICE); and

- Other initiatives, very relevant to water services infrastructure, but covering other sectors also, include EU-sponsored pilot studies of infrastructure management needs, the condition survey of municipal infrastructure in the Western Cape (currently in pilot stage), and the recently published South African edition (IMESA 2006) of the "International Infrastructure Management Manual" (based on an Australasian original).

None of these initiatives specifically state that new institutional models to perform operation and maintenance must be designed and implemented. Some of them identify the need to bring more skills, or finance, to bear on operation and maintenance; others identify the "how-to" of operation and maintenance, and, presumably assuming that these are in place, do not focus on skills or incentives; others merely diagnose, identifying problems that need to be resolved.

However, the Deputy President has opened the door to alternative delivery models "within the construction industry". Whether her intention is that these will only be models for operation and maintenance contractors to (in the case of the water services sector) water services authorities or their water services providers, or she has opened the door to other, maybe longer term forms of contracting (e.g. leases), remains to be seen. The national Department of Public Works (DPW) has been mandated to take the initiative. Either way, skills development, SMME development, and the promotion of BEE are very much part of the agenda.

The DWAF national water services infrastructure asset management strategy initiative (also work-in-progress) is known to be recognising the need for alternative delivery models, and to be taking its cue from the Deputy President and DPW.

The Deputy President/DPW and DWAF initiatives are both at a high level and, whereas SMME development is firmly on the map of both, it is unlikely that franchising will be specifically mentioned by either of them. Nevertheless, given that franchisees are a particular form of SMMEs, opening up opportunities for SMMEs can hardly not embrace franchising also.

In conclusion: It is fair to state that these initiatives, and also many of the initiatives within individual municipalities or individual departments of municipalities, are at inception stage, and have not to date had much effect. But there is little doubt that their beneficial impact on water services operation and maintenance will be very substantial. And none too soon, because the backlog in adequate operation and maintenance is huge, and growing. (Section 4.2.5 describes this in more detail.)

4.2.5 How are existing water services delivery models doing? Recent findings on the state of infrastructure and the state of its operation and maintenance

DWAF has for some time expressed concern as to how well water services infrastructure is (or is not) delivering services. Every Ministerial budget speech of recent years has raised the issue of non-delivery by infrastructure. For example, in her 2005 budget speech, the Minister stated that the monitoring of service quality by her department shows

> "how important it is to manage infrastructure effectively. Last year, I reported that water supply to 37% of households was interrupted for more than a day during the previous year – mainly for technical reasons, rather than for non-payment. …. This year, we focused on the quality of drinking water, and I regret to say that 63% of municipalities could not confirm that they met the Drinking Water Quality guidelines. [Also] there are serious problems in the management of wastewater treatment works – even in Metro municipalities such as Cape Town. An acute example is Emfuleni LM, in Gauteng where, repeatedly, untreated sewage has been discharged into the Vaal River". (DWAF 2005e:2).

(As an aside, it can be noted that DWAF has for several years made strong representations to the City of Cape Town, to little effect. The average effluent quality has further deteriorated during that time. (Cape Town 2005), (McConkey personal communication)).

As noted in Section 4.2.4, DWAF during 2005 appointed consultants to assist it with formulating a national "water services infrastructure asset management strategy". This is scheduled to deliver by the end of 2006 a "plan" of the actions required to radically improve the maintenance of water services infrastructure in the ownership of municipalities and water boards.

The terms of reference (DWAF 2005b) required the consultants to commence with a survey, a "desktop strategic study", of the state of water services infrastructure and the state of its management. The report of the survey findings, the "Phase 1: Status Report" (DWAF 2005d) is the primary resource from which the information in Section 4.2.5 is drawn.

The survey is not just about maintenance. Apart from the obvious link between how infrastructure is operated, and how this plays out on the state of the infrastructure (and vice versa, the state of the infrastructure is fundamentally important to how it is operated), the report makes it clear that "infrastructure management also strictly speaking includes the operation of that infrastructure". (DWAF 2005d:1).

In order to identify what is going right, or going wrong, and why, Section 4.2.5 summarises:

- the findings of the desktop strategic study mentioned above; and
- the findings of just one of the most significant of the studies released in 2006 of the state of water services infrastructure and the state of its operation and maintenance.

The "Phase 1: status report"

The report (DWAF 2005d, and in particular Chapter 7 "The state of WS infrastructure" and Chapter 8 "The state of WS infrastructure management") is available on the website of The Water Institute of Southern Africa (WISA), and can be referred to for more detail if required. It is sufficient for the purposes of the current report, which needs only a representative outline, to select only the extracts given below.

Comprehensive information on the condition and functionality of all infrastructure, or even only water services infrastructure, owned by all South African municipalities does not apparently exist. Future WSDPs will, it is hoped, provide a more comprehensive view of the status and functionality of individual water services infrastructure components.

A 2006 survey of water services authorities, to estimate their compliance with drinking water quality regulations (i.e. with SABS 241-2001), revealed that only 72% were compliant. (DWAF, 2006:25). However, the more urban water services authorities are, in respect of drinking water quality (as they are in respect of most other indicators of water services infrastructure operation and maintenance adequacy), more likely to be delivering satisfactory services. "… most non-metro Water Services Authorities in South Africa are failing in their compliance with the Compulsory National Standards for the Quality of Potable Water, and that in many instances this failure in regulatory governance is resulting in the provision of drinking water of unacceptably poor quality. A direct associated impact on primary health can be expected." (Mackintosh et al., 2004:133).

Some clues as to why the indicators from so many municipalities are so poor were found on a visit by the CSIR in 2004 to the water treatment works of three towns in the Northern Cape. The treatment process of two of the three was not operating effectively. To all intents and purposes, raw water from the Vaal River was flowing from the works and into the towns' reticulation systems. In the one case, the chemical dosing system had broken down, a readily fixable problem, but beyond the ability of any of the municipal staff responsible. A year later, the problem had still not been fixed, despite all representations by DWAF. (L. Manus, personal communication). In the other case, poor design and construction, together probably with inappropriate operation, had led to breakdown of the sedimentation and filtration processes, and the municipal staff responsible appeared to have no idea how to fix this. The third treatment works was at the time delivering water to an adequate standard, but the machinery showed signs of neglect.

DWAF conducted a nationwide sanitation sustainability audit in 2004/2005 to ascertain the functionality of sanitation projects completed during 1994 to 2003. This revealed for example that 28% of households sanitation facilities have failed or are in the process of failing, and only 53% of municipalities have adequate operations and maintenance capacity. The study concluded that:

- service level choice and affordability is critical to the overall sustainability of sanitation facilities;
- many of the more rural municipalities lack the capacity and procedures to effectively operate and maintain sanitation facilities;
- lack of construction supervision is a main culprit in sub-standard toilets being built;
- maintenance of sanitation infrastructure is inadequate for both dry and wet systems and urgently needs effective guidance and management; and
- operations and maintenance plans, where they exist, do not all draw a clear distinction between the respective responsibilities of households, community and the municipality.

Monitoring of effluent quality from wastewater treatment works of local municipalities in the Free State revealed that the province is experiencing extensive non-compliance of wastewater effluent quality, for example, 45% failure on bacteriological indicators. The main reasons for non-compliance in the Free State include: operational inefficiency, equipment shortcomings, lack of skills, inadequate monitoring equipment, and lack of proper dosing chemicals equipment. (Emanti, 2005)

A survey by the CSIR of a substantial number of the wastewater treatment works run by municipalities in Gauteng showed that many of these are producing effluent that is not meeting DWAF standards. The reasons for this frequently include one or more of gross under-budgeting by the municipality for wastewater operations and management, managers who have insufficient understanding of the technology of wastewater treatment, and officials who do not seem to be motivated to carry out their duties with the necessary care and energy. On the other hand, treatment under the auspices of the three MMs and by one of the LMs is meeting DWAF standards. Budgets are adequate, if in some instances barely so. Management levels are staffed by competent, qualified and experienced officials, and the same can be said for the supervisors and works operators, and also for other officials such as the laboratory staff. (Wall, 2005a).

To summarise, the desktop survey indicated that South Africa has some very adequate water services infrastructure and service delivery, but also has an increasing proportion of deteriorating infrastructure together with poor and often unacceptable quality services. Similarly, while some water services institutions have exemplary practices in place in respect of many of the aspects of infrastructure management, gross shortfalls in management policies and practice exist in many others. Between these two extremes, a wide range of capacity and competence can be found.

The point is strongly made in the report that water service provision has a functional supply sequence starting with water treatment, bulk distribution (pump station and bulk pipelines), storage, reticulation, sanitation (which, if a totally on-site system, ends the sequence there), wastewater collection, bulk sewer system, wastewater treatment, with the final element being effluent release to the receiving water body. The way in which any one of these elements is operated, and its condition and functionality, impact on all the elements that follow, and are thus likely to influence the final outcome of the scheme (e.g. drinking water quality, frequency of interruptions, lack of pressure, lack of flow).

"A poor state of infrastructure can be due to various reasons including amongst others, inadequate level of service (which could in turn be due to a backlog in the addressing of basic services needs and concomitant non-payment), inappropriate design, inappropriate technology, unskilled operators, inappropriate operating rules/systems, inadequate funding, unavailability of chemicals, lack of equipment and tools, or logistical problems. These aspects differ between water services infrastructure elements, and it is therefore necessary to look at each element separately to understand the infrastructure management challenges." (DWAF 2005d:7).

Figure 4.1 serves as one illustration of the results of unskilled operators, inadequate funding, unavailability of chemicals, etc.

To which can be added that this differentiation by elements is necessary also when looking at alternative means of resolving those challenges. Putting it simply, outsourcing, by the water services provider, to an SMME, is intrinsically more suited to assisting it with its operation of some elements than it would be with its operation of other elements. Section 4.3 takes this theme further.

2006 wastewater treatment works study

“The delivery of sanitation services is high on the local government’s agenda. The majority of wastewater treatment plants [works] in South Africa are relatively small systems. The larger metropolitan municipalities have relatively few, but large wastewater treatment plants. These plants are generally well equipped and operated. Legal compliance with discharge standards is generally good at these larger Metro plants. Specific challenges exist for smaller and poorer communities in respect of wastewater treatment.” (Snyman et al., 2006:1)

Figure 4:1: The dysfunctional wastewater treatment works of a small town

In order "to understand the extent of challenges faced by the small and medium municipal sector", a study of 51 wastewater treatment works was undertaken by consultants on behalf of the WRC and DWAF. The plants varied in size up to 10 Megalitres per day, and employed different technologies (ponds, trickling filters, activated sludge, etc). They were evaluated in terms of the resources deployed (capital, human resources, financial and information resources), unit process performance, maintenance, and performance.

"The compounding effect of all the aspects evaluated including the lack of maintenance showed that immediate intervention is required at approximately 30% of the plants in order to avoid crisis situations such as an outbreak of waterborne diseases. In the short to medium term, intervention would be required at more than 66% of the plants. The Department of Water Affairs and Forestry normally requires a 95 percentile compliance with the conditions stipulated in the authorisation. If these criteria are strictly enforced, only 4% of the surveyed plants are adequately operated and maintained. The overall conclusion of the national survey is that the majority of micro, small and medium size wastewater treatment plants in South Africa are in trouble and do not comply with the regulatory standards." (Snyman et al., 2006:1).

Interestingly, "the complexity of the treatment technology is not a major differentiating factor in plant performance." (Ibid:6).

“The root cause for the poor performance at the majority of non-compliant plants does not seem to be the need for additional or upgraded plant infrastructure or the need for additional funding. The challenge is that the available plant infrastructure and equipment are not well operated and/or sufficiently maintained.” (ibid:11).

In terms of resources, “some form of intervention is required with regards to the following:

- Capital infrastructure investment at 85% of the plants;
- Skilled operational staff required to operate the plant efficiently at 50% of the plants;
- Skilled maintenance staff required to adequately maintain the installed mechanical/electrical equipment and instrumentation at 56% of the plants;
- Financial resources to support the routine operation and maintenance at 21% of the plants; and
- Information resources required to properly operate the plants at 63% of the plants.

The most pressing deficiency is the critical shortage of trained, skilled and experienced process controllers and mechanical/electrical maintenance staff.” (ibid:4).

Section 4.2.5 conclusions

While many if not all aspects of water services infrastructure operation and maintenance are implemented to a high standard in a small number of municipalities, there are great shortfalls in policies and/or practice in many other municipalities. The sustained provision of services by a significant proportion of the municipal infrastructure is under threat. Generally, the municipalities in or close to the larger urban centres are coping best, while municipalities that are mostly rural in nature are struggling the most, but there are significant exceptions.

The unintended consequence of constructing more new infrastructure without addressing maintenance needs is a further widening of the backlogs in operation and maintenance. Generally, the poorest municipalities have, proportionate to their ability to look after it, acquired the most new infrastructure. They have the least resources to adequately maintain both this new and existing infrastructure, and they need concerted help.

To give just one instance of the heightened recent awareness of the state of infrastructure: DBSA staff have been expressing increasing concern at the impact of inappropriate infrastructure operation and maintenance on the infrastructure loans provided by DBSA. It is feared that in some instances loan agreements will still be in place, i.e. the loan is not fully repaid, when the asset ceases to perform as it was originally intended. This will impact not only on the service quality delivered, but also on the consequential revenues that had been anticipated in the original financial plan, and therefore impacting on the ability of the borrower to repay the loan. In some instances, loans will have to be restructured, as new funds will be required to refurbish or completely replace infrastructure that has failed.

Of greatest concern at municipal level is the state of wastewater treatment. Non-compliance with the standards laid down in the licensing of each wastewater treatment works is widespread, and the health hazard represented, particularly in respect of the effluent quality, is significant. There are two closely related probable main reasons for this neglect:

- The quality of the effluent has no "constituency" within the municipality, other than that represented by users of the water body into which the effluent is discharged (usually a watercourse, which may flow into another watercourse, or into a dam or, in some cases, into a waste facility such as a mine slimes dam). Whereas a pothole in a main road, or, even more so, a failure of electricity supply, would bring the protest of a large constituency to bear on the municipality, and a call for the problem to be rectified; and

- Wastewater treatment works effluent is often "somebody else's problem" in the eyes of the municipality, usually becoming the problem of DWAF in its role as the custodian of the nation's water resources, and the owner of the principal water supply dams.

The net effect is usually that the municipality's budget for wastewater treatment works operation and maintenance is that which, of the budgets for all of the municipality's responsibilities, most readily kept as low as possible, and most readily further reduced during the course of the financial year if other services and facilities require additional budget. From the point of view of the decision-makers at the municipality, if they are not penalised when in an election year they switch budget from refurbishing or otherwise maintaining a wastewater treatment works to (to quote a real example) new sports facilities, which please a larger constituency of voters, why not do it?

4.2.6 Diagnosis: State of infrastructure and state of its operation and maintenance

The following themes emerge most strongly from analysis of the evidence in Section 4.2.5:

- Rapid expansion of the infrastructure asset base in the ownership of water services authorities (and indeed of municipalities generally) has not been accompanied by appropriate growth in operation and maintenance capacity (i.e. human resources and funding).

- Water services authorities exhibit a very wide range of competence, of capacity, and of operation and maintenance of their infrastructure. This manifests in the state of their infrastructure, and in their compliance with standards (e.g. those laid down in wastewater treatment works licences). Although it is not by any means a hard-and-fast rule, the more rural municipalities are very often less able to operate and maintain their infrastructure than are the more urban and especially the metropolitan municipalities.

- Given this wide range, one size (of diagnosis, or of "solution") would not fit all.

- If a water services authority is a municipality, then the operation and maintenance of its water services infrastructure cannot be separated from issues surrounding the operation and maintenance of all of that municipality's infrastructure, and indeed from issues affecting the municipality as a whole.

Drawing together the themes that emerge from Section 4.2.5, it is apparent that budgets, skills (and processes, as in e.g. "business processes") and incentives (legislated and other incentives) are three systemic issues that need exploration in the current project to the extent that they might be material to discussion of alternative water services delivery models. That is, to the extent that an alternative delivery model might address them better than existing models do. The next three sub-sections of Section 4.2.6 explore each of these systemic issues.

Each of the issues needs to be taken up in DWAF's forthcoming "plan of action", but how this will be done is not known at present, other than that alternative delivery models is a topic definitely on the agenda.

Budgets

Many water services institutions are not making adequate financial provision for the long-term operation and management of the institution's infrastructure. The annual budgets for this purpose are inadequate generally because of their limited financial capacity (together with increasing responsibility) or their imprudent allocation of funds, or both.

The financial predicament that many water services authorities find themselves in may be so dire that they are disempowered to effect a turnaround in any of the critical areas raised. Ironically, this financial distress pertains to the operating budget only, for the institutions are usually able to obtain from government ample funding for capital expenditure.

Limited financial capacity is not an issue that can be addressed by alternative delivery models, unless alternatives are contemplated that would remove financial responsibility for selected water services infrastructure from the water services authorities or at least ringfence them financially.

Few WSAs put enough of their budgets aside for infrastructure operation, and even fewer put enough aside for infrastructure maintenance. The focus of municipalities (as expressed particularly in budget allocations) is so often "on the construction and commissioning of new infrastructure, and not on the operations and maintenance of existing infrastructure". (DPLG 2004b). This could be related to insufficient understanding by municipal elected representatives of the importance of maintenance. Furthermore, as the financial year progresses, often the first budget to be raided for funds is the maintenance budget.

A view from within DWAF is that: “Local authorities are reluctant to prioritise sanitation and related issues which have an impact on water quality, with the result that failed sewage pump stations [for example] often remain inoperative for weeks before money and resources are allocated." (DWAF 2005a). That is a budget issue, but is also a question of inadequate incentives, and it could also be a skills issue.

Skills and processes

Staff inadequacies generally, and in particular shortfalls in key qualified staff, are inhibiting infrastructure operation and maintenance, and in many cases can be identified as the main reason for poor service delivery. The water services sector has lost many key staff, and they have not been replaced, or have been replaced by others less qualified.

Where water services institutions have taken on additional complex infrastructure, they have seldom taken on the corresponding skills to manage sustainable delivery. According to SAICE, many municipalities have less technical expertise now than the equivalent institutions had in 1994, despite the increase in responsibility for infrastructure. (Lawless, 2005).

Capacity-building programmes are only part of an answer. 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. 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.

National government documents are awash with references to “capacitating” municipalities. A list of capacitating measures usually then follows, often including short-term outside assistance, programmes to increase the skills of currently under-qualified staff, and so on. Very seldom mentioned is any need to retain the services of current staff who are already suitably qualified and experienced.
Skills shortfalls is an area that could, in appropriate circumstances, be addressed by alternative delivery models. The same applies to improved business processes, which could also be addressed by alternative delivery models. These are taken up in Section 4.3.

Incentives

The current package of legislation (including regulations in terms of that legislation), taken together with its current levels of implementation or enforcement, does not strongly enough incentivise water services institutions to manage their infrastructure as they should.

Legislation guiding water services institutions towards sustainable management and good governance is in several respects not adequate. However, even when legislation and regulations are adequate to govern the specific actions of institutions, they are often inadequately enforced. For example, the requirements in terms of which water quality samples from wastewater treatment works have to be routinely submitted to monitoring authorities seem in many cases not to be complied with. Furthermore, DWAF's ability to enforce compliance is challenged by its own capacity limitations.

Perhaps the most damaging shortfall in legislation is in the area of financial provision for the long-term management of infrastructure. Funding for capital works entrusted to municipalities by National Treasury and other funders ought to incorporate conditions compelling municipalities to set part aside for ongoing operations and maintenance.

If the gap were closed between on the one hand what regulations require, and their implementation on the other, this would improve the present situation, but would not solve it. Much that needs to be fixed in terms of closing the performance gap cannot be fixed by tightening current regulations. Many of the things that are "going wrong" are not subject to regulations, i.e. no regulations have been passed, or the problem cannot be solved by regulations, but needs to be fixed in other ways.

For a very simple example, there is currently no enforceable regulation that the technical services manager of a water services authority or municipality be a qualified engineer or engineering technologist. But, even if there were, there appear not to be enough qualified people to fill all of the posts or there might in theory be enough in the nation, but some of them have lucrative engineering jobs in the private sector and/or in the big cities or have left engineering altogether, and there is no way, even for a salary well above the national norm for the type of work (which a largely rural water services authority is in any case mostly unlikely to offer), that they would move. This is so even if there were good schools for their children, a good job for their spouse to replace that which he or she would lose by leaving the current area of residence, and no political issues in the institution to be fearful of.

Much the same applies to any consideration of regulation in respect of a water services authority that does not have the financial resources to operate and maintain its infrastructure. Regulation might be able to ensure that budgets are better spent, and might also lead to improvement of the revenue stream (through for example reduction in unaccounted for water), but regulation will not increase the local economic base or the potential to raise revenue (e.g. from services charges).

Whereas incentives in the form of legislation and regulation are not having the fully desired effect, DWAF is in the process of reviewing legislation.

Alternative delivery models could be designed that have incentive structures that are much more compelling, and also more enforceable. Enforceable, that is, by authorities, but alternatively or in addition by the market, i.e. if the institution does not comply, it loses revenue, or its expenses increase, or its reputation suffers and it fails to win any new business, or in extreme cases it could be forced to close down. Incentives could apply also to individuals, and not just to institutions. Individuals could be fined, have their bonuses withheld, be demoted or lose their jobs. This is taken up in Section 4.3.

4.2.7 Section 4.2 conclusions

The point is adequately made in the first WRC report that there might be nothing intrinsically "wrong" with existing delivery models, but the task is so huge, that the desirability of looking at alternative delivery concepts cannot be denied. (Wall, 2005a:5).

However, the evidence summarised in Sections 4.2.3 through 4.2.6 above is to the effect that many of the owners of the water services infrastructure and/or their appointed water services providers are simply not coping. Given that, despite the efforts that have over the years been made to capacitate or otherwise support these institutions, water services operation and maintenance is in many areas still not adequate, then it is imperative that alternatives be investigated. It might be found that these alternatives have little potential to improve matters but it might also be found that they do have potential. Section 4.3 investigates this.

The key to sustaining and growing water services delivery is to greatly improve the operation and maintenance by water services institutions of the infrastructure for which they are responsible. A plan of action, embracing awareness, a funding formula, a legislative review, performance management, improved incentives to the owners of the infrastructure to responsibly operate and maintain it, and a skills plan, among other measures, needs to be put in place at national level. The plan of action must also consider alternative delivery models, which, if correctly designed and implemented, can be a powerful tool.

Also, as the amount of water services infrastructure increases, the resources allocated to its operation and maintenance must increase accordingly.

Phase 2 of the DWAF national water services infrastructure asset management strategy formulation is at the time of writing in the process of formulating a plan of action.

4.3 The relevance of franchising to water services delivery, and the potential for water services franchising as a means of improving water services delivery

4.3.1 Sequence of Section 4.3

Section 4.3 investigates the relevance of franchising to water services delivery, and the potential for water services franchising as a means of improving water services delivery

If suggested new models are to be taken seriously, it first has to be demonstrated that the existing models are not always doing well. It then has to be demonstrated in which respects they are not doing well that new models, and in particular the suggested models, would address these problem areas. Section 4.3.2 describes the commonly used delivery model, and then demonstrates this.

The argument would need to start by drawing out the key points from Section 4.2, and then telling how each could be addressed by the suggested model(s). Section 4.3.3 summarises the generic advantages and disadvantages of franchising. Section 4.3.4 discusses how franchising might address problems that the commonly used delivery model, or its implementation, is not addressing. The question is asked: are there characteristics of the way the "not doing well" are doing it, that, viewing the characteristics of franchising, one is led to believe that franchising might have the potential to deliver water services, or at least particular elements of the water service delivery chain, better?

Section 4.3.5 discusses capital and operational funding.

Outsourcing, by the water services provider, to a SMME, appears to be intrinsically more suited to assisting it with its operation of some elements than it would be with its operation of other elements. Section 4.3.6 takes this further.

Section 4.3.7 lists prerequisites for and limitations of franchising. Section 4.3.8 introduces the topic of selection of elements for the modelling that will be undertaken later in this project.

Section 4.3.9 draws conclusions for Section 4.3.

4.3.2 The common delivery model

It needs to be reiterated that the operation and maintenance of a large proportion of the water services infrastructure of South Africa is satisfactory, or at least adequate. This Section considers why this is so, given that the operation and maintenance of so much other water services infrastructure is not adequate.

One delivery model is commonly used by water services authorities, albeit with a number of variations as described in Section 4.2.2, under the heading "existing water services delivery models". This model relies heavily on municipalities' own in-house resources, and sometimes also, if that is the water services provider route the water services authorities have chosen, on water boards and municipal entities. Private sector involvement is extensive, but seldom other than limited term and task-based, for example, the private sector being contracted to construct, repair or refurbish specific elements of water services infrastructure. The private sector is very seldom contracted to assume full operational and maintenance responsibility for elements of infrastructure.

Also as noted in Section 4.2.2, water services authorities sometimes contract bodies that are not part of the public sector, such as CBOs, NGOs or private sector operations contractors, to be one of their water services providers (generally not their sole water services provider).

Two questions must be posed:

- Do delivery problems intrinsically lie with the common delivery model, or do they lie with how the delivery model is implemented?;
- If the problems lie with how the common delivery model is implemented in some cases, then what modifications should be made to this delivery model in order to rectify implementation or what alternative delivery model(s) should be considered?

Picking up on the findings of Section 4.2.6, the following are the essential differences between:

- the water services authorities that use the common delivery model, or variations on it, and operate and maintain their infrastructure at least adequately (for convenience, refer to these as "Category A").
- the water services authorities that use the common delivery model, or variations on it, and do not operate and maintain their infrastructure at least adequately (for convenience, refer to these as "Category B").

The essential differences, in respect of **budgets** for water services operation and maintenance, are:

- Category A: These authorities are financially viable, and they adequately fund operation and maintenance of their water services (although they invariably state that they could do with more funding). Some have ringfenced their water services, separating them from other municipal functions.
- Category B: These authorities are financially viable, but they do not adequately fund operation and maintenance of their water services, preferring to use their funding to provide other services or it could be that some of the funding is mismanaged.

OR

- Category B: These authorities are not financially viable, and are unable to adequately fund operation and maintenance of their water services.

In respect of **skills** and processes for water services operation and maintenance, the essential differences are:

- Category A: In these authorities, staff are in place that have more or less adequate skills (or these skills are outsourced, but the authority has staff competent to ensure that the outsourcing results in quality work being done), processes are adequate, policies support sound operation and maintenance practice, and practice is at least adequate.
- Category B: These authorities lack critical mass in one or more of the above (i.e. in-house skills, competence to supervise work that is outsourced, processes, policies and/or practice).

Note that the responsibility for ensuring water services delivery rests with the water services authorities. Using the word "outsource" in a broad sense, therefore, they are outsourcing to WSPs who in turn may of course outsource to others. That many WSAs choose to appoint their own (municipal) departments as the water services providers does not change the principle.

In respect of **incentives** for water services operation and maintenance, the essential differences are:

- Category A: In these authorities, leadership (principally, councillors, board members and officials) is committed to operation and maintenance, and sees to it that sound operation and maintenance is not only enabled (through adequate resourcing, including skills and funding), but also that sound operation and maintenance is practised.
  AND/OR
- Category A: The leadership is not as committed as it should be to all aspects of operation and maintenance, but is fully conscious of incentives that require sound operation and maintenance, and, whether as the institution or as individuals, does not wish to be penalised as a consequence of delivery failure.
- Category B: In these authorities, incentives are weak and/or not enforced, and/or the leadership feels that it can without being penalised ignore the incentives if it is to its advantage to do so.

Incentives could include:

- legislated requirements in respect of, for example, safety and environmental considerations;
- appreciation of the financial and economic cost of inadequate operation and maintenance, and of the cost savings that are often the direct result of, say, repair or refurbishment of infrastructure;
- "popular opinion" (e.g. environmental lobby);
- the voting power of constituencies; and
- external assistance offered or imposed (e.g. funding or skills. Cases in point might be external institutions' offers to provide skills at no cost to the authority, or to repair infrastructure at no cost to the authority, or to carry the risk of investment in an infrastructure improvement in return for a proportion of the revenue that it is anticipated will ensue).

Of course incentives might be only as strong as the prospect of the penalties being enforced is strong. A case in point is the weak enforcement of wastewater treatment works effluent regulation. It is possible that institutions and individuals are only incentivised by fear of the consequences but if the risk of being penalised is low, the incentive to comply is weak. On the other hand, and irrespective of enforcement of penalties, it might be that the water services institutions are incentivised by a sense that "the right thing must be done".

Clearly, addressing the first of the questions posed earlier in Section 4.3.2, the problem does not lie with the common delivery model, but with the way this delivery model is implemented. Some water services institutions have the will and the resources to make the existing delivery model work, whereas others lack one or other of will or resources, or they lack both.

To address the second question, but splitting it in two:

- what modifications should be made to the common delivery model in order to rectify implementation; or
- what alternative delivery model(s) should be considered?

As to modifications that could or should be made to the common delivery model, the discussion above provides a number of suggestions. For example, ringfencing water services would be of some value in almost all conceivable situations, but that value would be severely limited if the municipality were not financially viable, in which event the service would probably remain under-financed despite ringfencing. For another example, it would be of value for an institution to more actively and effectively recruit skilled staff, or retain and support existing skilled staff. For a third example, if externally-applied incentives were strengthened, that would be of value, but only if the water services authority had the ability to respond. In this latter case, it would not help if effluent regulation were strongly enforced, if the water services authority was not viable and could not source the funding to refurbish their treatment works and employ properly skilled and motivated staff.

Sections 4.3 3 and 4.3.4 investigate the merits of franchising as an alternative delivery model.

4.3.3 Advantages and disadvantages of franchising

The characteristics of franchising, and in particular the cardinal elements of the franchise process, are set out in Section 3.2 above.

Before discussing how franchising might be able to address some of the issues surrounding current water services delivery, described above in Section 4.3.2, it is as well to list the generic advantages of franchising. (The list is taken from Illetschko, 2005:29-32. Each point is described there in three or four lines.)

- Thanks to the experience of the franchisor, the franchisee should make fewer mistakes in setting up the business;
- Similarly, the systems and procedures have been tested;
- The franchise can be operational from day one, even if the franchisee has no experience in the field;
- Access to the franchisor's established network should assist the franchisee to obtain accreditation with suppliers;
- Given that the franchise is known, it should be easier to attract good staff;
- The brand and product and services range, and their reliability, are known, which should make it easier to attract customers;
- The franchisor takes care of matters such as market research (i.e. understanding the needs of customers and potential customers) and product and services development, allowing the franchisee to focus on customer service;
- Franchising's advantages are well understood by bankers, which should make it easier (than for a standalone business) for the franchisee to attract finance;
- The franchisor supports the franchisee on an ongoing basis with inspections and training; and
- The franchisor checks on quality on an ongoing basis.

Illetschko did not feel it necessary to state the obvious, that is, that franchisees, like all entrepreneurs, are in the business in order to make money. This is a very strong incentive. And franchisees will not succeed if they do not provide products and services that customers want, at a quality and reliability that customers want, at prices that the customers are prepared to pay.

Illetschko stated that the disadvantages comprise only:

- The cost of initial investment can be very high; and
- The franchisee is bound by the systems and controls imposed by the franchisor.

He stated however that the latter is more of an advantage than a disadvantage, being a discipline that the franchisor imposes in order to ensure quality. Thus the systems and controls relate to issues such as:

- setting up the business;
- the product and services range;
- rules on how the franchisee must operate; and
- financial reviews. (Ibid:32-33).

It is very pertinent to the primary reason for the current project, and in particular bearing in mind the findings of Section 4.2, to refer to the section in Illetschko that is headed "Do you really want a safety net?"

"Becoming a franchisee reduces the business risk. The support and cooperation you will receive from your franchisor is a kind of safety net. If you trip or fall it need not be a disaster…… The limitations stem mainly from the operational guidelines you will have to follow. As a franchisee, you are part of a network and not a one-man band. For the network to be successful, every member must follow the operations and procedures manual. This manual is so important that it will be frequently referred to in the franchise agreement. …. the franchisor will insist that you comply strictly with the systems and procedures. …. **If you join a successful network, it is obviously successful for a reason.** *(Emphasis added.)* Franchisees should also learn every aspect of the business and know all the products and services on offer. And they should never be scared to ask for more training from the franchisor." (Illetschko, 2005:27-28).

Finally, to recap the generic "cardinal elements" of franchising, so as to keep them in mind when discussing what franchising could (in theory at least) do to address current water services delivery problems:

- "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."
  (Wall, 2005a:29).

4.3.4 Could franchising address what is in some instances going wrong with implementation of the common water services delivery model?

This section in the first instance discusses whether franchising could assist the Category B water services authorities, that is, the water services authorities that use the common delivery model, or variations on it, and do not operate and maintain their infrastructure at least adequately. In the second instance it discusses whether franchising could assist Category A authorities with some of their responsibilities, or with some water services tasks that would complement their fulfilment of their responsibilities.

Primary focus is on the Category B authorities, having as they do by far the bigger set of water services delivery problems that need to be resolved.

The pertinent characteristics of the Category B water services authorities, to recall (from Section 4.3.2 above), are:

In respect of **budgets** for water services operation and maintenance, they are financially viable, but they do not adequately fund operation and maintenance of their water services, preferring to use their funding to provide other services or it could be that some of the funding is mismanaged. OR these authorities are not financially viable, and are unable to adequately fund operation and maintenance of their water services.

In respect of **skills** and processes for water services operation and maintenance, they lack critical mass in one or more of: staff that have more or less adequate skills (i.e. the staff are competent enough to ensure that outsourcing results in quality work being done), adequate processes, policies that support sound operation and maintenance practice, and practice that is at least adequate.

In respect of **incentives** for water services operation and maintenance, incentives are weak and/or not enforced, and/or the leadership feels that it can without being penalised ignore the incentives if it is to its advantage to do so.

Addressing each of these in turn:

Budgets

That a WSA is not financially viable is not an issue that can be addressed by any form of franchise. Unless part of the reason for its unviability is an inability to claim for or collect the revenue due to it. Given the right kind of arrangement (which could include franchising, but not necessarily so), the private sector could assist with that task.

Ringfencing of the water service is under most conceivable circumstances an essential first step to improving water services delivery. Again, this is irrespective of whether the service is then operated by a municipal entity, or an element of private sector assistance is brought in.

Summing up, franchising has no inherent characteristics that enable it to significantly assist a water services authority which has problems budgeting for water services operation and maintenance.

But the franchise has to be financially viable for the franchisor and franchisee. This issue is partly discussed here, and taken further in Section 4.3.7.

It is noted in Section 4.3.3 that "the cost of initial investment can be high". Investment, that is, in that usual forms of business format franchising involve the franchisee in spending considerable sums on alterations to premises and the purchasing of furniture and equipment (and maybe also vehicles). Substantial working capital is also required, for example, staff must be hired, and paid while they are being trained, and stock must be purchased. There is also the rental of premises. The franchisor also needs to be paid. There is the initial franchise fee (which covers costs of, for example, initial training, assistance with preparation of the business plan, help with selecting staff, and access to the company's systems, procedures and operating know-how). Then there are ongoing franchise fees to be paid to the franchisor, principally the management services fees, and including also contributions to the marketing and product development of the franchise.

Section 4.2 shows that there is a substantial amount of infrastructure that is already in existence but which is not adequately operated and maintained. In theory, therefore, if the operation and maintenance of this were franchised, then there would be no need for the franchisee to outlay on the purchase of this infrastructure. But, in any case, as discussed in Section 4.2.2, ownership of existing public sector water services infrastructure by the private sector is firmly ruled out – "we will not sell our public water services infrastructure to the private sector". (DWAF 2003c:19). Sure, it is not ruled out that the private sector could invest in new infrastructure to serve the public sector, but there is no necessity in the current report to address this option, which is very seldom encountered anyway.

Funding to bring up to operational requirements the infrastructure for which the franchisee is to be responsible, or to create such infrastructure from scratch, is discussed in Section 4.3.5 below.

Skills

Keynote from Section 4.3.2: In respect of **skills** and processes for water services operation and maintenance, Category B authorities "lack critical mass in one or more of": staff that have more or less adequate skills (i.e. the staff are competent enough to ensure that outsourcing results in quality work being done); adequate processes; policies that support sound operation and maintenance practice; and practice that is at least adequate.

Skills shortfalls is an area that could without question, in appropriate circumstances, be mitigated by correctly designed alternative delivery models. The same applies to improved business processes, which could also be addressed by alternative delivery models.

Private sector involvement in water services is extensive, but this involvement is seldom other than limited term and task-based, e.g. that the private sector is contracted to design, construct, supply or refurbish specific elements.

Outsourcing for periods of several years of elements of operation and maintenance to large private sector or public sector water services institutions (for example, to Rand Water or Amanz' abantu, see case studies in Section 3.6) does occur, but is very much the exception. A major attraction is the skills and processes that those institutions can bring to bear. The costs of the large institution are sometimes covered either in that it is doing the work at cost or below cost, or that a third party (e.g. DWAF) is helping to cover the costs. The mechanisms normally include temporary secondment of staff from the large institution, locating them with the water services authority, or straightforward contracting, which then does not involve seconding staff. Sometimes there is also an element of transfer of skills to the authority.

Outsourcing of operation and maintenance to SMMEs is not uncommon, but:

- SMMEs have to aim to make a profit, and cannot work at cost or below cost to the authority unless they are subsidised by a third party; and
- SMMEs in business on their own suffer from all the disadvantages of not being part of a support system such as that provided by a franchise network (see the bullet points below), in particular, it is highly unlikely that they would have access to the high-level specialist staff, and product and services development, that the economies of scale of a franchise network would enable them to have access to.

The advantages to the water services authority of outsourcing operation and maintenance to a franchisee are among those listed in Section 4.3.3 above. Those applicable are worth repeating here (without their meaning being changed, the phrasing of some is amended in order to more clearly highlight the advantages):

- thanks to the experience of the franchisor, the systems and procedures have been tested;
- the brand and product and services range, and their reliability, are known, which should be reassuring to the authority;
- the franchisee is able to focus on better servicing the needs of the customer (the WSA), because the franchisor takes care of matters such as product and services development;
- thanks to economies of scale, the water services authority is able to share in facilities and services that it could not afford to purchase for itself exclusively, most importantly product and services development, and specialist or high-level skills;
- the franchisor supports the franchisee on an ongoing basis with inspections and training; and
- the franchisor checks on quality on an ongoing basis, and will do its utmost to ensure that quality does not slip, because its reputation and the reputation of its network, depend on it.

The advantage to the SMME of being a franchisee rather than a standalone business, are all of those listed immediately above, to which can be added Illetschko's comment on "safety net" and the following:

- thanks to the experience of the franchisor, the franchisee should make fewer mistakes in setting up the business;
- the franchise can be operational from day one, even if the franchisee has no experience in the field;
- access to the franchisor's established network should assist the franchisee to obtain accreditation with suppliers;
- given that the franchise is known, it should be easier to attract good staff; and
- franchising's advantages are well understood by bankers, which should make it easier (than for a standalone business) for the franchisee to attract finance.

To sum up, assuming that the contracts between the WSA and the franchisee, on the one hand, and the franchisor and franchisee on the other, are correctly structured, and that the WSA has the skills to competently oversee its contract with the franchisee, the principal advantages to the WSA are:

- that systems and procedures have been tried and tested;
- that the franchisor ensures quality;
- that the franchisor ensures that if the franchisee fails, resources will be brought in to minimise interruption of the service;
- that economies of scale make it possible for the authority to gain access to high level scarce skills on a routine basis and also when they are urgently needed. (It does not have to bear the costs all on its own (it could not afford to anyway), but it can afford a share, because the skilled staff are retained by the franchisor and the costs of their employment are distributed over several franchisees.); and
- that economies of scale make it possible for the authority to gain access to the benefits of product and services development.

To illustrate one of the above. A WSA or WSP in Gauteng has only moderate difficulty in (if it is large enough to afford the expense) employing a full-time skilled treatment process specialist, or (if it is smaller) employing one on a retainer basis. To this specialist it would assign the duties of:

- regularly visiting each treatment works and checking on quality, advising on process adjustment, etc;
- managing routine planned events such as maintenance, advising on new equipment, commissioning the new equipment, etc;
- mentoring personnel; and

- being on hand at short notice to manage their response to unplanned events, such as breakdowns and significant changes to the quality of inflow.

On the other hand, the chances are remote that a WSA or WSP in the rural areas of the Eastern Cape, the Northern Cape or Mpumalanga would be able to access such expertise when they needed it. (Section 4.2 summarises ample evidence of this.) If, however, (continuing with the same example) their treatment works was run by a franchisee, the franchisee would access this expertise through the franchise network.

It is possible therefore to conceive, as one of many possible options, that a municipality remains responsible for the whole water service in its area, except that each treatment works is run by a franchisee based in a town nearby to it.

To conclude, it is usually the skills and the tried and tested systems and procedures that franchising can bring that would make franchising attractive to Category B WSAs, and also make franchisees attractive as subcontractors to WSPs. Everything else being equal, the more difficult it is for the authority to attract skilled staff, the more advantageous it would be for it to enter into an arrangement that brings with it the scarce specialist or high-level support, and quality control, that it could not otherwise reasonably hope to access.

Incentives

Keynote from Section 4.3.2: In respect of **incentives** for water services operation and maintenance, in Category B authorities, "incentives are weak and/or not enforced, and/or the leadership feels that it can without being penalised ignore the incentives if it is to its advantage to do so".

Current incentives for good water services operation and maintenance, in the shape of legislation, peer pressure, voter pressure and other forms are too often weak (e.g. regulations are not enforced by the regulating authority (e.g. DWAF in respect of wastewater treatment works effluent)) or are contrary (e.g. voter pressure is, if anything, usually to take resources away from wastewater treatment works operation and maintenance, and allocate them to benefits more visible to the voters).

Part of improving operation and maintenance must therefore include:
- reinforcing legislated incentives;
- reinforcing peer pressure (e.g. if the regulator were to name and shame errant authorities, and name and praise exemplary authorities); and
- changing the direction of voter pressure (e.g. by informing them. The Minister in 2005 thanked environmental lobby groups for their publicising of the wastewater quality problems in Emfuleni. (DWAF 2005e:2).

These will not be sufficient. Financial incentives, impacting on institutions or individuals, often work very well in other circumstances, and their application to water services operation and maintenance should be investigated. An obvious route to follow is that of alternative delivery models that have compelling, and enforceable, financial incentives. Enforceable, that is, by authorities, but alternatively or in addition by the market, i.e. if the institution does not comply, it loses revenue, or its expenses increase, or its reputation suffers and it fails to win any new business, or in extreme cases it could be forced to close down. Incentives could apply also to individuals, and not just to institutions. Individuals could be fined, have their bonuses withheld, be demoted or lose their jobs.

Financial incentives are the incentives that by definition drive the profit-seeking private sector. Models can thus readily be designed that place with the private sector the responsibility for operating and maintaining water services infrastructure, and operating this to meet targets. If these targets are met, rewards follow, but if they are not met, penalties follow.

Depending on the circumstances, SMMEs might be the appropriate arm of the private sector. Again depending on the circumstances, franchisee SMMEs might be appropriate. Either way, if improving the incentive is the key to improving performance, then both are worthy of consideration.

It stands to reason, however, that the penalties for non-performance must be in proportion to the financial strength of the SMME and to the impact of the non-performance for which the penalty is imposed. They must, everything else (such as the SMME's appropriateness to the task) being equal, not threaten the viability of the business for a relatively trivial reason. For a ridiculous example, the penalty for on one occasion not meeting one of the parameters in the effluent license agreement must not be of the same order as the fee paid per week to the SMME. For another example, the penalty should not substantially exceed (it could also be argued that it should be less than this) the cost of the damage caused by non-performance.

Category A authorities

Franchising can certainly assist Category A authorities with some of their responsibilities, or with some water services tasks that would complement their fulfilment of their responsibilities. The services rendered to private households and businesses by The Drain Surgeon franchisor and its franchisees are an excellent example of this. Also, were some of its clients WSAs rather than invariably being in the private sector, the services rendered by PWMSA and its franchisees are another excellent example. These two franchisors have identified franchisable elements of water services delivery, and have built their expertise and their network, and viable businesses, around providing that service.

There is no doubt that further service elements can be franchised. They await only their identification by a skilled and entrepreneurial supplier of the service, and him then applying franchising principles, and building a business.

Category A authorities might choose to franchise some activities currently performed in-house, even if current performance is satisfactory. Doing that might suit their other goals, such as BEE development, or it might enable them better focus on their core business.

There are precedents aplenty for municipal personnel resigning and setting themselves up as SMMEs, which then supply the same or similar service to the municipality as these individuals provided before, in-house. Some of these SMMEs could become the basis of franchises – perhaps some already have.

Section 4.3.4 conclusions

It is possible therefore to conceive that franchisors and franchisees, in partnership, can simultaneously:

- improve, in respect of selected elements, on the current operation and maintenance practices of many WSAs (particularly Category B authorities); and
- be viable business enterprises.

It is left for Sections 4.3.6 and 4.3.8 to identify which elements or types of elements might be suitable prospects for franchising.

Sketching out on paper the above advantages, to water services authorities and potential franchisors and franchisees alike, is one thing. Making useful, employable, attractive and viable businesses out of these apparent opportunities is another. A lot of work needs to be done. The outputs of the current project, and in particular the business models, will be a significant step in the right direction. The next step, after the conclusion of the current project, would need to be piloting the best prospects.

4.3.5 Funding to bring the infrastructure up to operational requirements, and funding the private sector partners' income stream

Much of the discussion in this Section is about ensuring the private sector partners' income stream, and does not distinguish between franchises or other forms of private sector partner. In the instances discussed, the problems, and possible solutions, are the same.

Funding for capital investment in water services infrastructure replacement and refurbishment

It is known that much of the water services infrastructure in South Africa, and especially that which is the responsibility of Category B WSAs, needs refurbishment and some of it needs replacement.

In appropriate circumstances, funding of the capital expenses should not be a problem if ministerial statements, and precedents at national level, are anything to go by. 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 sourcing of finance for worthwhile projects as and when the municipal sector improves its ability to spend funds responsibly. Given the ease with which it will often be able to demonstrate that improved operation and maintenance can either reduce costs of operation or increase revenue or save on future repair, refurbishment and replacement costs, a convincing case could readily be made for capital grants to bring the infrastructure up to operational requirements before handing its care to an improved operation and maintenance regime. And a very strong precedent has been set in that DWAF, before it has handed over to WSAs the services infrastructure that it inherited from the former homeland governments and that it built itself after 1994 in terms of the Community Water and Sanitation Services programme, spent considerable sums on refurbishing or replacing this infrastructure. (61% of the more than 13 500 bulk water services infrastructure components programmed for handover have required "substantial refurbishment" to reinstate their original design functionality. (DWAF 2003a).

The 2005 WRC report expressed it well:

> "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." (Wall, 2005a:77).

General

If the funding that is needed to get the infrastructure back into working order is resourced from outside the franchise arrangement, this leaves the franchisee to find the funding for his premises, vehicles and tools, and also working capital. On top of that are the initial franchise fee and the ongoing franchise fees. In the normal franchising world, an established and successful franchisee that had not had to take out loans purchase "equipment" (in the water services context, read "infrastructure") would, given time, have little difficulty in paying these out of his revenue. Illetschko stated that franchisees, with loans (i.e. loans for equipment or infrastructure) to pay off, should not expect to make an accumulated profit before the end of the third or fourth years.

The size and the reliability of the income stream are extremely important, i.e. an income stream for the franchisee that is sufficiently large to cover expenses and make a profit.

Two problem areas manifest, namely:
- many benefits of improved operation and maintenance do not appear on the financial balance sheet of the WSA, but appear on the balance sheets of others and/or many benefits are non-financial; and
- the expenditure priorities of many municipalities are notoriously changeable from year to year and even within a year.

The smaller the private sector enterprise, and the more dependent it is on income from a small number of WSAs, or, worse, from only one authority, the less likely it is to survive if its client does not on time and in full make the contractually obligated payments. The franchisee could in theory take the client to court, but it is most unlikely to have the resources to do this, and would in any case probably not survive the cash flow implications. It would be bankrupt before the case had proceeded very far.

Many of the benefits of improved water services infrastructure operation and maintenance cannot be quantified financially, or the financial benefit (usually in the form of cost saving rather than increased income) is received by parties other than the institution which has had to fund the improved operation and maintenance (generally the owner of the infrastructure). That is, the expense appears on his financial balance sheet, but the income does not.

However, that benefit will undoubtedly be there, manifesting itself in various ways, and it should form part of what would be a strong case to national government in motivation for financial support for any measures to improve operation and maintenance. While the benefits would not necessarily be financial, they would be manifest in environmental, social, health, and other improvements.

For example, improved drinking water quality would reduce sickness and individuals' absenteeism (with financial benefits to households and to employers).

For another example, improved wastewater effluent would improve the quality of watercourses that eventually wind up in dams, and pass through water treatment works, some of which are suffering so much from the effects of polluted wastewater treatment works effluent, that they have had to be modified at considerable expense, or were even closed, unable to cope. An example of the latter is the Bospoort water treatment works in Rustenburg, which was mothballed between 2000 and 2006 because it was unable to cope with the increasingly foul effluent from the two wastewater treatment works upstream of it. Water supply to Rustenburg had to be maintained from a pipeline specially built by Rand Water. (Marx, 2006:14). It has been argued that this pipeline would have been unnecessary had Rustenburg properly operated and maintained its two wastewater treatment works.

However, under certain circumstances the benefits of improved water services infrastructure operation and maintenance can be quantified financially and can reflect directly on the balance sheet of the water services authority. The simplest example of this is the water services authority fixing leaks in its water mains, and thereby saving on the amount and cost of the water that it purchases.

Under other circumstances the benefits can reflect on the balance sheets of both the water services authority and the entrepreneurial institution, be it public or private sector that invests in the improvement. Bospoort is one example of that. Bigen consulting engineers approached the Rustenburg LM with a proposal to refurbish the two wastewater treatment works, refurbish and upgrade the water treatment works, and refurbish the bulk water pipeline. The offer, which included funding (total project cost R280 million) and in the short term operating the infrastructure, was accepted, and the financial benefits are being shared between the municipality and the Bigen consortium. (Ibid:15).

While this PPP involved major expenditure, another PPP involved a capital outlay of a much lesser sum, namely R5 million. This was the partnership between WRP and Metsi-a-Lekoa, the ringfenced water utility owned by Emfuleni LM. WRP and its private sector funding partners funded the full cost of an installation to manage water pressures in the townships of Sebokeng and Evaton. Which installation, note, immediately became the property of the municipality – WRP and its partners took a huge risk.

For a period of five years after commissioning of the installation (2005), a proportion (of the order of 15%) of the savings (“savings” in terms of reduced purchases by Metsi-a-Lekoa from Rand Water) accrues to WRP and its funding partners, with a larger proportion going to Metsi-a-Lekoa. If there are no savings, then WRP and its partners receive no return on their investment. Fortunately, thus far, the savings (which are independently audited) have been substantial. (McKenzie personal communication; McKenzie et al., 2006; and WRP, 2005)

These two examples (and there are others that can be quoted) go to show that under certain circumstances PPPs can be profitable for the private sector, even though income may not come from sales of a product or service, but may come from savings, on a risk-sharing basis with the WSA.

All-important are the terms in the contract agreement between the franchisee and the WSA. Where will the surplus be derived from, who collects the income and pays the expenses, what is the sharing of benefits and of risks (what proportions, and what guarantees), who makes the necessary investments in new infrastructure or repair or refurbishment of old infrastructure, who carries the running costs, who are staff employed by and what are their employment conditions, for how long and under what conditions does the contract endure, and under what circumstances could the contract be terminated or extended. Proportions in which the risk is shared, and guarantees, such as guarantees that one or other party will not renege, and guarantees of income continuity, are hugely important. (Vide: "The greatest risk to the consultant is not necessarily that the savings are not achieved but rather that the client does not pay the agreed savings. In the case of the Sebokeng-Evaton project the support and honesty of the client has been the key to the success of the project." (McKenzie et al., 2006:10).)

For a cash-strapped WSA, and a private sector partner (whether franchise or not) that cannot survive if the income stream that has been contractually promised to it is not paid in full and on time, making savings for the WSA, and being paid out of these, might be a better prospect than depending on the annual municipal budget. Also, whereas the municipal budget gives certainty of a kind for only the next 12 months at most, an income stream from savings could, given the right scheme and contract agreement, provide certainty for longer, possibly for as long as the savings are made.

There is a need for an external agency with substantial funding resources to recognise this arrangement for what it is, namely, a financial saving for the nation (saves operating costs, improves return on capital investment (infrastructure better operated and maintained lasts longer, incurs less expense for repair and replacement, and provides improved financial returns)); a means to SMME and BEE development; a water conservation measure; and, through improved quality and reliability of service, an underpinning of the economy and improved quality of life. The agency should then be prepared to be a financial guarantor of last resort.

The agency would logically be an arm of national government. Obvious candidates include DWAF (as custodian of the nation's water resources and services), the national Department of Provincial and Local Government (DPLG) (as custodian of the Consolidated Municipal Infrastructure Programme (CMIP)) and National Treasury or these and others acting in concert.

4.3.6 Potential for franchising

The potential for water services franchising lies, broadly, in:

- initiatives that will lead to the establishment of franchisee WSPs that would offer a full range of water services; and
- initiatives that will lead to the establishment of franchisees that would offer elements selected from the full range.

These franchisees could be direct contractors to the WSA, or subcontractors to other WSPs.

All but a very few South African municipalities cover extensive geographic areas. The town in which the municipal headquarters is situated is often several hours' drive from the furthest village, not to speak of the deep rural areas that often lie beyond that. The roads even to the villages are sometimes difficult to travel on, a situation exacerbated in the wet season. Even telecommunications can often be limited in these areas. Yet a significant proportion of water services infrastructure lies outside the main towns, and it needs to be operated and maintained.

WSA officials trained in water services operation and maintenance would invariably be located, if not only in the town in which the municipal headquarters is situated, then in addition in one of only a small number of other towns in the municipality, and the travel time alone should they be required to routinely visit the infrastructure that needs to be visited is clearly very consuming. Hence the attraction of devolving to the local level the routine operations and maintenance functions of the simpler infrastructure elements, as is extensively practised in South Africa already.

However, even the simpler water services infrastructure elements do from time to time need the attention of expertise that is not routinely available locally. Also, some of the more sophisticated water services elements are located in areas that are some distance from where it is that the WSA has chosen to base the necessary expertise to even routinely operate and maintain these. Furthermore, as argued at some length in Section 4.3.4, many WSAs and WSPs do not have anywhere in the municipal area the expertise to adequately supervise operation and maintenance of the more sophisticated infrastructure, much less to be able to deal with anything that has to be done that is out of the daily routine.

It is possible therefore to conclude that:

i) In respect of less sophisticated infrastructure, it is quite conceivable that a locally based organisation could offer a lower-cost yet more rapidly responsive service than could a larger

WSP that has to service dispersed locations from a central depot, or even from satellite depots, and its employees incur substantial travel cost and travel time to respond to its service calls.

ii) It is also quite conceivable that a locally based organisation could offer a lower-cost and more immediately available service in respect of more sophisticated infrastructure. However, should this organisation have access to higher levels of expertise on an "as-needed" basis (as it would if it were a franchise), just as strong an attraction would be that it would be able to provide a better service than many WSPs can at present. This higher expertise could by the way be available in different levels of expertise according to the nature of the need.

As noted earlier, (i) above is extensively but not universally practised. CBOs are responsible for operation and maintenance of much of the water services infrastructure in the rural areas. Some of these are unsupported (the municipal WSP does not have the resources to support them, despite the best of intentions), and others are supported by the municipal WSP or by SSAs, or by others. The municipal WSPs generally speaking have the right types of expertise for this infrastructure, but the problem often is that it is too thinly spread.

On the other hand, many municipal WSPs have insufficient expertise to cope with the needs of the more sophisticated infrastructure, as discussed in (ii) above. They simply do not have it, or do not have it at the higher levels required for less routine activities, or they have so little of this expertise that it does not get to attend to the needs of the infrastructure further away from the main town or towns in the municipality. In some cases, they have sought the assistance of SSAs or others and in other cases, they are struggling on their own. Section 4.2 is ample evidence of that.

This readily suggests that a hierarchy of water services elements can be identified, as follows:

- those elements that are so unsophisticated that, even in rural areas, all operation and maintenance can be done by locally based trained persons;
- those elements of infrastructure that are more sophisticated, with the consequence that, whereas nearly all operation and maintenance can be done by locally based trained persons even in rural areas, some activities require expertise to be imported from further afield, but still within the municipal area; and
- those elements of infrastructure that are even more sophisticated, so that nearly all operation and maintenance expertise can only be found in a sizeable town, and furthermore some activities require expertise to be imported from further afield, possibly even from outside the municipal area.

In respect of the last of these, the type of expertise that would need to be imported would be that which an appropriate SSA or franchisor could provide. Which is not to deny that municipal WSPs can, and frequently do, hire this expertise when needed, or employ it on a short-term retainer. (As a non-water services example of the latter: in order to comply with national regulations, many municipalities retain a local electrical contractor to be the "responsible person" with respect to electricity distribution infrastructure in some of their areas.)

In addition to these, the possibility is wide open that a municipal WSP would, if it chose to, be capable of performing any of the above functions, but has simply decided that it prefers to outsource these, or leave it to the marketplace to perform them.

None of the preceding has touched on the additional advantages, as outlined in Section 4.3.4, of the stronger incentives that drive franchises, compared to those that drive public sector employees. Not to deny that many examples of like-franchising also offer improved incentives.

It remains only to identify a number of suitable elements, and the circumstances in which they may be suitable for operation and maintenance in terms of a franchise arrangement. This is done in Section 4.3.8 below.

That a franchisee should operate and maintain a full range of water services elements, from abstraction, through water treatment etc, all the way through to treatment and disposal of wastewater, is not excluded as a possibility. But the management skills demanded of the franchisee, and the great array of technical skills that he would have to have on board, make this a less likely option. So it is more likely that franchising of water services, in its development stages at least, would be of parts of the water services delivery value chain, rather than of the whole.

Note that in all the preceding, as discussed in Section 4.3.5 and elsewhere, franchising other than of operation and maintenance is not likely to be feasible. It is accepted that the ownership of, and responsibility for finding the funding for capital investment in, the water services infrastructure remains with the WSA, and are not transferred to the WSP, whether that be a municipal WSP or any other WSP.

4.3.7 Prerequisites for and limitations of franchising

All of these prerequisites for and limitations of franchising, and indeed desirable guarantees, have been explained and discussed at some length at various points in Chapter 4. Section 4.3.7 now brings them together in summary form.

Several of them relate as much to other forms of PPP in the water services sector as they do to franchising.

These prerequisites and limitations relate to:

- present relationship structure;
- procurement;
- financing;
- suitability to some elements and not to others; and
- the need to find franchisors and franchisees.

Each of these, in turn, is now discussed briefly.

Present relationship structure.

That a WSP, or a contractor to a WSP, is a franchisee rather than any other form of SMME or private sector partner or public sector entity, must not disturb the present relationship structure between DWAF, the WSA, and the funding partner(s). Franchising is an additional WSP option, only one of several alternatives in the array of possible WSPs.

The financial aspects of not disturbing the present relationship structure are described further below under Financing.

Procurement.

The case studies of Section 3.6 raised the issue of the limits that public sector procurement policies place on the potential of the private sector contribution. This issue needs to be resolved, and mistaken applications of policy must be identified and corrected. It is acknowledged that this will not be an easy task.

Financing.

The key prerequisites and limitations with respect to financing relate to:

a) ringfencing the contractual obligations;
b) not disturbing present funding relationships;
c) capital funding;
d) changeability of municipal expenditure priorities; and
e) an external funder or guarantor of income.

a) The water services function and department must be ringfenced, and the function of representing consumers must be separated from the function of delivering that part of the service that is outsourced.

   Where justified, this could be through the establishment of a specialist municipal entity for water services. An example lies in the creation of Johannesburg Water, which is mandated to deliver the service, and Johannesburg Municipality, a body elected by the citizens, and duty-bound to represent their interests.

   Providing basic services free of charge, and tariffs levied on consumers for water services, on the one hand, and on the other hand payment to the private sector partner, must be independent of each other. The relationship of the private sector partner to the WSA or WSP is governed by contract, and payment must be directly linked to delivery in terms of the contract. Tariffs, and associated issues such as payment for services, allocation between municipal functions of equitable share and any other national transfers, must not affect the contract-related payment obligations. If the WSA or WSP is unable to pay the private sector partner through having insufficient income to do so, contributory reasons could include that it might be over-extended in respect of its free basic services policy, or might not have raised tariffs sufficiently or might not be recovering the services income due to it. If it is unable to pay the private sector partner, it is in breach of contract. If the WSA is chronically unable to fund its obligations, this needs to be addressed by national government.

b) That a WSP, or a contractor to a WSP, is a private sector partner (whether franchisee or not), must not disturb the present funding relationships. For example, if equitable share went to subsidise the water services to a specific set of households when water was supplied by a municipal WSP, the same equitable share must continue to subsidise them even if the suppliers change, and the new supplier is a SMME.

   The private sector partner is, depending on the terms of the contract with the WSA or WSP, providing a specific service either (i) for a defined fee (which is presumably not more than it would cost the municipality to do it in-house, or why would they outsource the work? Unless they regard it as non-core, and for that reason wish to outsource it provided that costs are not unreasonable) OR (ii) for a share of the savings OR (iii) a proportion of both.

   Equitable share or any other subsidy must be allocated to the indigent water services consumers exactly as if the operation and maintenance were being performed in-house. Similarly, consumers receiving free basic water before the contract must continue to receive free basic water afterwards.

c) Another pre-requisite not so much to public-private partnerships in general, but certainly to those where the private partner is an SMME, relates to capital funding, as discussed in Section 4.3.5. An SMME is not likely to have the resources to contribute to capital investment.

d) A potentially dangerous limitation to the viability of SMMEs is the notorious changeability of budget (and, worse still, actual expenditure) priorities of many municipalities. This is also described in Section 4.3.5.

e) The case that DWAF should assist with nurturing and growing the franchise concept, and assisting in at least the formative years with the funding of franchising projects, is made in Section 4.3.5 and also in the first report in Section 7.1.5. If it wishes to see a healthy SMME involvement in the water services sector, together with LED and BEE development, DWAF (maybe alone, or maybe in concert with other national government departments) should be prepared to be a financial guarantor (of contractual financial obligations) of last resort, is also suggested there.

Suitability to some elements and not to others.

Outsourcing, by the WSP, to a SMME, appears to be intrinsically more suited to assisting it with its operation of some elements than it would be with its operation of other elements. Section 4.3.6 discussed this.

The need to find franchisors and franchisees.

Water services franchising will of course be limited to the extent that suitable franchisors are willing and available, and suitable local entrepreneurs are willing and able to take up water services franchise opportunities. Also that franchising proves to be a viable business for franchisor and franchisee alike, and that service to customers meets the specification in the franchise contract with the WSA or WSP.

4.3.8 Section 4.3 conclusions

It is not that the water services delivery model in common use (i.e. a heavy reliance on WSA's/municipality's own in-house resources) is intrinsically flawed, and that is why many of the owners of the water services infrastructure and/or their appointed WSPs are not able to deliver satisfactorily. Evidence that it is not flawed lies in that in many instances water services are being delivered satisfactorily, or more-or-less satisfactorily. It is in the implementation, rather than in the model itself, where the problems lie.

Essential differences between WSAs, using the common model, that deliver satisfactorily and those that do not deliver satisfactorily, are analysed in this Section 4.3 under the headings of "budget", "skills" and "incentives".

The franchising model for water services delivery has undoubted potential for assisting with the resolution of skills and incentives problems that are encountered by, or in, many WSAs and WSPs, or to structure alternatives to current water services delivery institutions. The model cannot, however, be expected to directly address a WSA's budget problems. Nonetheless, any measures that led to more reliable and sustainable water services would (for example through reducing wastage of water) result in cost savings to a WSA, thereby improving its financial situation.

Franchisee WSPs, dependent for their continued existence on the success of their business, have a strong incentive to perform, stronger than the incentive that in-house WSA personnel would usually have. Franchisees would also enjoy the benefit of the franchisors' expert guidance and quality assurance. On this latter point, a franchisor can ensure a professional approach, and provide quality control, ongoing training, as well as advice and help when needed.

This help from the franchisor would be of particular value to WSAs away from the major urban centres, few of which can afford to employ sufficiently skilled staff and it shows in the state of their infrastructure. Significant improvements would soon be seen if the generally under-qualified or under-resourced water services staff in these WSAs could have this ongoing support, mentoring and quality control or if the WSA could contract out some of their operations and maintenance responsibilities, entering into agreements with SMMEs that enjoy the necessary ongoing support, mentoring and quality control.

Given that the costs of the franchisors higher levels of specialist expertise are shared by several franchisees, the franchisor could afford to make this expertise available to each of them on an as-needed basis, and could provide other resources normally only available to larger WSPs. This holds significant benefits for WSAs.

A WSA client's competence to monitor performance and enforce contract compliance is key to its effective reaping the benefits of appropriate outsourcing. Evidence is that the necessary competence cannot, sadly, always be taken for granted of many WSAs. However, if a client is short of skills, it would be putting these to more efficient use in managing the work of the contractor than in trying to cope with the operational issues itself.

Whereas franchisees, being SMMEs, are generally unable to assist with capital investment in infrastructure, a very strong case can be made for this funding, whether for new infrastructure or for refurbishment or replacement, to be made available by national government.

If improved service delivery results in cost savings to the WSA and/or to improved service, this should improve the financial situation of the WSA, but in practice this financial improvement is not always realised, and/or for other reasons the contractually obliged payments to the franchisee whose efforts have improved the service are not made, or not made on time. As a result of which the financial viability of the franchisee would be threatened. This is not easily resolved, and possible solutions, such as paying the franchisee directly from financial savings made as a direct result of the improved service, or the presence of a national government financial guarantor of last resort, might not be feasible or acceptable.

National government must, however, perceive that the franchise option has in a significant number of circumstances at least as good or maybe an even better chance of providing sustainable water services than any other option has. It would therefore be in the government's own best interests to facilitate the participation of franchised WSPs.

That a WSP, or a contractor to a WSP, is a franchisee rather than any other form of SMME or private sector partner, or a public sector entity, must not disturb institutional, financial and other relationships of the delivery model in common use. For example, in respect of funding, if equitable share is currently used to subsidise the water services to a set of households when the WSP is a municipal WSP, this must not change, and the same subsidy must flow, should the WSP be a SMME.

There are many situations where applying the principles of franchising could improve water services operation and management. Franchising appears to be advantageous in respect of some elements of water services delivery infrastructure, and in some circumstances, but not in respect of those same elements in other circumstances. Franchising should therefore be preferred in appropriate situations but not all situations are appropriate. As just one example: given the huge geographic areas that many municipalities cover, a locally based institution would have a distinct cost advantage over an organisation more centrally based in the municipality, and therefore at a greater physical distance and the customers would receive better service. Being a franchisee would ensure that it could access higher levels of expertise when they were needed.

4.4 The argument for franchising as a means of promoting LED, SMMEs and BEE

4.4.1 Sequence of Section 4.4

Chapter 6 of the first report concluded that there is an enormous need for LED in South Africa, and in particular for the creation and nurturing of more entrepreneurs. Section 4.4 of the current report résumés and updates the argument for water services franchising as a means of promoting LED, SMMEs and BEE.

4.4.2 Water services franchising, SMME and BEE

What is said in Section 4.2 about the inability of many water services institutions to cope with their operation and maintenance responsibilities, and particularly what is said about the incentives (or weakness thereof) on them to comply in the necessary respects, suggests roles for the private sector at many levels. Given that these existing institutional role-players are clearly not coping with all the needs, there is definitely a strong "push factor" reason to investigate alternative concepts for water services operation and maintenance.

However, there is also a need for greater LED, and for SMME development, or "emergent business enterprise" development, and for BEE development. The need in South Africa for less unemployment, for higher household incomes, and for more entrepreneurs, is unquestionable. It is intolerable that of the order of 40% of those between 15 and 65 are not formally employed. Furthermore, South Africa ranks low in global entrepreneurship surveys, indicating inadequacies in creating a climate in which sufficient numbers of emerging businesses can grow and thrive.

Thus there is without question a "pull factor", i.e. the need for LED, and in particular the need for the creation and nurturing of SMMEs, that also strongly motivates the investigation of franchising in South Africa as a water services delivery concept in addition to, and complementary to, the current operational models.

The appropriate SMMEs, appropriately regulated and appropriately supported, could readily be incentivised to play a role in providing locally-based systems, offering niche services in the larger urban areas, and niche services or more comprehensive water services operation and maintenance services in the less urbanised areas.

Franchising provides a suitable support system. The emerging businesses will not have experience, nor will they have the time, given the urgency for development of their potential capacity for water services delivery (in the interest of both assisting Category B WSAs, and building emergent businesses), to develop this expertise.

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.

(For definition of SMMEs in the context of water services, see DWAF et al., 2005, reproduced in part in Annexure C to the current report.)

4.4.3 The emergent business and BEE environment

Emergent business

An unfriendliness to emergent business, particularly in respect of bureaucracy and regulation, is a sore point described in Section 6.3.3 of the first report. Since then it has become an issue more and more frequently raised in business circles. For example:

"In more than 6000 interviews with researchers, SA's small and medium-sized enterprises have sent government a damning message: the enabling environment for small business development, and hence job creation, needs a major overhaul. … [However] growing the bureaucracy to support small business had been disastrously counter-productive. Bureaucrats did not have the entrepreneurial experience or the expertise to guide small businesses." (Holmes, 2005). Other research showed that "entrepreneurs and prospective entrepreneurs are not aware of government initiatives to help SMMEs. Those who are aware have either been sceptical of obtaining assistance or have been unsuccessful." (Business Day, 2005). The obstacles are spelled out in another article, that listed the time and cost of procedures involved in starting a business. Often the worst, requiring "superhuman energy", is "obtaining a business licence from municipalities". (Stafford et al., 2005:30-31).

A common theme of much media coverage is the need that is felt to address underlying issues such as lowering the barriers to entry, reducing the bureaucracy, and establishing an environment friendly to private investment. These are regarded to be more effective than government investing in support programmes such as training and capacity building. (Bernstein et al., 2006). Also, "In a detailed study of the small business sector, [researchers find that] rather than overemphasising costly interventions to support small enterprises, the state should focus on eliminating the barriers created by excessive regulation and the absence of effective markets." (Financial Mail, 2005:57) This is a theme that runs directly counter to much of government's recent and current initiatives. (For example as described in Jacks, 2006:50)

One of the smaller of the SMMEs consulted in compiling the like-franchising case studies volunteered the comment that "there must be six or more parasite taxes that simply kill the business. If government just added the 2% back onto the company tax and paid these parasite organisations directly, it would save huge time and effort. We now also get a 26-page questionnaire from the Department of Statistics which we have to fill in. It takes five hours to do so."

The advantages to an emergent business entrepreneur of being part of a franchise network, better able to cope with or overcome many of the above, are apparent. For example, the franchisee would generally find no need to investigate government's programmes of assistance, or find out for himself how to negotiate the obstacles in starting up a business, because the franchisor would assist him with these and other issues. And, for another example, a fight against the tax judgment described in the next paragraph will no doubt be led by franchisors.

A tax judgment has caused consternation in the franchise industry. "A landmark judgment by the Cape Tax Court will hit franchisees, who will now have to pay back deductions claimed for the payment of trademark royalties. … royalty payments used to be tax deductible." (Temkin, 2005). (Also Fourie, 2006).

It is now being acknowledged at the highest level that the environment is not by any means as friendly to emergent business as it could be. In particular that, of six "binding constraints" on "achieving [the] objectives" of ASGISA that have been identified, one is the "regulatory environment and the burden on small and medium businesses."

> "The mediocre performance of the small, medium and micro business sector in terms of contribution to GDP and employment partly arises from the sub-optimal regulatory environment. The administration of tax, the planning system (including environmental impact assessments (EIA)), municipal regulation, the administration of labour law, and in specific sectoral regulatory environments, regulation unnecessarily hampers the development of businesses." (The Presidency 2006:3)

It is significant that, in this document of only 12 pages, no less than two full pages describe interventions "to develop small business and broad based empowerment". While one can argue that some of the measures listed have been tried before and found wanting (for example "to improve the capacity of local government to support local economic development"), there are others that hold real promise. In particular:

- access to finance;
- best practices for affirmative procurement;
- "timely payment by government";
- new venture funds for SMMEs; and
- "to pursue the recommendations made to Cabinet on the regulatory environment for small businesses", including "a review of labour laws", "reforms in tax administration affecting small businesses" and "how to improve the regulatory environment for small businesses in municipalities". (The Presidency 2006:8-10).

While all of these, if carried through (and the strong commitment by national government to see that this is done is very encouraging), will benefit all small business, there is no doubt that franchisees will benefit disproportionately. The franchise network, or, more correctly, the franchisor, has the incentive and the capacity to investigate the developments listed above, and to at the earliest possible opportunity take advantage of these in the interests of its franchisees (and itself). Standalone small businesses do not have that kind of capacity.

That is quite apart from franchising's intrinsic advantages in the creation of small businesses, whatever the environment, as summarised in Section 4.3.3 above.

Franchising very seldom, if media coverage is anything to go by, receives specific attention from government or parastatal agencies. A rare recent example is that the Industrial Development Corporation (IDC) has set up a franchising unit with a specific focus on addressing the financing of franchisees. "Franchisees struggle to get reasonably priced loan funding for their operations. The problem is becoming particularly acute now that franchise businesses are trying to expand into the township and rural market; the majority of black franchisees simply do not have enough cash to put down the required deposits to secure loan funding. … [Through the IDC] financing to franchise operators can now be priced as low as five percentage points below prime. … [The IDC has become] one of the largest funders in the franchise industry [and] has partnerships with about 18 franchisors" including well-known fast food and retail brands. (Lunsche, 2006:69-70).

Franchising and BEE

According to the Franchise Association of Southern Africa (FASA), "almost half of all new franchisees recruited since 2001 have been from the PDI sector". (FASA, 2004:94). One franchise consultancy reports that 80% of those on its database of persons that have expressed interest in being franchisees, and have at least the minimum of the financial and other prerequisites, are "Black", i.e. not just a previously disadvantaged individual (PDI). (Lutge personal communication 2006). "FASA is committed to working with its members to give impetus to the BEE policy in making the franchise industry properly reflective of our rich diversity and to promote equality for all. To this end, a BEE working group is preparing guidelines for the franchise sector that should be made public during the course of 2005." (FASA, 2004:94). In addition, "FASA has, for the past two years, been working together with the African Development Bank, major local banks and financial institutions, to spearhead an initiative that will see franchising becoming more accessible to the emerging market."

“Given the consistent growth of franchising in South Africa of around 15%, with a track record of success that far exceeds that of business in general, there is no reason why any business cannot be franchised. [The researchers comment that the last part of this sentence should no doubt be taken with a pinch of salt.] The buoyant economy and Government’s push to stimulate the small business sector is steering a lot of people towards owning their own businesses. BEE initiatives are fuelling not only businesses to look at franchising as a way to fulfil their BEE obligations in terms of enterprise development, skills development and job creation, but it has opened the door for many more potential franchisees to get into the franchise system by owning their own businesses.” (FASA website)

4.4.4 Section 4.4 conclusions

It is clear from the preceding that the environment for emergent business in South Africa is not by any means what it should be, and that for this reason alone, being part of a franchise network rather than a standalone business is in most conceivable circumstances hugely advantageous to both the SMME and its client.

It is also clear that PDI ownership of franchises is by no means representative of South Africa's demography, but a great effort is being made to improve that.

Given the extent to which the potential for water services delivery improvement lies in the more rural areas, the proportion of potential interest in water services franchising from PDIs can be expected to be higher than a national average of the interest in water services franchising. One of the reasons why the franchise concept could achieve significant impact is its potential for opening the water services industry to smaller companies in general and to BEE in particular.

To conclude: there is no question but that water services franchising can be a powerful avenue for local economic development, and SMME and BEE development. This must, however, be seen in the context of whether water services franchising could or could not become a viable business opportunity in many parts of South Africa and whether, despite its obvious advantages to water services delivery, problems, such as procurement and an assurance of ongoing funding, can be overcome.

It is as well also to recall "an important word of caution" expressed in the first report.

> "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 [and BEE development]. ….. [in respect of that] the focus [must be on] providing the water services and getting the SMME up and running [and on] the needs of the market, the business system development, and financial viability." (Wall, 2005a:68-69).

4.5 Market potential, and Chapter 4 conclusions

4.5.1 The case for franchising

The evidence summarised in Section 4.2. above is to the effect that many of the owners of the water services infrastructure and/or their appointed water services providers are simply not coping with their operation and maintenance responsibilities. If, despite efforts having been over the years made to capacitate or otherwise support these institutions, water services operation and maintenance is in many areas still not adequate, then it is imperative that alternatives be investigated. It might be found that these alternatives have little potential to improve matters, but it might also be found that they do have potential. The need for alternative water services provider systems is indisputable.

One such alternative concept or system is franchising.

Through water services franchising there is potential to simultaneously:

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

Indeed, one of the reasons why the franchise concept could achieve significant impact is its potential for opening the water services industry to smaller companies in general and for BEE in particular.

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 WSP types.

4.5.2 Two advantages

Two very significant advantages of franchising in the water services sector, and being part of a network, as opposed to local WSPs being unsupported SMMEs (or CBOs in the SSA model, many of the advantages of which, for the CBOs, are similar to the advantages that the franchise model provides to SMMEs), are:

- the leverage that the franchisor can exert on behalf of the franchisees; and
- that the franchisor can, if necessary, step in and perform the duties of the franchisee, should the franchisee fail to perform in terms of its contractual obligations to deliver a water service.

The leverage can best be described by means of an example of an actual instance (the role-players can remain unnamed). Given that there are no business format franchising examples yet in the water services sector in South Africa, this example is of a SSA some years ago intervening on behalf of a water services SMME. In this instance, the SMME had been formed under the guidance of the SSA, and the SMME was contracted to the municipality. At a certain point in the history of this contract, the municipality began paying late, despite calls from the SMME. This threatened the financial viability of the SMME. The SSA noticed this, and, realising that the people who ran the SMME would not readily have known who to talk to the municipality and how to deal with the bureaucracy, apart from which, they were located at a considerable distance from the municipal headquarters, and the time and effort to get there would alone have been quite daunting.

So, in consultation with the SMME, the SSA forcefully advocated on its behalf to the municipality, pointing out to the municipality that it was in breach of contract. Fortunately, the municipality saw the point and resumed payments promptly.

Whereas of course the relationship between the WSA or WSP client, franchisees and the franchisor, should always be a partnership, that partnership must be one in which both risks and obligations are shared. If one partner is not delivering on its obligations, then it is not unfair that it be sharply reminded of that. In an extreme case of the client's non-performance, the franchisees, supported by the franchisor, would be entitled to withhold their services. If one franchisee did this, it might be suicidal for it in terms of future relationship with the client, but all the franchisees and the franchise acting in concert would be a safer and also more effective way to make the point.

The other advantage named above, i.e. the franchisor if necessary taking over the franchisees responsibilities, would kick in should the franchisee fail to perform. Given that it is a responsibility of the franchisor to monitor the quality of the franchisee's work, and to assist, by means of training, direct intervention, and other means, at some point the franchisor would have to make a decision whether to continue with a regularly sub-standard performance franchisee, or to find a way to replace them. Thus franchising provides the WSA or WSP client with quality assurance.

Should the franchisee, despite the franchisor's best efforts, fail without warning, the franchisor should have the backup capability to take over the franchisee's obligations, presumably as a temporary measure, until another franchisee can be put in place.

In other sectors, where a customer can usually either readily move its custom to another outlet that provides the same service, or can make a substitute purchase (e.g. the fried chicken franchisee is closed, so tonight we eat burgers!), or use of the service can be postponed until the franchisee re-opens. In contrast, in respect of water and sanitation there are seldom other outlets that provide the same service, there are no substitutes, and use of the service cannot be postponed. The analogy between water services franchising and, say, the franchising of fast foods or groceries, is by no means exact. In those areas there is a contract between the customer and the franchisee, and a contract between the franchisee and the franchisor, but there is no contract between the customer and the franchisor. The franchisor can cancel the franchise agreement for non-compliance on a number of scores, including poor performance (and non payment of royalties, and other reasons). However, the provisions in current franchisee-franchisor contracts that allow the franchisor to take drastic steps to intervene in the business of or take over from or replace the franchisee, are incorporated in those contracts with a view to protecting the interests of the franchise brand. They are generally not drawn up with any direct recognition of the interests of the customer.

Therefore, to cover for the possibility of water services franchisee failure just described, there would appear to be a need for some form of contract between the water services client and franchisor, even if that is a contract the provisions of which only come into play in the event that the franchisee fails. This issue is taken further in Phase 2 of the current project.

4.5.3 Potential, problems and essentials

It is impossible to quantify the potential of water services franchising, but undoubtedly there are numerous situations where the principles of franchising would be of great value, as sketched out in this chapter. Franchising should, however, be preferred in <u>appropriate</u> situations. It is not a panacea, for widespread application.

The main problems foreseen lie in (i) the apparent reluctance of many WSAs to go a private sector route, (ii) assurance of funding for the service (i.e. will the franchisee be paid in terms of its contract with the WSA or WSP?), and (iii) whether sufficient numbers of existing or potential local entrepreneurs would perceive that water services franchising presents them with a viable business opportunity.

The first two of these are discussed in Section 4.3. The third of these cannot be gone into now, but is in Phase 2 of the current study.

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 fully competent WSPs, 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.

To conclude: 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;
- that franchising proves to be a viable business for franchisor and franchisee alike; and
- that a programme for implementing the water services franchise concept will not 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).

5. Service delivery mechanism review

5.1 The purpose of Chapter 5

The purpose of Chapter 5 is to review water service delivery mechanisms.

This chapter does not consider franchising specifically. Franchisees are SMMEs of a particular type, and, as far as the WSA is concerned, the contractual principle of utilising them in water service delivery would not be different to the contractual principle of utilising any other variety of SMME. Thus, wherever an SMME is referred to in this chapter, read "SMME including franchisee", unless stated otherwise. The converse does not apply. References to franchisees are specific to the circumstances of franchisees, and would often not apply to other forms of SMME.

The Constitution, which creates the ground rules for the interactions between the citizens of the country and the government, stipulates, inter alia, that local government is responsible for ensuring that all citizens have access to water and sanitation services. Much legislation and regulation has been written since 1994 to give effect to this constitutional requirement. Indeed, local governments' delivery problems in these critical areas seem to have generated an ever-increasing amount of legislation and regulation. One result has been that little attention has been paid to issues such as the participation of SMMEs, or to new approaches such as franchising.

5.2 Introduction: water service delivery mechanisms

5.2.1 Service delivery responsibilities

The National Water Act (South Africa 1998) governs the water resources part of the water and sanitation business cycle, while the Water Services Act (South Africa 1997) governs the water services part. (Figure 5.1 refers (DWAF 2001:34)) The current project is, with minor exceptions, concerned only with the latter.

The Water Services Act provides that every WSA must:

- **ensure access** to efficient, affordable, economical and sustainable water services for all consumers;
- **regulate** locally (including enforcing bylaws);
- prepare a water services development **plan** (WSDP); and
- either perform the function of **water services provider** (WSP) itself or contract a water services provider.

Figure 5.2 shows how these legislative responsibilities lie in two key areas.

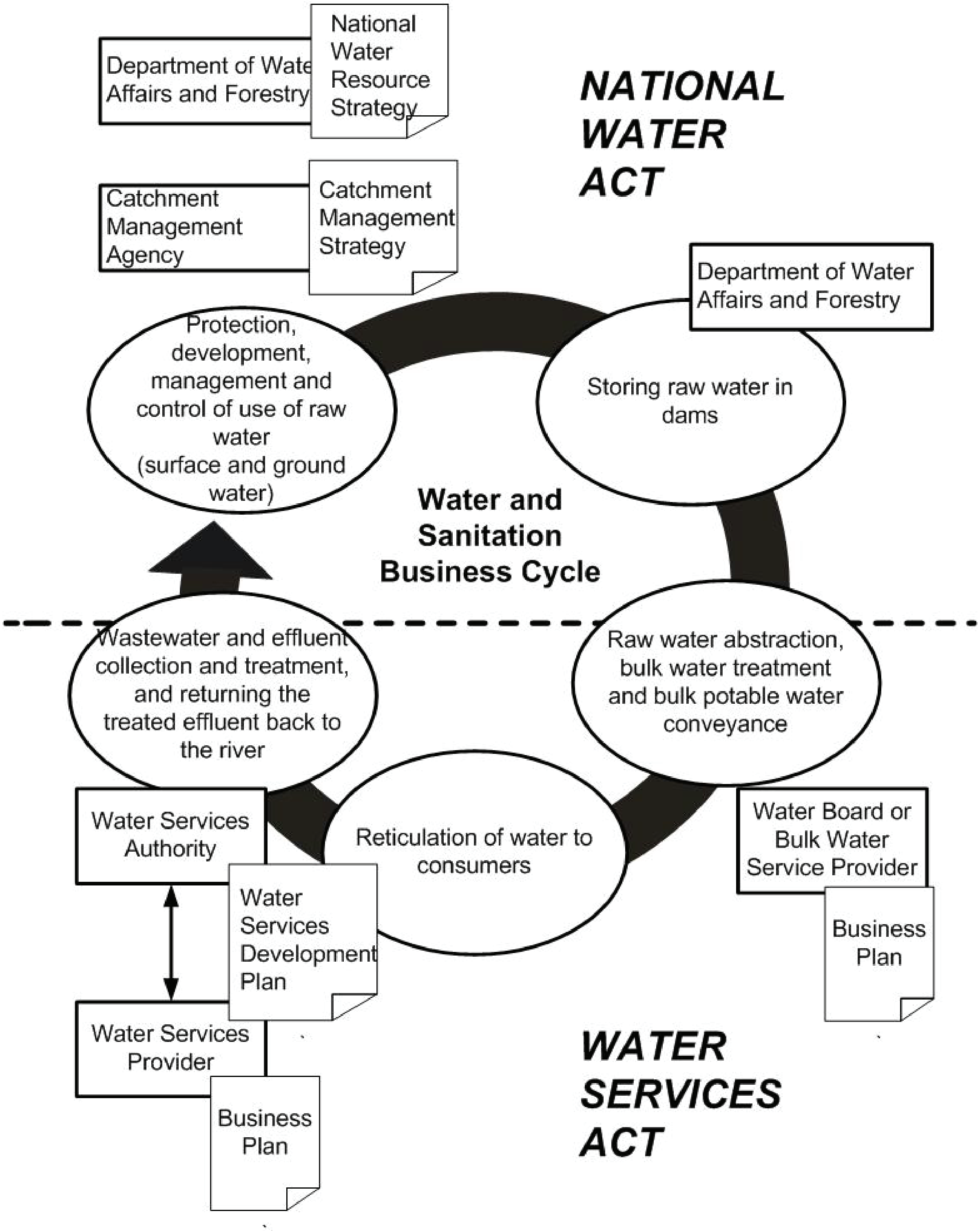

Figure 5:1: The water and sanitation business cycle

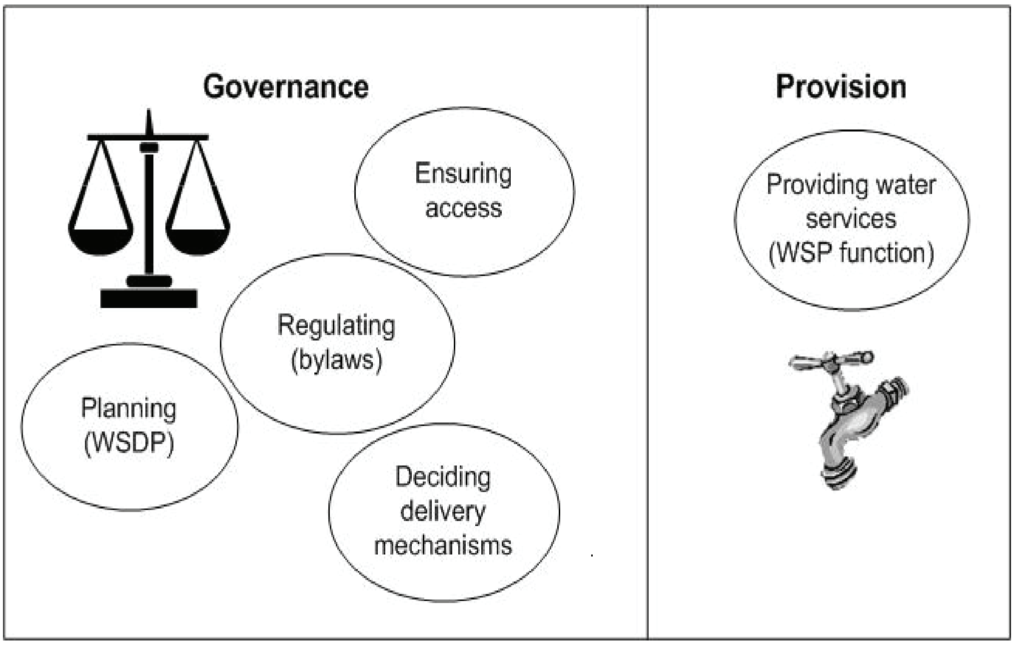

Figure 52: Water services legislative responsibilities lie in two key areas

The **governance functions** cannot be delegated to any other local entity. However the WSA can contract support to assist it with some governance functions.

If the WSA also performs the WSP functions, the governance functions must be managed and be accounted separately from the provision functions.

The **provision function** is the actual provision of the water services to consumers, for example operating and maintaining the infrastructure, consumer relations, revenue collection, administration and financial management. A WSA has a choice. It may carry out the functions of a WSP itself or it may enter into a contract or form a joint venture with another WSP. (Figure 5.3 refers.)

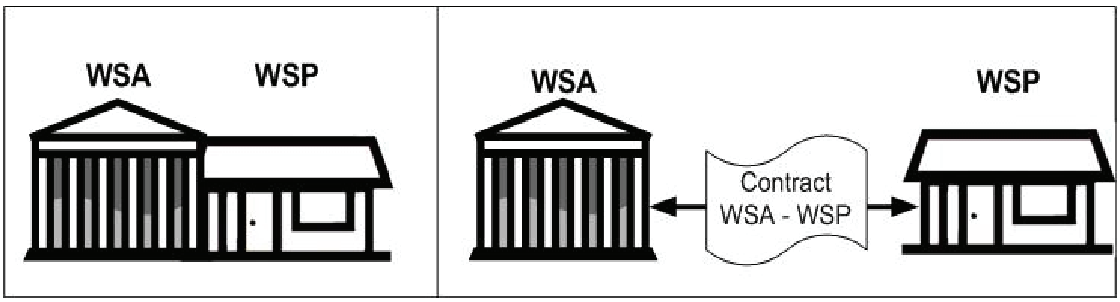

Figure 53: The WSA's choice with respect to water services provider functions

5.2.2 Service delivery mechanisms as defined in legislation

Current legislation makes provision for both "internal mechanisms" and "external mechanisms" to be the WSPs at a municipal level. In these instances, the legislation envisages that the provider is responsible for all or most of the elements which are required to ensure that consumers have access to a sustainable and ongoing service.

In this report, the term "service delivery mechanism" is used to indicate a type of organisation that is permitted in law to act as a service provider to a WSA, both as a directly contracting party with the WSA and as a subcontractor to such a party. The legislation in mind, and which is described further below, would not only specify the type of organisations, but would also identify the types of contract that would generally be used to govern the relationship between the municipality and its service providers.

The Municipal Systems Act (MSA): 2000 (Sections 76 to 82)

This Act outlines the following mechanisms for provision of services. It says that,

"A municipality may provide a municipal service in its area or a part of its area through-

1. an internal mechanism, which may be-
   - (i) a department or other administrative unit within its administration;
   - (ii) any business unit devised by the municipality, provided it operates within the municipality's administration and under the control of the council in accordance with operational and performance criteria determined by the council; or
   - (iii) any other component of its administration; or
2. an external mechanism by entering into a service delivery agreement with-
   - (i) a municipal entity;
   - (ii) another municipality;
   - (iii) an organ of state, including
     - (a) a water services committee established in terms of the Water Services Act, 1997 (Act 108 of 1997); [Item (aa) substituted by s. 40 of Act 51 of 2002.]
     - (b) a licensed service provider registered or recognised in terms of national legislation; and
     - (c) a traditional authority;
   - (iv) a community based organisation or other non-governmental organisation legally competent to enter into such an agreement, or
   - (v) any other institution, entity or person legally competent to operate a business activity.*"*

5.2.3 Contractual relationships permitted in terms of local government legislation

The Green Paper on Municipal Services Partnerships (MSP) describes typical contractual arrangements between the services provider (in the water services case the WSP) and the municipality in this case in its capacity as the WSA. (Refer also to Section 3.9.1 of WRC Report TT 432/3/10.)

These contractual arrangements are listed in increasing order of complexity:

- Service contract: (1 to 3 years)
  - The contractor is paid a fee to provide a short term service (one to three years).

- Management contract: (3 to 5 years)
  - The contractor is responsible for the overall management of all aspects of a municipal service, but not for the financing thereof.

- Lease: (8 to 15 years)

- The contractor is responsible for the overall management of a municipal service, and the council's operating assets are leased to the contractor, who is responsible for the operating, repair, and maintenance costs of these assets. The contractor may also be responsible for collecting tariffs from consumers of the service, thus bearing the collection risk.

- Build-operate-transfer (BOT): (8-20 years)
  - The contractor undertakes to design, build, manage, operate, maintain, and repair, at its own expense, a facility to be used for the delivery of a municipal service. Typically, a BOT requires the council to pay the contractor a fee for the services provided, leaving responsibility for tariff collection with the council.

- Concession:(up to 30 years)
  - The contractor undertakes the management, operation, repair, maintenance, replacement, design, construction, and financing of a municipal service facility or system. The contractor often also assumes responsibility for managing, operating, repairing, and maintenance of related existing facilities. The contractor collects and retains all consumer tariffs, assumes the collection risk, and pays the council a concession fee.

The Green Paper further asserts that "Any other contractual arrangement or any variant of the contractual arrangements … between a council and an MSP service provider is also an MSP."

5.2.4 Procurement

The Strategic Framework for Water Services (SFWS) (DWAF 2003c) insists that all water services providers that provide water services to or on behalf of water services authorities must do so in terms of a service delivery agreement (contract) with the water services authority.

DWAF's "Consolidated guideline for water services authorities relating to selecting water services providers" (DWAF 2003b) states that management and service contracts (but not necessarily other types of contracts) are not subject to Section 78 requirements of the MSA. This appears to contradict the MSP Green Paper, which specifically mentions that considering outsourcing management and services is subject to Section 78. The "Consolidated guideline" reasons that management contracts and service contracts deal only with part of the water service and are therefore not considered to be water service provider contracts and are not subject to the requirements of Section 78.

In essence, the Green paper on MSPs seeks to force all forms of contracting through the Section 78 process, while the DWAF Consolidated Guidelines take a more practical approach and opens the door for simpler procurement requirements in the case of certain contractual relationships.

In all procurement matters, it can be argued that a competitive bidding process has both a positive and a negative side. Care should always be taken, when adjudicating bids received, to ensure that the qualitative aspects of the service are given greater weighting than the pure pricing criteria. The ability of bidders must be carefully scrutinised. Often, there is merit in including a pre-qualification stage in the procurement process.

Section 5.3 briefly describes the "internal" (i.e. in-house, within the municipality) service delivery mechanisms open to municipalities to carry out their water (and other) services responsibilities.

Section 5.4 briefly describes the external mechanisms defined in the MSA.

Section 5.5 investigates outsourcing of elements of the service delivery chain, which, it appears, does not require the complex, time-consuming and expensive processes legislated in Sections 78 to 81 of the MSA. Rather, it would appear, outsourcing can be entered into through the normal procurement processes of the WSA. Also, it is in respect of outsourcing elements, rather than outsourcing the full water service even for a limited geographic or administrative area, that outsourcing to SMMEs (franchisees among them) will most likely be successful, because the scope of work and resources required would in most circumstances be less than for a full water service contract. Operation and maintenance contracts would fall into this category.

5.3 Internal delivery mechanisms

Section 5.3 describes "internal" delivery mechanisms. In water sector terms, these are situations in which the WSA, in various forms, is its own WSP.

The information contained in Sections 5.3 and 5.4 is largely sourced from a guide produced by Rand Water, National Business Initiative and Standard Bank (Rand Water et al., 2006:13-18).

5.3.1 Municipal department

The most common mechanism used by municipalities to provide municipal operating services is to do these in-house, i.e. to place the responsibility with one of the municipality's departments. These departments are usually focused on the provision of a technical service (such as the provision of water, sanitation, electricity, roads), <u>or</u> a support and administrative function. They are in that respect unlike business units, which have full responsibility for not just their technical functions but also for related financial and administrative functions.

The Water Services Act states that where a municipality provides water services itself, it must manage and account separately for that service. This concept does not require the municipality to create a separate entity, but to keep separate accounts. A technical department can source the additional financial and administrative services from other departments within the municipality rather than provide those services itself. However, in doing so it must fully account for these services, so that it can accurately identify all the costs associated with the use of the shared services and thus account for the full cost of the service as required in the Act.

A common example follows: The Water Department of a municipality provides water supply services to customers (end users). It is responsible for the day-to-day operation and maintenance of water purification plants and reticulation systems. The Treasury Department of the municipality is responsible for credit control and debt collection, i.e. billing, collections, etc. When a customer fails to pay for water services provided to him / her or it, the Legal Department of the municipality will be responsible for taking legal action for the recovery of arrears from that customer.

The majority of service providers in all municipalities still fall within this category.

5.3.2 Municipal business unit

Some municipalities have created "business units", each responsible for all aspects of one of the services, and including the technical, financial and administrative aspects thereof. (This is often referred to as "ringfencing".) The business unit remains an integral part of the municipality, and does not have a separate legal personality. It operates under the control of the council and in accordance with the operational and performance criteria set by the council.

The benefits of a business unit are that the municipal service can easily be managed and accounted for separately, i.e. the costs of providing the service are more easily known and the level of cross-subsidisation to or from other municipal services is quantified. In addition, it provides for a holistic focus on all aspects of effective service delivery, whereas a department tends to emphasise its particular line function at the expense of the others.

The major disadvantage is that a duplication of functions may occur, i.e. a situation may arise where two business units each run their own meter reading and billing functions. In the case of electricity and water this will practically double the cost of these functions when done separately. However, these and other issues of duplication can be resolved if the organisations have the will.

For example: The eThekwini MM created a business unit for the provision of water and sanitation services. The unit functions independently from Council and is responsible for all aspects of water and sanitation provision, i.e. technical, financial, legal, customer services, credit control, infrastructure development and the like. The business unit issues separate accounts for water services rendered and conducts its own credit control and debt collection. The unit is, however, not a separate legal entity and is an integral part of the municipality. It is legally similar to a department or administrative unit described above but different in that it provides a full range of services. Subsequently, the Council split the unit into two separate units, i.e. one focusing on waste and the other on water.

5.3.3 Any other component of the municipality

This mechanism also includes the catchall “any component of the municipality’s administration” which is the third internal element listed in the MSA.

Clearly, this category has been created to provide for service delivery alternatives that the drafters of the Act were not able to envisage. However, Rand Water et al., 2006 describe one possibility, namely, "municipal service districts", a mechanism to focus on service delivery in a particular geographic or administrative section of the municipal area.

Thus a municipality may establish an internal municipal service district in a part of the municipality to promote service delivery in that area, in accordance with the municipality’s own policy framework for such districts and Section 85 (3) of the MSA. Factors which have to be taken into account before establishing an internal municipal service districts are the municipality’s development needs and the extent to which the district will promote the total economic development of the municipality. A consultation process is required and the majority of residents must consent to the establishment of the district.

The researchers of this report do not know of any examples of internal municipal service districts in the water sector.

5.4 External delivery mechanisms

Section 5.4 describes "external" delivery mechanisms. In water sector terms, these are situations in which the WSA has outsourced all or most of its water services provision function to a WSP that is not a component of the municipality itself.

The following are considered:

- another municipality;
- a municipal entity;
- an organ of state;
- a water services committee or a traditional authority;
- a CBO or NGO; and
- any other institution.

5.4.1 Another municipality

Two (or more) municipalities can enter into a service delivery agreement in terms whereof the one provides a municipal service to the other(s).

This arrangement could be an advantage where adjacent municipalities could combine their resources and available expertise on a more efficient basis or where additional capacity or existing capacity in a municipality could be utilised for the benefit of another. (The latter option is becoming increasingly unlikely where most municipalities are struggling to meet their own capacity requirements). An advantage of outsourcing functions, such as the WSP function, to another municipality is that the competitive bidding requirements of the MSA do not apply.

5.4.2 A municipal entity

The MSA recognises the following kinds of municipal entities:

- a private company as referred to in the Companies Act, 1973, established by one or more municipalities, or in which one or more municipalities have acquired or hold an interest;
- a service utility established by a municipality; and
- a multi-jurisdictional service utility established by two or more municipalities.

(As an aside: Other than the three categories listed above, the MSA allows a municipality to hold an interest in a company(s) listed on the Johannesburg Stock Exchange (JSE) only if the interest is for investment purposes, or it is for a pension or medical aid scheme for the benefit of its employees.)

Where the municipal entity is a private company, the municipality may only acquire or hold ownership of such a company as the sole shareholder, unless all the other interests are held by one or more other municipalities. For a private company to qualify as a municipal entity one or more municipalities must have effective control of the company. There are a number of restrictions on a municipality forming or acquiring an interest in a private company, which makes it onerous for the municipality to do so. Thus it is only when it assists the municipality in performing its functions and is in accordance with good business practices and it benefits the local community that a municipality can establish a municipal entity as a private company. Such a company is obliged to restrict its activities to those which the parent municipality has specified and these cannot fall outside the municipality's powers and functions.

A service utility is created by municipal bylaw, which establishes its purpose, powers, funding and duties, and is regulated and controlled by the municipality. It is a separate legal entity. It is thus a statutory organisation similar to a water board that is established and regulated in terms of the Water Services Act. It must restrict its activities to the purpose for which it was established and has no competence to act outside of the powers and functions that are laid down for it in the relevant by-laws.

A multi-jurisdictional service utility is similar to a service utility above and may be established by written agreement between two or more municipalities to perform their powers or functions within their municipal areas or designated parts thereof.

The municipal entities above are all forms of corporatisation, which is aimed at creating independent, separate legal entities which operate in the same way as private companies do, but which remain either fully owned by the municipality or under the ownership control of the municipality. These entities are regulated in respect of financial governance and financial accountability and reporting by the Municipal Finance Management Act (MFMA).

If a municipality decides to provide a municipal service through a service delivery agreement with a municipal entity, it does not need to comply with the competitive bidding requirements of the MSA. This is a distinct advantage over other options to the municipality that require adherence to the procedures of the Act.

Johannesburg Water is an example of a municipal entity. The Johannesburg Metropolitan Municipality created this company, and contracted with it to provide water and sanitation services to end users. The company is under the ownership control of the council and is thus a municipal entity. The company entered into a five-year management agreement with a private company, in terms of which the latter would provide management skills and systems, and would build capacity in Johannesburg Water. It would progressively withdraw its staff as it achieved its contractual obligations. The contract expired during 2006, and the last of the private company's staff withdrew.

A second example is ERWAT, a public utility established in 1992, which is majority owned by the Ekurhuleni MM. The Johannesburg MM and the Sedibeng DM are minority owners of ERWAT. It provides bulk wastewater treatment for the Ekurhuleni MM and to a lesser extent, to other MMs. It is currently custodian of 20 wastewater treatment works. (See also Section 3.4.7 above.)

5.4.3 An organ of state

The Constitution defines "organ of state", amongst others as any department of state or administration in the national, provincial or local sphere of government or any other functionary or institution exercising a public power or performing a public function in terms of any legislation.

In the water services here, the most common organs of state are water boards, established in terms of the Water Services Act. There have been a number of instances where water boards were contracted by municipalities to be their WSPs. For example, between 2000 and 2005, Maluti-a-Phofung LM appointed Rand Water for the former Harrismith area, while in the former Qwa-Qwa area Sedibeng Water was the WSP. A three year management contract was signed by the municipality separately with each water board, which was used to govern the relationship, improve service delivery and enhance the capacity of the municipality. (See also Section 3.6.6 above.)

5.4.4 Water services committees and traditional authorities

Whereas the researchers of this report are not aware of any examples, the Water Services Act specifically mentions that water services committees and traditional authorities may be appointed as WSPs. Their inclusion in the legislation is a recognition of the roles that they play in rural areas, especially in regards to water and sanitation.

It is noted in the legislation that it is up to the Regional Director of DWAF to determine if a water services committee or traditional authority is ready to assume the necessary responsibility. As there were no examples of these committees at the time of this study, there is no precedent for determining when a local committee is ready for statutory recognition. Furthermore, there is a strong perception that recognition of these committees will only be forthcoming if, in the view of the municipalities in their area, they will not pose a threat to the municipalities. Given that these committees would normally be formed in reaction to poor service provision by the municipality or its entities, there would appear to be potential for conflict of interest on the part of municipal councillors and officials.

5.4.5 A CBO or a NGO

The discussion that follows uses the same definition of "community-based" that appears in "definitions used in this report", in the front of this report.

A CBO is a not-for-profit organisation situated within a defined community that is mandated by that community to provide a specific municipal service to that community on behalf of the municipality, provided that:

- all members of the governing body of the organisation are nominated members of the community and are permanently resident within the community;
- all employees of the organisation are members of the community and are permanently resident within the community; and
- the area constituting the community is defined by the municipality.

CBOs must have a written constitution giving them independent legal status and mandating them to enter into service delivery agreements.

A NGO is a not-for-profit organisation that focuses on supporting communities and / or municipalities to provide effective municipal services. It, also, must have a written constitution, giving it independent legal status and mandating the entering into service delivery agreements.

NGOs need not be confined to communities or groups of communities. Some NGOs even in South Africa are substantial. The outstanding example in the water services sector is the Mvula Trust.

When community-based service providers are referred to, it is generally accepted that the context is that they are non-profit. Small and micro-enterprises would often also be based in a community, but are by definition for-profit organisations. This report endeavours to make clear which is referred to at any point.

The use of the CBO mechanism generally requires clearly defined communities of a size where communication and consensus can be readily achieved. It is particularly appropriate for more isolated communities where they have their own supply system such as a borehole and where they can control the service provision with some technical support from the authority or its overall service provider. Use of this mechanism may assist the community in creating an income base, which can be used to fund other needs, and ensures that as much of the money as possible goes back into the community.

(Also see discussion in Sections 3.6.2 and 3.7. around requirements that the appointment of CBOs and NGOs as service providers need or need not be subject to a competitive bidding process.)

5.4.6 Any other institution

Appropriately-resourced private sector institutions, competently managed by the municipal client, can bring flexibility to the approach of service provision. An added advantage in some circumstances would be that they would normally be able to achieve higher efficiencies and can generally access operating and investment capital from other private financial institutions. Procurement of these service providers can only be done through a competitive bidding process.

For example, Mbombela LM entered into a concession agreement with a private company, Biwater. In terms of the agreement, Biwater is contracted to improve service delivery and make a substantial capital investment in infrastructure within the municipality’s area.

SPVs, generally owned by a range of shareholders (including financial institutions, operating companies and consulting firms, etc.), are from time to time established to act as WSPs for specific jurisdictions and municipalities. (e.g. concessions, affermage (lease), etc). (The GNUC, described in Section 3.6.4, is such a SPV.) These SPVs (in some instances Joint Ventures for shorter-term contracts) are generally only formed where there is a need to tie together the new shareholders for undertaking a specific contract. These contracts will generally include for the raising of capital finance, or would be of sufficient size the warrant the creation of a new entity.

Operational contracts undertaken by established operating companies for defined scopes of works on behalf of municipal clients. These operation and maintenance contracts are often referred to as “management contracts” as they do not normally require the contractor to provide capital financing. Joint ventures or associations are often formed between specialist companies to undertake this type of work as it is generally of a more short-term nature.

5.5 Outsourcing of elements of the water service

Section 5.5:

- summarises contractual issues related to outsourcing of elements (Section 5.5.2); and
- discusses important factors when considering outsourcing, and when deciding who or what to outsource to (Section 5.5.3).

5.5.1 Outsourcing

As described in Section 5.1 above, the Green Paper on MSPs states that “any other contractual arrangement or any variant of the contractual arrangements ….. between a council and an MSP service provider is also an MSP.” Also as noted above, this is contradicted by the DWAF "consolidated guideline" (DWAF 2003b). The latter holds that simpler management and service contracts (i.e. excluding, among others, full water service provision contracts) are not subject to Section 78 requirements of the MSA, as these contracts deal only with part of the water service and are therefore not considered to be WSP contracts.

Conventional wisdom indicates that an organisation needs to identify those activities which are core to its survival and performance and concentrate on them. All other activities are non-core in nature and do not necessarily need to be performed by the organisation. Parts of the service delivery chain which can easily be separated out from the other elements and performed by a separate party could be suitable candidates for outsourcing by the WSA or WSP. An example could be the maintenance of motor vehicles by a municipal water department. The cost of hiring and training auto-electricians and mechanics is generally far higher than the cost of having the maintenance done by an external provider, and does not assist the WSP to achieve its real purpose, the provision of water services.

WRC Report TT 432/4/10 spells out in detail the elements of the value chain for providing water and sanitation services and then identifies a short list of those elements which are suitable for outsourcing. The following are examples of elements of the service delivery value chain that could in appropriate circumstances be outsourced by the WSP:

- Training WSA staff;
- Mechanical and electrical maintenance;
- Meter reading;
- Process treatment;
- Laboratory testing; and
- Water quality sampling.

5.5.2 WSA and WSP outsourcing elements

Whether a WSA performs the service provision itself through an internal delivery mechanism as described in Section 5.3 above or contracts an external service provider to undertake the functions (Section 5.4), the WSA or its WSP can and may wish to outsource some of the activities which make up the value chain.

The question arises as to whether an internal department or business unit of a municipality, in its capacity as a WSP, is required to undertake a section 78 process when outsourcing an element of the water service. As the WSP is not a separate legal entity, it is governed by the all the requirements placed on the WSA. In this instance the approach taken in the DWAF Consolidated Guidelines seems to be the most sensible and logical. However, there is a limitation to what can be achieved through normal procurement processes. Section 77 of the MSA prescribes the circumstances which give rise to the need for the complex Section 78 process. These triggers are:

- The significant upgrading or extension or improvement of an existing municipal service;
- A performance evaluation in terms of the Act; and
- A restructuring or reorganization of the municipality.

It appears to be a question of degree. To what extent is the activity being outsourced considered a municipal service or simply a part of that service? Similarly, to what extent can the outsourcing be considered a reorganisation or simply an improvement to an element of the service delivery value chain? Each WSA or WSP would have its own interpretation of this.

A common sense approach would indicate that many activities can be outsourced as part of the normal procurement procedures of the WSA or WSP.

Outsourcing of elements of the service delivery chain can, it would appear, be contracted out in terms of normal supply chain management policies, and not in terms of Sections 78 to 81 of the MSA. This is much closer to the typical outsourcing concept, and is more appropriate if the intention is to outsource to SMMEs.

Where the WSA has already appointed an external service provider, the process of outsourcing elements of the water services provision chain is greatly simplified, due to the fact that the WSA has already gone through the Section 78 process. The outsourcing of services or the procurement of an external supplier or contractor is generally much simpler for the WSP than for the WSA.

In both cases, where the WSA is its own provider or where it has contracted with an external service provider, there is no legislative obstacle to the WSP outsourcing parts of the value chain. This opens the door to the introduction of SMMEs (and franchising) to perform these activities.

5.5.3 Factors to consider

Section 5.5.3 discusses a couple of the more important factors, other than those provided in the MSA and Water Services Act and the regulations deriving from there, that need to be taken into account when considering outsourcing, and when deciding who to or what to outsource.

Local Economic Development (LED) and Black Economic Empowerment (BEE)

Municipalities are in competition with one another to attract individuals and organisations which will provide growth, development and employment. This competition is not limited to South Africa only but extends beyond its borders into a global competition. On the other hand many municipalities have large numbers of impoverished and needy citizens, who do not have the ability to move easily in search of opportunities and employment. They are faced with the need to attract the people and organisations which are mobile, while at the same time trying to meet the needs of the larger impoverished residents.

The challenge for municipalities is to create an environment where the people can do it for themselves. Well thought out and implemented LED and BEE strategies can play a key role in boosting growth, development and employment.

SMME advantages

SMMEs are small and can be quickly established, particularly in the case of sole proprietorships. They are easy to start up and can be constructively employed in the water sector doing work which is not profitable enough for bigger organisations. For example, doing the meter reading for 1000 houses in a remote area will not generally be cost-effective for a large organisation based in an urban area. However, if this activity was contracted to an SMME based in the area, it would represent an attractive income especially if it allowed the SMME time to do other work in between the meter reading dates. The ability to do a specific task at regular pre-set intervals each month, say, should, if cost-efficiency is the criterion, make outsourcing to a SMME an attractive proposition to a large organisation that would otherwise have to employ staff on a full time basis to do a similar job.

Unrealistic expectations

Finally a problem often encountered is the unrealistic level of expectation which is created in the minds of the community when SMME opportunities are presented to them, regardless of whether the messengers are the councillors, the officials of the WSA or WSP, or private sector business people. The income earned by a few SMMEs will never be able to support the whole community from which this income is earned. The personal experience of one of the researchers has indicated how quickly community expectations can bloom out of control. This can be a problem where government employment programmes have been operating such as “Working for Water’s” eradication of alien vegetation. The large scale, temporary employment created by these programmes is not sustainable in the longer term. Thus the quantum or size of sustainable business or employment opportunities for SMMEs in the water sector is generally over-rated by the communities.

5.6 Conclusions: water service delivery mechanisms

The majority of WSPs are internal WSA delivery mechanisms, namely internal municipal departments or business units. Outsourcing parts of the service delivery chain can be complex, because in each case the requirements of the MFMA and the MSA must be complied with. In the cases where the WSA has already gone through the process of appointing an external WSP, it is much easier for the WSP to outsource certain portions of the service delivery chain.

The DWAF Consolidated Guideline for WSAs states that management and service contracts are not subject to Section 78 requirements of the MSA, as these contracts deal only with part of the water service. Thus there is nothing in the legislation to prohibit either internal or external WSPs from outsourcing well defined functions, which are not municipal services, but rather subsets thereof.

Nonetheless many factors militate against the outsourcing parts of the water services chain. The lack of suitable role models, the fact that it has seldom been done before, the reduction in the direct influence of both councillors and officials who perceive that their jobs and influence are reducing, the perceived “re-colonisation” of municipal services by outsourcing them to private sector companies, the resistance from communities who believe that the government should provide the services and the inertia of many decades of doing it in-house all contribute to a significant resistance to outsourcing, period, whether to SMMEs or SMME franchises, or to any other external institutions, including NGOs.

The information in Chapter 5 shows that in spite of this resistance, outsourcing appropriately, including to SMMEs and franchises, can offer many advantages which will benefit the WSA, the WSP and the communities.

It appears that in all cases, contracting with small franchisees will be a less risky option than employing SMMEs directly. The disadvantage is the need to deal with a three-way relationship between the WSP/WSA, the franchisor and the franchisee. It may turn out to be more effective to establish a foundation relationship between the WSP/WSA and franchisor and allow the franchisor, through its normal channels, to source, set up and train franchisees. Once this has happened the franchisee then signs a performance contract with the WSP/WSA.

Franchising is best suited only to certain activities in the water services supply value chain. In the first instance the franchisees would operate as contractors or sub-contractors to the WSP directly such as community-based WSPs. Secondly they could operate under licence from the WSP or WSA, and contract directly with the consumers, providing services such as plumbing services, or septic tank emptying, or the operation and maintenance of on-site wastewater or water treatment systems.

6. Funding stream review

6.1 The purpose of Chapter 6

The purpose of Chapter 6 is to identify and then review the generic funding streams for WSAs on the one hand and for SMMEs on the other.

This chapter, like Chapter 5, does not consider franchising specifically. Franchisees are SMMEs of a particular type, and, as far as the WSA is concerned, the contractual principle of utilising them in water service delivery would not be not different to the contractual principle of utilising any other variety of SMME. Thus, wherever an SMME is referred to in this chapter, read "SMME including franchisee", unless stated otherwise. The converse does not apply. References to franchisees are specific to the circumstances of franchisees, and would often not apply to other forms of SMME.

6.2 Introduction: funding streams

A point made in several other chapters needs to be reiterated, and that is that capital investment in infrastructure is not under discussion, for a number of reasons. One of those is that there are dynamics relating to infrastructure investments in any country, and in South Africa in particular there is significant socio-political controversy relating to private sector investment in and ownership of infrastructure that is traditionally regarded as the responsibility of the public sector. And, on a more pragmatic level, because of the capital intensity of pipe networks, etc., the tendency for the public sector to subsidise investments and tariffs, as well as the context of water as a social rather than an economic good, it would only be in exceptional circumstances that there would be possibility of obtaining returns on investment that could satisfy commercial loans.

However, the strongest argument for confining to operation and maintenance the discussion on a project that is investigating the scope for franchising, is that franchisees, like all SMMEs, would not have the financial resources to contemplate substantial investment in capital works. The business premises and field equipment of the franchisee would be the significant capital 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.

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 with substantial financial resources, and a profile of lending risk that could cope with the occasional loss of one of its investments.

The corollary of this is that the infrastructure to be operated and maintained must either be in a good state of repair at the start of any operation and maintenance contract, or it must be put into good order at the cost of the owner of the infrastructure, not at the cost of the contractor.

As an aside, the private sector has often stated its willingness to fund capital works in the local government sphere, and to enter into municipal services partnerships. Indeed, in terms of the Financial Sector Charter, it is obliged to lend a considerable sum of money over the next three years. However, according to Hesketh et al. municipalities and water boards are seldom willing to approach the private sector, when so much public sector money is available, and is generally cheaper and has fewer strings attached. Every "even slightly bankable project" is being investigated by the private sector. The private sector lenders regard the lack of capacity in many municipalities as a very significant risk. (Hesketh et al., 2006).

Hesketh et al. and also Danai Magugumela (MIIU) saw much scope in "management, operation and maintenance" MSPs, especially if these "protect the revenue base that sustains municipal services", and credit control, indigent policy and other issues of political risk "remain with the public sector", and even more so if national government provides "sovereign guarantees to give comfort to prospective lenders". "On the other hand, private sector partners and/or lenders need to continue to devise innovative risk-sharing products (financial), or risk-sharing arrangements (incentivised performance rewards or success fees)". (Magugumela, personal communication 2006) and (ibid).

6.3 Generic funding streams for water services

These are well known, and therefore this description and discussion are of the briefest.

If the WSA is a municipality, then its main operating income sources usually are or have in recent years been both sourced externally (i.e. national grants for the most part) and sourced internally. The main sources of the latter are usually assessment rates on property and user charges for infrastructure services (especially water and electricity). On average, for all municipalities, property rates are about 20% and user charges about 40%. Lesser ones include interest, rental received, regional services council levies, operating subsidies other than equitable share, restructuring grants, capacity-building grants, and more).

However, these averages mask a huge range in the ability of South African municipalities to raise income for their own operations. The Equitable Share system of grants from national government has for some years been in place with the specific purpose of addressing the presence in all municipalities of so many indigent households unable to make significant payments towards services. Questions as to the adequacy of the system in general, or in specific municipalities, are beyond the scope of this report.

Also beyond the scope of this report is any discussion of the ease with which municipalities have often been able to obtain funding for capital works, and how so often these works are constructed and commissioned without sufficient thought being given to the future operational funding that will be needed.

Where equitable share flows into the municipal coffers from National Treasury, it is then in turn used to finance activities identified by the municipality in terms of the criteria specified by Treasury against which these funds can be spent, in the case of the Equitable Share, this is for assisting the poor/indigent (e.g. Free Basic Services, etc). Funding from Treasury is allocated through the annual “Division of Revenue Act”, and the chief finance officer of the municipality is accountable for its expenditure against the criteria laid down for its use.

Where the municipality is providing “Free Basic Services”, the funds allocated for these services must then be paid over to the service provider in accordance with the services supply contract.

Pertinent to any consideration of the viability of suppliers dependent on the payments that they are contractually obliged to receive from a municipality for the services they have rendered to the municipality, is the issue not of how much money the municipality gets, but how it chooses to spend. For example, it is in many instances by no means certain that equitable share is spent on service provision as it should be. Also, much use is made of cross-subsidisation (indeed, is there anyone to cross subsidise from because some municipalities have a low proportion of households that are not indigent, and also lack a substantial business and industrial base)?

These (i.e. where funding comes from in the first place, and how is it spent), plus the whole question of how does operating revenue compare with operating income (remember Mr. Micawber), are crucial to funding of the water service and therefore to the whole discussion of franchising. And not just "how much" funding, but "how reliable", "how consistent (how variable)", and cash flow considerations.

While the question of whether it is paid for its services to the municipality on time, and in full, is hugely important to each individual supplier, it is a topic of concern to all suppliers to a municipality, and therefore it cannot be addressed in this project. However, its implications must be taken note of, and this is raised elsewhere in this project.

6.4 Generic funding streams for SMMEs

6.4.1 Introduction

(The team is indebted to Lewis, and to documentation that he has provided, for the basis of the description that follows. Any interpretation is, however, the responsibility of the team.)

“More than 95% of [South Africa’s] formal businesses are defined as small, medium and micro enterprises (SMMEs), each selling less than R5 million worth of goods or services a year.” (Radebe, 2006:74). What is more, worldwide it is the SMME level that is creating the most jobs, as big corporations downsize, retrench and cut costs. However, “the latest Global Entrepreneurship Monitor saw South Africa dropping from 20th position to 25th out of a total of 35 ranked countries.” (Ibid).

Compare this with South Africa’s 30%-40% unemployment rate and it becomes obvious why government needs to do much more to support SMME development. Factor in the contribution of micro enterprises as survivalist mechanisms for the very poor, and the situation becomes even more important for this country.

There are as many as three million SMMEs in South Africa. Micro enterprises, including survivalist businesses, comprise all but half a million of that number.

The commercial banks generally classify a “small business” as one which has a turnover of under R5 million per annum. The South African Revenue Service (SARS) classifies a small business as having an annual turnover of less than R6 million. The Small Enterprise Development Agency (SEDA) defines a small business as “any enterprise with less than 50-100 employees”. A micro enterprise is generally considered to be one with less than five employees (again, SEDA’s definition) and an annual turnover of less than R200 000 (according to the National Small Business Act). Definitions of a small business also vary according to their sector in the classification provided in the National Small Business Act. So, for the purpose of this document a generic definition of a small enterprise can be a business which has less than 50 employees and an annual turnover of less than R5 million; and a micro business can be defined as one which employs less than five people and has an annual turnover of under R200 000. (see also Annexure C definitions, which are similar.)

The discussion of Section 6.4 is confined to “small enterprises” and “micro enterprises”.

They need working capital and may also need capital to purchase fixed assets. (Section 6.4 is a generic discussion, not specific to water services. But, in a transposition of the discussion to the specifics of water services operation and maintenance by small and micro enterprises, “it is essential to eliminate capital investment in infrastructure from all of the options available for review and systematisation.” (Section 5.7 above.)

SMMEs come in a variety of shapes and sizes and pose various financing problems. An enterprise with a turnover in excess of R5 million per annum should be able to get access to debt financing (usually in the form of bank credit) whereas small businesses with a turnover of, say, some R150 000 per annum remain crucially dependent on loan finance or equity from either friends or family. For all small enterprises, however, the finance that the owner-managers can access in their personal capacity plays a critical role in the provision of finance to the enterprises.

So what funding and support is available to the start-up enterprise or entrepreneur seeking to expand an enterprise?

There are over 30 registered banks in South Africa which an entrepreneur can approach for funding. The commercial bank sector is not outlined here as it is huge and largely well known. The prime lending rate is currently 12% and commercial loans are available to the entrepreneur who has the required collateral and a viable enterprise. The funding sector for small enterprise development in South Africa is vast and to a large extent uncoordinated. Section 6.4 endeavours to outline those agencies which are most accessible. The focus here is on the sources of funding available in the form of loans, grants, incentives, joint ventures, investments, micro finance, etc. This assistance is provided largely by government and also by numerous private and public enterprises and NGOs. Each has its own rules, processes and procedures, central to which, in most cases, will be a proper business plan to convince the lending institution that an enterprise is viable. The information provided here is not intended to be exhaustive.

National government gives various incentives and grants to stimulate business growth and development. These include export incentives, preferential trade agreements, skills development help, and grants for research and development. Access to funding can also sometimes be eased through credit guarantees. In addition to offering funding, funding institutions sometimes also offer non-financial forms of support.

Section 6.4 identifies sources of funding for small and micro-enterprises. It does not specifically deal with or refer to funding of franchises, unless specifically stated, nor does it specifically deal with or refer to funding in the water services sector, unless, again, specifically stated.

In addition to offering funding, finding institutions sometimes also offer non-financial forms of support. Access to funding can sometimes be eased through credit guarantees. Both of these topics are briefly covered.

Funding can be of a loan or grant nature. Thus by way of introduction:

Non-repayable grants are available from government to fund the start up of cooperatives with 50 or more members, but for the average individual entrepreneur or small group of entrepreneurs, applying for a loan is the only way to go. Some institutions require collateral.

There are three predominant sources of funding available to the SMME that needs to borrow start-up capital: the commercial banks, subsidised loan agencies funded by government, and microfinance institutions. In almost all cases the loans need to be repaid. Thus the loan applicant needs to demonstrate that the business will be viable, and that it will be able to repay the loan, thus business plans are essential. Generally loans require repayment at prime-linked lending rates over a fixed period. In the case of micro loans the smaller the loan, the higher the interest rate.

The rest of Section 6.4 briefly discusses the following in turn:

- non-financial forms of support available from funding institutions (6.4.2);
- sources of funding (6.4.3);
- if only a small loan is required (6.4.4);
- specific funding for franchisees (6.4.5); and
- specific funding for youth (6.4.6).

The list in Section 6.4 of sources of finance for small business is not exhaustive.

6.4.2 Non-financial forms of support available from funding agencies

A good business idea, but do not know where to start?

SEDA provides free assistance to small enterprises in accessing loans and providing business advice, support, coaching and mentoring services through a service network established throughout the country. (SEDA, by the way, is a merger of the previous small enterprise development agencies Ntsika Enterprise Promotion Agency, NAMAC Trust and the Community Public Private Partnership (CPPP) into a single small enterprise support agency. SEDA was established in 2004 in terms of the National Small Business Act.)

Thuso Mentorship provides pre-loan and post-loan support and it will help with business plans and applications for finance. Subsidised consultation fees are payable to Thuso after the granting of the loan.

Business Partners Ltd is also active in this area and is involved in a number of support initiatives with commercial and state-subsidised loan agencies (see below). No collateral is needed to access these services.

South African Woman Entrepreneurs (SAWEN), under the umbrella of the national Department of Trade and Industry (DTI), provides support to South African women entrepreneurs in the form of facilitating access to business resources, information and opportunities.

You've got your loan but you have not got much experience

The commercial banks offer a comprehensive range of support services for the new entrepreneur, covering start up skills and mentorship once the enterprise has been established. Also, all the commercial banks have franchise divisions to provide support to their franchisee customers (see below).

ABSA Bank's "Small Business Toolbox" provides support for small businesses which includes assistance and guidelines in starting, managing, expanding and protecting a small business. Mentorship programmes include monthly visits by a mentor (New Enterprise Banker) who will monitor the progress of the business against the business plan and provide guidance where necessary.

Nedbank has partnered with Sizanani Advisory Services to provide assistance with business coaching, applications for finance, business plans, etc., along with a 12-month mentorship programme, for newly established enterprises. Nedbank's partnership with Business Partners Ltd ensures that its customers can receive specialised assistance to restore or improve profitability (assistance with budgets, administration, credit control, cash flow, information systems, marketing, human resources and production). Nedbank also offers free transactional banking for up to two years for new account holders with a start up loan of "more than R100 000". (Gunnion, 2006). (However, given that annual turnovers of many micro enterprises are of this order, a R 100 000 loan would be beyond their reach.)

Similarly, Standard Bank provides an extensive range of guidelines for small business under its "Small Capital" service, and First National Bank (FNB) offers a range of business tools and access to business expertise.

6.4.3 Sources of funding

If you do not have cash or collateral

A number of solutions are available for entrepreneurs who do not have surety for their loans, the most prominent being the state-subsidised credit guarantee scheme of Khula Enterprise Finance which works in partnership with commercial banks. Khula agreements are in place with ABSA, FNB, Standard Bank and Nedbank.

The DTI has recently announced measures to enable Khula to lend directly to its customers, bypassing the commercial banks in the interests of greater efficiency, but this option has yet to be implemented (October 2006).

Loans of less than R1 million

If a loan application is approved by a commercial bank but the borrower does not have collateral, then Khula can be applied to for help. If the borrower needs to borrow a maximum of R1 million and is able to make an own capital contribution of 10% of the loan amount, and a commercial bank has approved the loan, then the borrower is eligible to approach Khula for a credit guarantee. Khula will guarantee up to 90% of bank loans, up to a total of R1 million. It charges an average service fee of 3% per annum, plus VAT, and the first year's fee is payable in advance. In standard cases Khula will guarantee loans for fixed assets or working capital, via its Khula Standard Credit Guarantee Scheme. But it also has packages tailored to specific sectors of the economy which government has targeted for assistance.

Loans of more than R1 million

The IDC has traditionally focused on larger industrial and resources projects but is also funding specifically black-owned SMEs with loans as low as R1 million. The IDC lends funds directly to the customer, bypassing the commercial banks. Normal competitive interest rates are charged on its loans based on prime bank overdraft rates. Loan finance can also include equity (taking a share in the business) or equity-related finance.

The IDC targets specific sectors in terms of national economic priorities: franchising, health care and education, media and motion pictures, ICTs and techno industries, tourism, transport, financial services, 2010 Soccer World Cup ventures, public-private partnerships, wood paper, metals machinery, chemicals, textiles and allied industries, agro-industry (agriculture, food, beverage and marine). In some sectors, specific loan conditions apply:

Credit guarantee schemes

Khula's Emerging Entrepreneur Credit Guarantee Scheme.
This is available to individuals for new business start up. Loans of up to R120 000 are granted, a 4% p.a. fee is payable to Khula in advance, the applicant must contribute his own capital to the value of at least 10% of the loan amount and must have the necessary skills and/or experience. Khula may guarantee a range of loan facilities which can include term loans, bank overdrafts, revolving credit, instalment sale, bank guarantees and construction performance guarantees.

Loan funding specifically for businesses in selected sectors.

Enablis-Khula Fund.
Preference is given to PDIs.

If someone wishes to start a business in ICT, then this could be the source of finance. ICT enterprises are the target in this scheme, with Khula in partnership with FNB Enterprise Solutions and Enablis. The fund provides credit guarantees to First National Bank for loans of between R100 000 and R2.5 million. This package also comes with entrepreneurial support via business coaching, business linkages and educational events.

Bridging finance.
Preference is given to PDIs.
The IDC provides short-term finance for secured private sector contracts and secured government tenders (expect construction). Loans need to be a minimum of R500 000 (an exception to the R1 million floor).

Tourism development.
Preference is given to PDIs.
Commercial projects in the medium to large sectors of the tourism industry are funded by the IDC with a minimum loan amount of R1 million. These typically include the creation of new tourist facilities or upgrading/renovation of tourist facilities, including hotels, conference and convention centres.

Mining and beneficiation.
Preference is given to PDIs.
For a minimum loan amount of R1 million, the IDC funds ventures to establish or expand junior mining houses, the acquisition of mining assets by PDIs, contract mining, and jewellery manufacturing.

Expansion of manufacturing sector.
In the sectors of chemicals, textiles & allied industries, metal-based products, wood, paper & other, the IDC funds start-ups and expansion of facilities or capacity, through a minimum loan amount of R1 million. Applicants should make their own cash contribution of 33% to the venture, but PDIs are required to contribute only 10-20%.

Imports.
Preference is given to PDIs.
IDC funding may be sought for medium- to long-term import credit facilities.

Techno-Industry Development Finance.
Preference is given to PDIs.
The development of new a business or the expansion of a business in the sectors of IT, telecommunications, electronic and electrical, a minimum loan amount of R1 million may be applied for.

BEE support.
Preference is given to PDIs.
Within its targeted industry sectors, the IDC will fund management buy-ins or buy-outs and strategic equity partnerships. Loans start at a minimum R5 million, going up to R120 million. Applicants need to make their own cash contribution of at least 10% to the venture.

BEE support: Khula's Empowerment Credit Guarantee Scheme.
Preference is given to PDIs.
Khula also finances empowerment transactions to a maximum amount of R5 million, with a 2.5% p.a. fee payable in advance. Under this scheme Khula targets enterprises that will ensure one or more of the following criteria: job creation, labour intensive projects, economic empowerment, management buy-out, and sub-contracting and outsourcing transactions.

What about money from business?

Anyone with expertise and capital and assets that needs a loan and/or an investment or equity partner, can turn to a private sector development foundation which might be the answer, particularly if the proposed venture has a strong empowerment or BEE component. Prominent amongst these are the following:

Anglo Zimele provides funding support for SMEs, usually in the form of a minority stake in areas such as engineering, mining, logistics, transport, chemicals, waste management, industry services, and manufacturing.

The Eskom Development Foundation provides grants for capital equipment in the manufacturing, tourism and agricultural processing sectors. It gives preference to enterprises with export potential, to the establishment of new business, and to ventures which provide job creation and training (including the training of women).

The Anglo-Khula Mining Fund focuses on junior mining projects. Loans of R1 million to R5 million are available for plant and equipment and working capital. Job creation and empowerment are important requirements. The fund targets mainly pre-mining feasibility studies and the acquisition of mining licences.

The above does not exhaust the list of retail finance institutions. Among the others, operating with the support of state subsidies and providing outlets throughout South Africa, are:

- Small Enterprise Foundation: Group lending model, encourages saving, its clients use the Post Bank;
- Land Bank Marketing Department: farming and agri-business. Loan sizes between R250-R18 000;
- Artpac Lending Services: Construction industry: R1 000-R100 000; and
- New Business Finance: Start up of SMEs: R5 000-R250 000

6.4.4 If only a small loan is required

Microcredit outlets (MCOs) typically provide loans of R350 to R3 500 to groups for the start up of very small “survivalist” enterprises. Women or previously disadvantaged youths are likely to be given preference. Usually such loans are made along the lines of the Grameen Bank, using the group solidarity method. Loans are made to groups. Each member of the group is encouraged to save, and their combined savings provide collateral for a loan. Preference is given to small scale manufacturing, crafts and tourism, especially supporting “non-traditional” business activities for women.

Prominent amongst such MCOs are the following:

KhulaStart programme:
Loans are offered to groups of 3-10 members for amounts from R300-R3 500 per member within a group. Under this programme Khula lends to the lower end of the micro enterprise sector, with preference given to PDIs and women in rural and peri-urban areas. 70% of KhulaStart loans are allocated to women.

Marang Financial Services
Loans to groups of up to 30 members, restricted to Black youth and women. Loan amounts of R400-R2 200 are available, with a deposit of 10% required plus a fee of R20 per month. The repayment period tends to be from 4-9 months and the average income of clients is around R1 000 per month. Preference is given to PDIs.

The Nations Trust
Preference is given to PDIs. The Nations Trust offers loans in three categories, with differing conditions for each category. This service is not exclusive to groups; individuals may also apply.

- Small loans: R1 500-R5 000, with a repayment period of 3-12 months at an interest of 45% p.a., and a 6% service fee payable up front;
- Medium loans: R5 001-R10 000, with a repayment period of 6-18 months, interest at 35% p.a. and a 6% service fee payable up front; and
- Large loans: R10 001-R40 000, with a repayment period of 12-24 months, interest at prime + 8% p.a. and a 6% service fee payable up front. Furthermore, a minimum cash contribution of 10% of the loan is required from the applicant.

Government & private tender contracts are eligible for loans over a maximum period 90 days, under the following conditions: small loans: R3 000-R10 000, 3% service fee payable up front, interest 60% p.a. (5% per month); large loans: R10 001-R 40 000, 6% service fee payable up front, interest: prime + 8% p.a.

The Youth Enterprise Finance component of the Nations Trust lends an average of R5 000 to unemployed or under-employed youth and a 100% loan repayment is required.

While interest rates are high on these loans, various discounts on interest are available if certain criteria are met, e.g. no black listing on credit bureaux, proven track record, previous repayment behaviour, owner's cash contribution, etc.

6.4.5 Specific funding for franchisees

All commercial banks have franchise divisions. Some are proactive in helping to develop the franchise sector, through association with FASA, and through sponsorship of franchise-related activities, advice and mentorship to would-be and new franchisees and financial services tailored for this sector. Typically franchise support from commercial banks includes guidelines and after service care, from drawing up a business plan to cost projection to crisis management. Banks can also help with finding the right franchise product for their customer.

Usually new franchisees borrowing from commercial banks need around 30-40% of their own capital. If they do not have this capital, then loans may be guaranteed through the Khula Enterprise Finance or through the IDC or the Umsobomvu Franchise Fund (with the latter two agencies giving preference to PDIs).

IDC Franchising:
Individuals who have been selected as franchisees by an established franchise brand and have been allocated a site, may apply directly to the IDC for finance. A minimum loan amount of R1 million is available for assets, working capital, refurbishment and acquisitions. Focus areas are fast foods, bakeries, cellular, restaurants, real estate, speciality stores, travel, retail petroleum, waste management depots, manufacturing and distribution centres.

Umsobomvu Franchise Fund (a partnership with Business Partners Ltd):

Loans from R150 000 up to R3 million are available to entrepreneurs with some knowledge and experience of business for the purchase or expansion of a franchise or multiple franchises. Companies qualify for funding only if at least 30% of the equity is held by young Black people (aged 18-35 yrs). Flexible repayment periods of 5 to 10 years are offered, with interest rates linked to prime lending rates, but also affected linked to the client's risk profile. The higher the risk profile, the higher the interest rate. Technical assistance is provided (this is where Business Partners plays a role) in the form of free initial consultations, a database of consultants, mentors and sector specialists available to franchisees, and a property broking service to assist entrepreneurs in finding rental premises or suitable properties to purchase for their business.

6.4.6 Specific funding for youth

The Umsobomvu Youth Fund (UYF) supports youth aged 18-35 and women. Micro loans, small loans of R100 00 to R500 000 and medium loans of R500 000 to R5 million are available. Most prominent is its partnership with FNB and Momentum Life in the FNB Momentum UYF Progress Fund which supports Black youth companies with loans from R100 000 to R8 million. Preference is given to PDIs.

6.5 Conclusions: funding streams for SMMEs generally

Not enough is known on supply and demand issues. In many cases, the performance of in particular state-funded grant programmes and loan agencies has been interrupted by management and capacity problems and the jury is still out on how effective they are. Clearly there is a problem in the very diversity of options available, which in itself may make it difficult for emerging entrepreneurs to find out where their needs might best be met.

Demand also fluctuates, along with the range of experience that would-be entrepreneurs have in business, particularly for those entering business for the first time.

That there is no shortage of money overall for small business development is clear. Some 80% of the DTI's budget for enterprise and industry development is spent on SMMEs. Identifying viable enterprises and matching these to appropriate finance is not easy. Commercial banks are getting better at this, but South Africa's long history of risk-adverse stakeholder prioritising and first world banking systems has made them latecomers to the challenge. In the interim, government has picked up the slack, but with mixed success.

"Financial Mail" put it more bluntly: SMMEs "… find it extremely difficult to raise state-backed or bank funding to launch or expand operations. The effort in the BEE scorecard and in government's broader push to create jobs will go to waste if not complemented by an institutional framework that promotes the establishment of SMMEs. Key to achieving this are the DTI's development finance institutions (DFIs) whose task is to improve access to finance and develop business management skills. However, the DFI landscape is full of institutions which, if not duplicating their mandates, have a patchy performance track record." (Radebe, 2006:74).

6.6 Conclusions: funding streams for water services SMMEs

The certainty and reliability that they will be paid for their services should be prominent on any checklist of the issues that need to be weighed up by SMMEs (and their bankers and sponsors) when they consider contracting to supply operation and maintenance resources to a municipality in its role as a WSA or even when they consider subcontracting to a third party that is directly contracted to the WSA.

If the funding is promised, will it be budgeted and if it is budgeted, could that budget be cut and even if the budget as such remains firm, will the funds be paid? Could the funds be diverted to other purposes? Could payment be subject to delays? What would consequences be? Why would these things happen and what can be done about them?

SMMEs offering operation and maintenance services to the public sector would often be dependent on a single client for their existence. If this client fails to pay on time and in full, that could be disastrous for the SMME. One client not paying it for 30 or even 60 or more days would be a nuisance to a large enterprise with a large spread of clients, but for a micro enterprise, its main or, worse, sole client not paying it for even 15 days could ruin it financially.

Small businesses unable to meet their obligations, because their clients do not pay them off or any other reason, simply close down, and the entrepreneurs move on. This sounds harsh, but it is reality. Larger businesses lay off workers and downsize.

These are well-known business risks. The corollary is that the structural flexibility of the private sector can greatly improve the efficiency of local government. If all the municipal services were provided in-house, when the budget is frozen or the revenue stream dries up, the municipality must continue to employ and pay an underutilised and unproductive work force. That the budget which is available would under most circumstances go to salaries rather than to other disbursements, such as fuel or spare parts, would lead directly to cost to the ratepayer / fiscus without productivity.

This flexibility constitutes another strong argument for municipalities / WSAs to consider outsourcing but it threatens the viability of the small enterprises contracted to them.

One supplier put it as follows (paraphrased): "The problem with any funding provided by a municipality is that they can assure funding for only one year, not even into the medium term. Thus you can train plumbers, but next year they have no work to do. It has thus far been financially viable for The Drain Surgeon to set up and train franchisee plumbers, because his customers in the more affluent areas and the commercial and industrial areas will always have money to pay for the service. They are not dependent on municipal budgets. If he were to extend his service into the townships, even with municipal guarantees, that guarantee would only be for one year, and we already know that the householders in the townships cannot pay from their own wallets for his services. A viable business needs assurance of at least a minimum amount of revenue in future years. And given that our municipalities focus in the year or so preceding elections on impressing voters with development above the ground, that year there will be even less money for maintenance than usual."

Elsewhere in this report, pointed out at some length is the extent to which franchising of water services can improve efficiency and provide municipalities with access to capacitated resources at the operational level. As Hesketh et al. are quoted a couple of pages ago, there is a need to explore measures that "protect the revenue base that sustains municipal services". That notwithstanding, capacity problems in many municipalities, and the poor record of payment for contracted services that is too-frequently encountered, are substantial threats to suppliers to municipalities, and especially to SMMEs, because they do not have substantial resources, may be heavily dependent on one municipality for their livelihood, and other reasons.

7. Conclusions and recommendations

7.1 Report WRC TT 432/2/10 conclusions

7.1.1 On franchising's potential:

Many public sector owners in South Africa of the water services infrastructure, and/or their appointed water services providers, are not coping with their operation and maintenance responsibilities. If, despite efforts having over the years been made to capacitate or otherwise support these institutions, water services operation and maintenance is in many areas still not adequate, then it is imperative that alternatives be investigated. It might be found that these alternatives have little potential to improve matters but it might also be found that they do have potential. The need for alternative water services provider systems is indisputable.

The water services delivery model in common use (i.e. a heavy reliance on WSA's/municipality's own in-house resources) is not intrinsically flawed. The model is not the reason for many of the owners of the water services infrastructure and/or their appointed WSPs not being able to deliver satisfactorily. Evidence of this lies in that in many instances water services are being delivered satisfactorily, or more-or-less satisfactorily, using the same model. It is in the implementation of the model, and not in the model itself, that the problems lie.

Franchising partnerships could in many instances bring to water services operation and maintenance the range of advantages that franchising is said to bring in other areas, including:

- initial and ongoing training;
- ongoing monitoring, and assurance that corrective action would be taken when necessary;
- more ready access to finance for operation and maintenance; and
- when needed, a level of expertise that would not normally be available.

Thus, through water services franchising partnerships, there is significant potential to deliver more reliable and sustainable water services. In many instances, this would (for example through reduced wastage of water) result in cost savings to the WSA, thereby improving its financial situation.

A franchising model for water services delivery cannot address a WSA's budget problems, but can undoubtedly greatly contribute to resolution of the skills and incentives problems that are encountered by, or in, many WSAs and WSPs, or to structure alternatives to current water services delivery institutions.

Franchisee water services providers, being led by entrepreneurs with a financial and reputational stake in successful service delivery and financial viability, have a greater incentive to perform than, for example, in-house WSA personnel would usually have. Especially in areas away from the skills resource base that is in the metropoles (but by no means only in those areas), franchising partnerships can bring to the franchisees, and hence to the benefit of the water service, the franchisors' expert guidance and quality assurance. Caveats include that the client WSA has the competence to monitor performance and enforce contract compliance.

There are many situations where the advantages of franchising would be of great value to improved water service delivery. Franchising appears to be advantageous in respect of some elements of water services operation and maintenance, and in some circumstances, but not in respect of those same elements in other circumstances. Franchising should therefore be preferred in appropriate situations but not all situations are appropriate.

Franchisees are SMMEs with particular characteristics. In terms of size, they would invariably be towards the smaller size end of the range of typical SMMEs size. Thus they would with few (if any) exceptions be unable to make capital investments in infrastructure. If, therefore, new infrastructure or refurbishment or replacement is required, this would have to be funded by other parties. If, however, it could be shown that franchising would result in far better utilisation of the infrastructure, and more reliable or otherwise superior service delivery, then a strong case could be made to the other parties (e.g. national government) for that investment to be made.

That a WSP, or a contractor to a WSP, is a franchisee rather than any other form of SMME or private sector partner, or a public sector entity, must not disturb institutional, financial and other relationships of the delivery model in common use. For example, in respect of funding, if equitable share is currently used to subsidise the water services to a set of households when the WSP is a municipal WSP, this must not change, and the same subsidy must flow, should the WSP be a SMME.

Also, there is no question but that water services franchising partnerships can in many instances improve water services operation and maintenance, and that it can also be an avenue for LED, SMME and BEE development. Indeed, one of the reasons why the franchise concept could achieve significant impact is its potential for opening the water services industry to smaller companies in general and for BEE in particular.

7.1.2 Issues to be resolved

Significant issues that need to be resolved include:

- the apparent reluctance of many WSAs to outsource operations and maintenance;
- the need for assurance of funding for the service (i.e. will the franchisee be paid in terms of its contract with the WSA or WSP?); and
- whether sufficient numbers of existing or potential local entrepreneurs would perceive that water services franchising presents them with a viable business opportunity.

The first two of these are discussed in the current report. The third of these is dealt with in Phase 2 of the current project.

Apparent reluctance

There are many factors which militate against outsourcing parts of the water services chain. The lack of suitable role models, the fact that it has seldom been done before, the reduction in the direct influence of both councillors and officials who perceive that their jobs are being reduced, the resistance from those who believe that only the government should provide the service, and the inertia of many decades of doing it in-house. All of these contribute to a significant resistance to outsourcing to SMMEs (including franchisee SMMEs).

There are thus actually three steps of breakthrough required. The first is the breakthrough to acceptance by WSAs of outsourcing the operation and maintenance of infrastructure that they, the WSAs, own. (This outsourcing need not necessarily be to the private sector. It could be to NGOs or CBOs as well.) The second is the acceptance that the institutions outsourced to could be SMMEs. The third is the acceptance that this could be franchising. (The third should not be a problem once the second level of acceptance is in place. Franchised SMMEs should be easier to sell to clients than SMMEs that are standalone.)

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 fully competent WSPs in South Africa, entrepreneurs should be offered the opportunity, to see if they can assist. However, the case for franchising partnerships does not depend on the case for or against the participation of for-profit organisations.

Nonetheless, it is apparent that, even if franchising of elements of water services might be a valid option, most WSAs and WSPs are likely to need a lot of convincing before they would be prepared to seriously contemplate franchising these elements. They need to be convinced that not only is outsourcing a valid option, and preferable (by whatever criteria are agreed) to current delivery methods, but also that franchising partnerships will be simple to undertake and will also be in the interest of the officials and elected representatives responsible for motivating the change, making a decision on the change, and then supervising franchisees' performance.

Authorities may have a variety of reasons for not wishing to allow alternatives to in-house performance of operation and maintenance. Thus it is one thing to say that there might be nothing stopping them taking this route. But it must become as easy (or easier) for them to take this route rather than to each time opt for in-house performance. Thus, inter alia, the following must at some stage be done:

- drawing up model contracts;
- drawing up a standard form of analysis of the finances, and draw up financial models;
- doing case studies of successes; and
- disseminating all of the above, to publicise their existence.

Contracts should by rights be simple, because they are for operations and management, and not for construction.

Funding assurance

Franchising of water services can improve efficiency and provide municipalities with access to capacitated resources at the operational level, with beneficial results including protecting the revenue base that sustains municipal services. That notwithstanding, the certainty and reliability that they will be paid for their services should be prominent on any checklist of the issues that need to be weighed up by SMMEs (and their bankers and sponsors) when they consider contracting to supply operation and maintenance resources to a WSP or to a municipality in its role as a WSA. Furthermore, a viable business needs assurance of at least a minimum amount of revenue in future years.

Will adequate funding be budgeted and if it is budgeted, could that budget be cut and even if the budget as such remains firm, will the funds be paid? Could the funds be diverted to other purposes? Could they be subject to delays? Could it get diverted (e.g. budget cut), or not and what would consequences be? Why would these things happen and what can be done about them?

Reliability of payment due to the franchisee could also be threatened not by deliberate action (e.g. cutting the budget) but by WSA ineptitude, e.g., the official responsible "forgets" to make the due payments.

SMMEs offering operation and maintenance services to the public sector would often be dependent on a single client for their existence. Capacity problems in many municipalities, and the poor record of payment for contracted services that is too-frequently encountered, are substantial threats to suppliers. If this client fails to pay on time and in full, or it decides to terminate the services of the SMME or otherwise not continue with its services, that could be disastrous for the SMME.

If improved service delivery results in cost savings to the WSA and/or to improved service, this should improve the financial situation of the WSA, but in practice this financial improvement is not always realised, and/or for other reasons the contractually obliged payments to the franchisee whose efforts have improved the service are not made, or not made on time. The financial viability of the franchisee would then be threatened. This is not easily resolved, and possible solutions, such as paying the franchisee directly from financial savings made as a direct result of the improved service, or the presence of a government financial guarantor of last resort, might not be feasible or acceptable. National government must, however, perceive that the franchise option has in a significant number of circumstances at least as good or maybe an even better chance of providing sustainable water services than any other option has, and therefore it would be in government's own best interests to facilitate the participation of franchised water services providers.

The jury is still out on the extent to which water services franchising could or could not become a viable business opportunity in many parts of South Africa and whether, despite strong evidence of its advantages to water services delivery, problems such as procurement difficulties and uncertainty of multi-year funding – common to all outsourcing, and especially problematic to SMMEs – can be overcome.

In these circumstances, two generic advantages of franchising in the water services sector (or any other sector, for that matter), and being part of a network as opposed to being standalone and therefore unsupported SMMEs, become very important. These are:

- the leverage that the franchisor can exert on behalf of the franchisees; and
- that the franchisor can, if necessary, step in and perform the duties of the franchisee, should the franchisee fail to perform in terms of its contractual obligations to deliver the water service.

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Website addresses

Department of Provincial and Local Government:	www.dplg.gov.za
Department of Water Affairs and Forestry:	www.dwaf.gov.za
Department of National Treasury:	www.treasury.gov.za
Franchise Association of Southern Africa (FASA):	www.fasa.co.za
Small Enterprise Development Agency (SEDA):	www.seda.org.za
Water Research Commission:	www.wrc.org.za
WISA:	www.wisa.org.za

The website of Franchise and Advice and Information Network (of NAMAC) (FRAIN) (www.frain.org.za) has been closed, but searching for it opens up the SEDA website. The website of NAMAC (www.namac.co.za) has been closed.

Annexure A: General advice to a potential franchisee

From "Getting to grips with the finances". In "Real Business", "Business Day", June 2006.

"An upfront fee – also called an initial fee or joining fee – is a once-off payment that all franchisees must make to the franchisor.

The amount varies from network to network, industry to industry. The amount will reflect the franchisor's assessment of his investment in the franchise operation, plus goodwill.

Some franchisors include training costs in their upfront fee, others do not. The extent of training and the number of people to be trained also vary widely.

If your key personnel have to be trained at the franchisor's premises, expect to carry their costs, including their salaries.

As owner of the business, you will have to pay for equipping it with everything the franchisor advises is necessary. Again, capital expenditure can vary hugely. You will need working capital for stock, utility and other running expenses, and probably a property lease.

No franchisor can say for sure when your business will become profitable, so ensure you keep money for a rainy day.

Franchisors derive income from ongoing fees or the sale of products to franchisees, or both. The management service fee, wrongly referred to as a royalty, is usually a percentage of sales paid by the franchisee. The fee typically varies from less than 1% for a high turnover, low mark-up retail franchise, to 10% for a low turnover, high mark-up service franchise.

Great caution is advised when a franchisor asks for a fixed monthly franchise fee. Such a fee would break the important link between the franchisee's performance and the franchisor's income stream.

A banker's job is to lend money, but taking a risk is more than their job is worth. So they love franchising."

Annexure B: A brief history of franchising in South Africa

While franchising and its origins, and its success in South Africa, are more than adequately described in the first report, this brief history of non-water services franchising in South Africa has since come to light, and is of interest, although not in the least directly relevant to the feasibility of water services franchising partnerships.

"Modern franchising, as we know it, became a legitimate business format with the emergence of a recognizable brand. The Singer Sewing Machine Company was probably amongst the first to have a distribution business method that became so successful that it developed into a well-known brand and soon petrol companies, soft drinks companies, motels and fast food outlets proliferated, joining the commercial quest to be recognized in this form of duplication. Each added another piece to the "franchise business format" formula and in 1960 the first Franchise Association was formed in the United States to harness the runaway success of franchising as we know it today.

In the 1960s, whilst the United States had already formed their Franchise Association to steer their many franchised concepts into a formal business sector, South Africa was just starting to toy with franchising. An American franchise hamburger concept called Wimpy, conceived by Ed Gold, was brought to South Africa by J H Lyons, a subsidiary of SAB. The very first Wimpy opened in Murchie's Passage in Durban and was an instant hit. Other concepts started to take root in South Africa and in 1979 a group of those pioneering franchise companies, amongst them Wimpy, Mend-a-Bath, Steers, Milky Lane, Minit Print, Juicy Lucy, Mike's Kitchen and King Midas, got together to network, lay down some ethical business guidelines and ultimately form an association. That was the birth of the Franchise Association of Southern Africa."

(FASA website).

Annexure C: SMMEs in the context of job creation in water services

In 2005, DWAF and others brought out a set of documents on the topic of "the creation of employment on sanitation projects, both during the implementation stage and during the operation and maintenance stage". (DWAF et al., 2005:5). Of interest is a table of "job opportunities in the operation and maintenance of sanitation facilities". (DWAF 2004:15-16). This table summarises the operation and maintenance tasks, the skills level, who should be responsible, and other pertinent information, in respect of a range of sanitation technologies, including VIP latrines and flush systems.

Of greatest interest however is a section on "development and support of SMMEs as a vehicle for job creation." This is worth quoting from at length, as follows. Bear in mind that the context of the quotation is not just operation and maintenance of sanitation facilities, but also their construction.

> "In sanitation programmes, there are many opportunities for starting small businesses. These businesses can be owned individually or by the community as a whole (broad-based empowerment (BBE)). Although in some municipalities, small businesses have been established in the delivery of sanitation services, more still needs to be done in terms of the legal and financial requirements of those entities. This section will briefly detail the types of companies and some of the considerations in promoting and supporting their establishment. A key requirement however is that a structured entrepreneurial mentorship programme must be implemented to ensure quality and sustainability.
>
> The definition of a small business (according to the National Small Business Act) is any enterprise with less than 200 employees, an annual turnover of less than R20 million, and a total asset value of less than R5 million. However, for the small businesses that can be developed and supported on sanitation projects, the classification would fit into the very small and micro categories which are defined as follows (for community enterprises):

Size or class	Total full-time equivalent of paid employees – less than	Total annual turnover – less than	Total gross asset value (fixed property excluded) – less than
Very small	10	R1.00m	R0.50m
Micro	5	R0.15m	R0.10m

> In helping to establish smaller enterprises, it is important to take note of the legal and regulatory requirements for their establishment. This does not necessarily mean that by registering businesses they will be required to pay high taxes and fill in lots of forms each month. On the contrary, businesses that are registered but where employees earn less than the amount stated annually by SARS do not pay any personal or company tax, and may even qualify for certain types of support.
>
> Choosing the legal form of business has a significant impact on the complexity of regulatory compliance necessary, the amount of tax to pay, the extent of personal liability for debt incurred, and whether financial institutions are more or less likely to provide finance. It is therefore important to understand what options exist, and to select the best form for each particular venture. The options are sole proprietor, close corporations, companies with limited liability (Pty) Ltd, co-operative businesses, and section 21 companies (i.e. not for profit). The latter form of enterprise may be the most relevant to many community based organisations as they are exempt from most tax requirements.

> Finding the finance for starting business may be the most challenging part in starting new businesses. In sanitation programmes, municipalities might consider providing bridging finance for the SMMEs coupled with intensive mentoring.
>
> There is increasing evidence that community-based co-operative businesses are very successful particularly in more remote rural communities. In this case the business has community ownership rather than individual ownership, and benefits are shared within the community. Success in this approach has been experienced in pilot projects launched by the "Job Creation Trust"." (DWAF et al., 2005:24-25).

The potential that franchising has to be a significant component of the "structured entrepreneurial mentorship programme" raised in this DWAF document, is obvious.