

# Water services franchising partnerships: Institutional review for the application of franchising

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**Water Research Commission**

by

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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](http://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 roleplayers 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, importantly, that is 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 control.

To investigate this approach, the Water Research Commission initiated a study (completed in 2005) that explored the concept of franchising partnerships, 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 partnerships 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, 2005)

The study described at a conceptual level how a water services franchise model could be made available to emerging entrepreneurs, and concluded that franchising water services 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 development and black economic empowerment.

## **Objectives of the project**

The objectives of the current, follow-up project, were:

- 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 and water services providers.

The context in all instances is South Africa.

## **Focus of this report**

This report (which is the fourth report of the project) draws together, summarises and reviews the first three reports of the project (TT 432/1/10, TT 432/3/10 and TT 432/4/10). Thereafter it:

- describes the current national-level environment for water services franchising partnerships;
- seeks to identify potential franchisors, and gauge their interest in principle; and
- seeks to identify potential water services authorities, and gauge their interest in principle.

Its findings, conclusions and recommendations are summarised below.

## **The first three reports**

Franchising is a concept put forward to improve water services quality, coverage and efficiency through introducing a new (to water services) supply-side mechanism. In particular, many water services authorities do not have staff or systems to deliver a reasonable service. A carefully designed set of water services authorities /franchisor/franchisee arrangements, efficiently implemented, could assist.

At the same time, franchising partnerships offer opportunities to the small-, medium- and micro-enterprise sector and local economic development.

All choices of institutions for water services delivery are between alternatives. The water services delivery model in common use (i.e. a heavy reliance on water services authority'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 operate this infrastructure satisfactorily lies in the implementation of the model, rather than in the model itself. Franchising might not be ideal, but it might in many situations offer the prospect of improved services. Given the deplorable state of operation and maintenance of some of the water services infrastructure under the current institutional regime, many water services authorities need to consider different and potentially more successful options, and to give serious consideration to change.

Three main priorities need to be addressed simultaneously if the operation of public sector water services infrastructure is, in the cause of improved water services provision, and to the benefit of water services users, to be franchised where it is appropriate to do so. As follows:

- Ensure that the necessary steps are taken to allow the private, non-governmental organisation and community-based organisation sectors to compete on even terms with in-house providers. At very least, this must be done where in-house operation and maintenance is showing obvious signs of serious or repetitive nature of non-compliance.
- Address funding stream and municipal financial stability issues.
- Ensure that a few water services franchising partnership pilots are up and running as soon as possible. These pilots will, through their success, demonstrate the potential of water services franchising partnerships.

National government is the key roleplayer in terms of addressing the first two of these priorities.

Research shows that municipalities are for the most part unlikely to change anything in respect of the first of these priorities. If, therefore, national government wishes to effect change, it is going to have to demonstrate strong leadership.

Research also shows that not many municipalities are able of their own accord to bring about significant change in respect of the second of these priorities. Again, therefore, national government is going to have to take the leadership itself. In this instance, national government has shown some commitment to change, but much more needs to be done.

A “three-step breakthrough” is needed:

- The first step is the breakthrough to acceptance by water services authorities of outsourcing the operation and maintenance of infrastructure that they, the water services authorities, own. (This outsourcing need not necessarily be to the private sector – it could be to non-governmental organisation and community-based organisations or community-based organisations as well.)
- The second is the acceptance that the institutions outsourced to could be small-, medium- or micro-enterprises (SMMEs).
- The third step is the acceptance that these SMMEs could be franchisees. (This third step should not be a problem once the second level 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.

Note that what is good or bad for SMMEs is good or bad for franchising. But the converse doesn't necessarily apply – or, putting it differently, a franchisee SMME, given the support it would receive from the franchisor, would in all likelihood find it easier to meet some regulatory and other requirements than would a standalone SMME, everything else being equal.

Finally, whereas a business based on a single element of the water services delivery value chain might not be viable, a franchisee might be able to make a viable business by offering several water-related services, thereby achieving dual objectives, *viz.*:

- economy of scale; and
- lessening dependence on one or a limited number of clients.

### **National-level environment**

National government plays several roles highly pertinent to the current project. These include particularly its roles in:

- setting service delivery standards, and regulating performance;
- promoting and enforcing legislation;
- funding infrastructure delivery; and
- enforcing funding accountability.

Dissatisfaction of national government spokespersons with some or other aspect of local government performance of service delivery is periodically reported. Given that municipal lack of capacity has long been known to be a major obstacle to water services delivery, it is surprising that national government is not showing more interest in widening the choice of delivery institutions. Building capacity at local government level should not be confined to building capacity in-house – alternative ways of building local capacity must be sought.

This report suggests examples of some directions in which national government could, in the interests of service delivery, be more influential than it presently is.

Report TT 432/3/10 found that national procurement legislation and regulation is not a barrier to the outsourcing of water services operation and maintenance. Given that, water services authorities need to investigate on their merits alternatives to in-house performance. Alternatives must be judged fairly and on merit – both when choosing whether to outsource or not, and when selecting which institution to outsource to.

In terms of the “three-step breakthrough” noted above, the biggest step that needs to be taken is the first one – that is, acceptance of the principle of outsourcing.

The importance of this step has been recognised in the final report of the consultants charged with assisting national Department of Water Affairs and Forestry (DWAF) to formulate the national water services infrastructure asset management strategy. One of 10 “priority actions” is in part described as:

“Even if existing water services institutions are fulfilling their duties entirely as required (by no means generally the case) ... there is a need to investigate the generic merits and demerits of alternative delivery institutions.

Some of these institutions could, under some circumstances if not others, more effectively or more efficiently undertake these duties, or could offer advantages such as greater consumer satisfaction, small, medium and micro enterprises development, or Broad-Based Black Economic Empowerment ownership. Another reason for investigating alternative institutions is the knowledge that current institutions are often under great pressure and unable to fulfil all their duties – an option that enabled them to share the load with others could be welcomed.”

There is much to be said for national government to do more than play its role in addressing only the first two of the three main priorities. If it is as concerned about water services performance at local government level as senior government officials say it is, it should

consider proactively supporting feasible solutions. If therefore DWAF or National Treasury, say, is of the opinion that water services franchising is a valuable option, they should be seeking ways to nurture franchising. One way it could assist would be by supporting specific proposals put forward in the form of sound business plans.

This report is not about exploring water services franchising partnerships only in order to improve compliance with standards (such as water reliability and quality standards) or about infrastructure asset management. Important also could be the returns from improving operation and maintenance of water services infrastructure neglected by water services authorities. These can be substantial – returns, that is, measured in terms of for example water loss reduction, improved wastewater treatment works effluent quality, and more reliable water supply. Funding that would enable the trying out of promising new ideas (and franchising of water services operation is one) would be money well spent.

National government should also assist with focused initiatives to address the second of the three main priorities set out under the heading of "The first three reports" above. Potential franchisors are inhibited by the fear that, contractual commitments notwithstanding, municipalities may make due payments late or not at all. Ideas need to be found, and measures put in place, to remove the cause of these fears.

There is little to be gained from pursuing an independent initiative that seeks to make the third breakthrough of the "three-step breakthrough" before the first breakthrough is made. National government initiatives such as the forthcoming water services infrastructure reform strategy, revisions to the Water Services Act, the outcome of discussions between National Treasury and national Department of Provincial and Local Government, and the national water services infrastructure asset management strategy's set of initiatives will, the current researchers are confident, between them lead to the first-step breakthrough being more frequently made and in more water services authorities.

In summary:

- If national government really wants to improve water services operation and maintenance, and wants to encourage more participation by community-based organisations and SMMEs in water services delivery, it needs to review the procurement regime (i.e. how water services authorities implement procurement regulations) and also the budgeting and funding of water services operation and maintenance.

Thus the strong recommendation from advocates of franchising partnerships of the operation of public sector water services infrastructure is:

- for an enabling water services authorities procurement environment, and
- for an enabling water services authorities budgeting and funding environment.

The team does appreciate that DWAF needs to consult with its sister departments on resolving these issues. For example, it could well be that Department of Provincial and Local Government and National Treasury would have as much or more influence than DWAF has. However the team looks to DWAF, as the department responsible for water services, to drive the process.

## **Potential franchisors**

Six of the largest of the water services institutions other than municipalities, municipal entities and DWAF itself, that operate and maintain water services infrastructure in South Africa were approached by the team order to gauge their "experience and resources" and "interest in principle".

All have “the right experience and resources” to play the franchisor role.

Two other institutions approached already offer water services franchising partnerships services, and wish to extend their market.

Of the six:

- two are willing in principle, and are exploring the franchising opportunities that they perceive; and
- the other four are considering the matter.

It is still early days in the development of the water services franchising partnerships concept, but it is likely that any of these six institutions could make an operational and financial success of franchising if it chose to make the attempt. And, bearing in mind the wide range of their current activities (i.e. the many elements of the water services chain that they undertake), and their depth of skills, each of them could be the franchisor for any one of several elements.

The “big six” are the largest of their type, but are not the only organisations of their type – other water boards, for example, could also be franchisors.

Many organisations offer more limited elements and more specialised services than the “big six” do, but nevertheless could be franchisors of those services. Some organisations do this already. Two existing franchisors were also approached, and their success amply demonstrates the suitability of the franchising partnerships concept to many applications (but by no means all applications) where the franchisor and franchisees alike can focus on providing quality and reliability in delivery of selected elements of the water services value chain.

Future franchisors could be any entities that choose to offer services and that are able (if they desire, by contracting in required skills) to develop packages embracing the relevant business method elements.

### **Potential water services authorities**

Few municipalities use the private sector beyond IT, planning, design and construction, and (in the water services sector) a few other tasks such as meter reading and water sampling and testing. The reason is clear – it is usually the councillors' choice.

It takes a bold official to suggest outsourcing of more water services operation than that, despite that procurement legislation is in principle permissive of outsourcing. The statutory and regulatory environment might be enabling, but the local-level political environment for outsourcing of water services operation is disabling.

Franchising is a subset of outsourcing. If outsourcing is opposed by a council, that opposition, wittingly or not, will rule out franchising partnerships.

The implication is that if Water Research Commission seriously wishes to see franchising implemented at scale in many water services authorities, i.e. go beyond a few pilot studies in addition to where circumstances have created what could be unusually favourable conditions (e.g. Biwater's track record in Mbombela), then councillor resistance will need to be addressed.



Only a small minority of water services authorities appear to be willing in principle to contemplate outsourcing of the operation of their water services infrastructure – by franchising or any other means.

Which by no means shuts the door on franchising of public sector water services infrastructure. If a few pilots can be started up in those municipalities that are willing, and those pilots in due course deliver improved services, are Broad-Based Black Economic Empowerment and small-, medium- and micro-enterprise success stories, and are commercial successes for the water services authorities franchisor and franchisees alike, then the perceptions of some of the other water services authorities may begin to shift.

Successful franchising could also be undertaken of operation and maintenance of public sector water services infrastructure not owned by water services authorities, but by provincial government (e.g. schools sanitation franchising partnerships) and by water boards. This could also be valuable in changing water services authorities' perceptions.

The absence of good role models is one of the biggest factors militating against knowledge of (never mind acceptance of) franchising in the water sector. Until it is proven to work, many peoples' minds are closed to the opportunities, and they cannot see the benefits. The need for successful pilot projects to overcome these negative perceptions, many of which were built up over generations, is clear.

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## Notes

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

All references to or quotations from policy, statutes, regulations and so forth are to the best understanding of the researchers up to date to August 2007. 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 432/5/10 Institutional review for the application of franchising".

## Abbreviations and acronyms

Amanz' abantu	Amanz' abantu Services (Pty) Ltd
BBE	broad-based empowerment
BBBEE	Broad-Based Black Economic 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
CIDB	Construction Industry Development Board (Not in Document)
CSIR	Council for Scientific and Industrial Research
CSP	community service providers (Not in Document)
DBSA	Development Bank of Southern Africa
DFI	development finance institution
DOL	Department of Labour
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
EPWP	Expanded Public Works Programme
FRAIN	Franchise and Advice and Information Network (of NAMAC)
GIS	Geographic Information System
GNUC	Greater Nelspruit Utility Company
ICT	information and communication technology
IEEM	Institute of Environmental Engineering & Management
IMESA	Institution of Municipal Engineering of Southern Africa
LED	local economic development
LSP	Local Service Providers
MFMA	Municipal Finance Management Act
MIG	Municipal Infrastructure Grant
MSA	Municipal Systems Act
MSP	municipal services partnership
NGO	non-governmental organisation
PPP	public-private partnership or public-public partnership
PSP	private sector partner
PWMSA	Professional Water Management South Africa
SAICE	South African Institution of Civil Engineering
SALGA	South African Local Government Association
SEDA	Small Enterprise Development Agency
SFWS	Strategic Framework for Water Services
SMME	small, medium and micro enterprise
WRC	Water Research Commission
WRP	WRP Consulting Engineers
WSA	water services authority
WSP	water services provider
WSSA	Water & Sanitation Services SA (Pty) Ltd
WMA	water management authority

## 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? 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, page 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 “community-based organisation”, abbreviated 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 – which 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;
- to state the objectives and phasing of the project, and introduce the project team; and
- to 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 national Department of Water Affairs and Forestry 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 does the operations and maintenance workload escalate. 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, 2005.) 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

This 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 over the contract period. (Also see “project schematic” on the next page.)

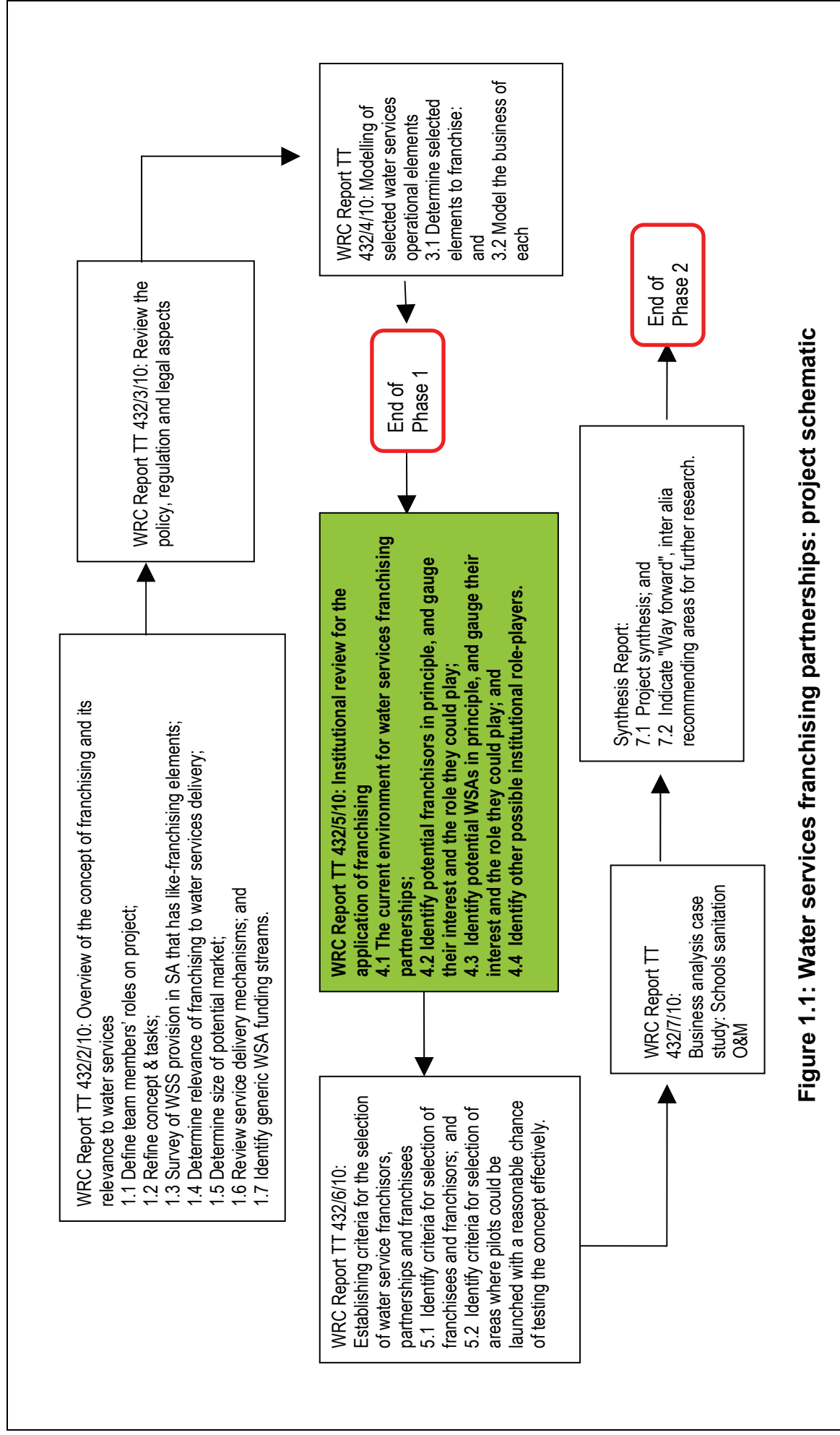
The first phase consisted inter alia of:

- survey of water services provision that has like-franchising elements;
- determination of relevance of franchising to water services delivery, and determination of the magnitude of that potential;
- review of service delivery mechanisms, and identification of generic funding streams;
- review of policy, legal, regulatory and other aspects which impact on water services;
- identification of those elements in the water services delivery 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, of which the current report is part, consisted of:

- identification of potential franchisors and WSAs in principle;
- identification of generic criteria for selection of franchisees and franchisors, and for selection of pilot areas; and
- case study of an element in a hypothetical situation.

Note that a further two phases, not part of this WRC 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:

- Identify potential franchisors and WSAs, and industry developer and sponsor.

More specifically:

- Whereas water services franchising might be a great concept in theory, it would only work if, among other things, suitable institutions with the right experience and resources were willing and able to play the role of franchisors. Thus potential franchisors and WSAs need to be approached, and their willingness in principle obtained.

This “TT 432/5/10: Institutional review of the application of franchising” is hereinafter referred to as “the report” or “this report” or “the current report”.

### **1.3.2 Purpose of this report**

The objectives of this report are:

- to summarise the three first phase reports;
- to describe the national-level environment for water services franchising partnerships;
- to identify potential franchisors, and gauge their interest in principle;
- to identify potential WSAs, and gauge their interest in principle; and
- to identify other possible institutional roleplayers.

## **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), followed by five chapters that deal with the objectives of the report. Chapter 7 draws conclusions.

- Chapter 1: Describes the project and this report.
- Chapter 2: Summarises what the first three reports (i.e. the three phase 1 reports) have to say that is most relevant.
- Chapter 3: Describes the current national-level environment for water services franchising partnerships, referring also to the opinions of some significant roleplayers.
- Chapter 4: Seeks to identify potential franchisors, and gauge their interest in principle.
- Chapter 5: Seeks to identify potential WSAs, and gauge their interest in principle.
- Chapter 6: Seeks to identify other possible institutional roleplayers.
- Chapter 7: Draws conclusions and makes recommendations.

## **2. Findings of the first phase reports**

### **2.1 The purpose and structure of Chapter 2**

The purpose of Chapter 2 is to summarise and discuss what the first three reports (i.e. the three Phase 1 reports) have to say that is most relevant.

Drawing together the findings of the first phase of the project is an obvious and essential preliminary to identification of potential franchisors and WSAs. What the first phase reports have concluded, and what this means for the prospects of water services franchising – and what the environment for water services franchising partnerships would appear to be – must be spelled out.

Thus the sequence of Chapter 2 is:

- summarise (in Section 2.2) “Report TT 432/2/10: Overview of the concept of franchising and its relevance to water services”;
- summarise (in Section 2.3) “Report TT 432/3/10: Review of the policy, regulation and legal aspects”;
- summarise (in Section 2.4) “Report TT 432/4/10: Modelling of selected water services operational elements”;
- highlight (in Section 2.5) the strongest and most relevant to the project of the themes that emerge from these three reports.

The implications of these findings for the national-level environment for water services franchising are described and discussed in Chapter 3, and the implications for the local-level environment for water services franchising are described in Chapter 4 and especially in Chapter 5.

### **2.2 The overview report summarised**

#### **2.2.1 Introduction**

“Report TT 432/2/10: Overview of the concept of franchising and its relevance to water services” summarised the findings of the earlier WRC study. Thereafter it:

- surveyed water services provision that has like-franchising elements;
- discussed the relevance of franchising to water services delivery, and discussed the size of the potential market;
- reviewed the existing service delivery mechanisms;
- reviewed the funding streams; and
- drew conclusions.

Each of these is summarised below.

#### **2.2.2 Like-franchising survey**

One franchise, several water sector like-franchises, and other forms of public-private partnerships (PPPs) were described in Report TT 432/2/10, outlining (at minimum) the circumstances under which they were established and are operating, the small-, medium- or micro-enterprises (SMME) (or franchise SMME) and the supporting institution (or franchisor), and their success or otherwise. There are not many instances of franchising partnerships or like-franchising in the water sector, and their nature, circumstances and achievements are so varied, that it was 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 R 1 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 their 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 municipal or WSA 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 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 partnerships can also assist with the resolution of skills and incentives problems that are encountered by or in many WSAs and water services providers (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 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 such as a franchisee would often have a distinct cost advantage over an organisation such as the WSA itself, which is more centrally based in the municipality, and therefore at a greater physical distance – and the customers should receive a quicker response.

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 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 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 that 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 partnerships, but undoubtedly there are many 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 outsourcing operation 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 presents them with a viable business opportunity.

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 NGOs or CBOs as well.) The second is the acceptance that the outsourced-to institutions in question 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 broad-based empowerment BEE in particular.

### **Service delivery mechanisms**

The great majority of water services providers are in-house delivery mechanisms, namely internal WSA/ municipal departments or business units. Outsourcing parts of the service delivery chain can be complex, because in each case the requirements of the Municipal Finance Management Act and the Municipal Systems Act must be complied with. 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 DWAF Consolidated Guideline for Water Services Authorities states that management and service contracts are not subject to Section 78 requirements of the Municipal Systems Act, 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.

Contracting with small franchisees is invariably less risky for 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 would not by any means be suited to all activities in the water services supply value chain.

Franchisees could operate as contractors or sub-contractors to a WSP, as community-based water service providers do. Alternatively, 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.



If the contractually obliged payments to the franchisee are not made, or are not made on time, this would threaten the financial viability of the franchisee. This problem of late payment, or non-payment, 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.

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 microenterprise'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 don't 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 advantages of franchising in the water services sector (or any other sector, for that matter – these are generic advantages of franchising), 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.

### **2.2.3 WRC Report TT 432/2/10 conclusions**

There is no doubt that water services franchising partnerships 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 for water services operation and maintenance, problems, such as procurement and an assurance of ongoing funding, need to be overcome. It is too early to say if 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 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 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 does not depend on the participation of only for-profit organisations. Franchisors could, with a minimal diversion from a purist definition of franchising, be parastatals or large NGOs, and franchisees could be CBOs and small NGOs.

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.

## **2.3 The policy and legal report summarised**

### **2.3.1 Introduction**

"Report TT 432/3/10: Review of policy, regulation and legal aspects":

- described and discussed the policies, statutes, legal issues, financial issues, regulations etc that could affect water services franchising;
- described and discussed relevant issues of procurement;
- described and discussed SMME and BEE issues that could affect water services franchising; and
- drew conclusions.

Each of these is summarised below.

### **2.3.2 Policies, statutes, legal issues, financial issues, and regulations**

The following statutes, regulations and policies are those most relevant to water services franchising:

- The Water Services Act (South Africa 1997) governs the approval of water services providers and promotes access to information:

- ▣ The Water Services Act provides for, and in fact encourages, water boards to provide water services to municipalities:
  - ▣ In addition the Water Services Act provides requirements for a contract between a WSA and a WSP.
- Water Services Provider Contract Regulations set out the contents of WSP agreements. These regulations thus provide a scope or check list for the contractual relationship between the franchise operator and the municipality. (DWAf 2003a)
- Regulations Gazetted under the Water Services Act provide for the annual submission of a water services audit by the WSA.
- DWAf's (Department of Water Affairs and Forestry) Strategic Framework for Water Services (SFWS) sets out the water services sector's vision, goals and targets as well as the institutional framework, the financial framework, the planning framework, national norms and standards, the regulatory framework and the support and monitoring framework. The SFWS recognises that a process of institutional reform is required. This reform process opens up a window of opportunity to explore different options for water services provision.
  - ▣ The SFWS insists that all providers of water services to or on behalf of water services authorities must do this in terms of a service delivery agreement (contract) with the water services authority.
  - ▣ The SFWS also insists that where water services providers provide retail services to consumers, they must do so in terms of a consumer charter and consumer contracts. (DWAf 2003b)
- Sections 76 through 82 of the Municipal Systems Act is the most authoritative set of requirements that must be observed by municipalities in determining mechanisms for the procurement of service providers. (South Africa 2000a)
- The Department of Provincial and Local Government (DPLG) compiled the Green Paper on Municipal Services Partnerships (MSPs) in order to create a policy environment that enhances the viability and feasibility of MSP service delivery.
  - ▣ The Green Paper on MSPs describes typical contractual arrangements between the Services Provider (in the case of water services, the WSP) and the Municipality (in the case of water services, the WSA). Service contracts and management contracts can be relatively simple forms of MSP. Build-Operate-Transfer BOTs and concessions are typically the most complex of MSP arrangements, and can impose heavy demands on a municipality's management and systems capacity. Even relatively simple forms of MSPs could deliver services cost-effectively, and may merit consideration. (DPLG 1999)
- The Local Government Municipal Finance Management Act (MFMA) stipulates conditions to be complied with and processes to be followed when entering into public-private partnerships:
  - ▣ The MFMA requires that a municipality must show, through a feasibility study, that a public-private partnership is superior to an in-house approach to providing the service before entering into such a partnership.
  - ▣ The MFMA also stipulates requirements for services (and goods) contracts procured by municipalities. (South Africa 2003b)
- The governance of companies is primarily regulated under the Companies Act. (South Africa 1973)

A very significant challenge to outsourcing, especially outsourcing to SMMEs, is the financial state of many municipalities. The SFWS highlights the weak financial position of many WSAs.

## **Procurement**

Legislation requires that a municipality undertakes a feasibility study to compare the private sector option with an in-house option before procuring a MSP. The main policies, legislation and regulations that guide procurement of providers are:

- The Water Services Act sets out requirements that must be observed by WSAs before entering into contracts with private sector water services providers.
- DWAF has published a “consolidated guideline” for selecting water services providers. These guidelines amplify Sections 78 to 81 of the Municipal Systems Act.
- The Green Paper on MSPs describes the feasibility study required before appointing, or entering into an MSP.
- The Municipal Systems Act (South Africa 2000a) sets out a competitive bidding procedure that must be followed in procuring an external service provider, if the decision is taken to follow the external provider route.
- The MFMA (South Africa 2003b) sets out requirements that must be complied with before municipalities may enter into contracts that have future budgetary implications.
- Additional procurement requirements for public-private contracts are set out in Municipal Public-Private Partnership Regulations.
- The Prevention and Combating of Corrupt Activities Act (South Africa 2004) makes a criminal offence of certain activities relating to the awarding of contracts and the procuring and withdrawing of tenders.

### **2.3.3 BEE and Local Economic Development (LED) issues**

The key pieces of legislation governing BEE and preferential procurement are:

- The Preferential Procurement Policy Framework Act (South Africa 2000b); and
- The Broad-Based Black Economic Empowerment Act (South Africa 2003a), which aims to promote economic transformation in order to enable meaningful participation of black people in the economy.

### **2.3.4 WRC Report TT 432/3/10 conclusions**

The conclusions of Report TT 432/3/10 with respect to the possible outsourcing and procurement of water services operation and management, but not specific to franchising partnerships, can be summarised as follows:

There appears to be nothing in policy, legislation or regulations preventing outsourcing of water services operation and management. (This outsourcing can be a public-public partnership or a public-private partnership, or a partnership with a NGO or CBO.)

However numerous requirements must be met before any aspect of water services operation can be outsourced. Municipal service or management contracts need to be procured in accordance with the legislation and regulations. Even contracts that appear to fall within DWAF’s Water Services Act relatively narrow (compared to that in legislation originating from National Treasury and DPLG) definition of procurement by a water services provider do still have to conform with the rules for procurement by private sector municipal service providers or external providers in terms of the Municipal Systems Act.

Legislation relating to procurement by municipalities mainly relates to procurement of private sector service providers. The rules relating to feasibility studies etc do not all apply where the services of public sector providers (e.g. water boards) are procured.

The municipality must make the effort to undertake the Section 78 process before it can consider outsourcing. However a municipality is not required to demonstrate that it can provide the service in-house better than any outsourcing could do. This must be challenged.

In practice, few municipalities feel that they have to go to the trouble of seriously considering alternatives to in-house, and thus only a minority of municipalities do make the effort. The current researchers feel that all municipalities must be encouraged to undertake Section 78 investigations in order to determine to what extent they are able to best carry out their responsibilities in-house – and thereafter to determine to what extent they should outsource as opposed to what extent they should use in-house service provider solutions. By denying themselves the opportunity to explore alternatives through an objective Section 78 process, these municipalities may have no reliable financial or information-supported rationale for the decisions they need to take in the interests of improving services to their customers.

The bias evident in many municipalities against the procurement of private sector, NGO and CBO water services providers cannot be addressed through legislation or regulations – it can only be addressed by clear political leadership.

A major potential source of information, and also a regulatory tool, is the water services audit which should be enforced by DWAF.

Legislation does not prejudice SMMEs. In fact, the procurement legislation favours small procurements – particularly, procurement of service providers offering services for contracts under R200 000 is simplified. (Procurement of service providers for all contracts of a value above R200 000, regardless of whether SMME, CBO or NGO, and BEE or not, must be in accordance with the municipality's supply chain management policies compiled in accordance with National Treasury regulations.)

Company legislation gives important guidance for the screening of potential MSPs.

The financial affairs of many municipalities are not in order. Many medium and low capacity municipalities are unable to report on their financial status. Inability to always follow acceptable accounting and payment procedures, including inability to process invoices and pay them on time, is much in evidence. Many municipalities are not able to recover all of the revenues due to them – sometimes they cannot even recover most of the revenues due to them. This does not bode well for private sector involvement in the provision of water services, because:

- Private enterprises will only survive if they are paid.
- If municipal inability to process invoices and pay them on time presents considerable problems for outsourcing even to larger MSPs, it would very likely be fatal to SMMEs, which have much less (maybe minimal) financial resources and might be dependent on only a few clients or even on only one client.
- It is unlikely that the private sector will be able to collect revenue on behalf of the municipality if there is no political will to support such efforts.

There are indications that unions will resist any outsourcing of municipal service provision. They would do this on the grounds that it could lead to retrenchment of their members.

The conclusions of Report TT 432/3/10 specific to the franchising of water services can be summarised as follows:

The policy, statutory, and regulatory regime with respect to water services franchising is a subset of the wider environment determining and controlling WSPs. Franchisees are SMMEs of a particular type, and SMMEs in turn are part of a wider private sector, so anything that affects outsourcing (that is, outsourcing not just to the private sector) would affect franchising as well.

There appears to be nothing in policy, legislation or regulations preventing franchising of water services.

That franchising is not specifically mentioned in the procurement-related material that is reviewed in this report would seem to be only because national government has regarded it unnecessary to have specific provisions relating to franchising.

DPLG, National Treasury and DWAF support will be required for the franchising approach.

Some water boards could be in a good position to fulfil the role of franchisor.

What is good or bad for SMMEs is good or bad for franchising. But the converse doesn't necessarily apply – or, putting it differently, a franchisee SMME, given the support it would receive from the franchisor, would in all likelihood find it easier to meet some regulatory and other requirements than would a standalone SMME, everything else being equal.

The franchise approach does have the potential to substantially lever up the black ownership component of the contractor through a real contribution by the franchisee, and is clearly not fronting.

## **2.4 The business analysis report summarised**

### **2.4.1 Introduction**

“Report TT 432/4/10: Modelling of selected water services operational elements” described the water services value chain, identified elements in the water services delivery chain which offer the greatest scope for franchising, and set out the results of the business analysis of possible franchising of three selected elements.

Figure 2.1 (on the next page) sketches the water services delivery value chain.

The report's findings, conclusions and recommendations are summarised below.

### **2.4.2 Findings from the modelling/business analysis**

Once the water services value chain had been set out, more than a dozen elements of the chain were identified that (on paper at least) both:

- would appear to present good opportunities for outsourcing by a WSA to small or micro-enterprises; and
- are elements in respect of which many WSAs undoubtedly need assistance.

Three of these elements were then selected, primarily on the grounds of the current researchers' view that they are among the most suitable for franchising partnerships of the dozen or so.

The three elements modelled were:

- caretaker management;
- schools sanitation;

- pressure control system management.

The objectives of the modelling, or “business analysis”, were very much borne in mind when doing the modelling/analysis – most importantly, the objective to provide a basis for a comparison of performance of the element by franchising methods with performance of the element by other means.

Given that the ultimate purpose of the project is to identify the scope for franchising, and to identify the viability of franchising partnerships and/or to make a case for franchising to be considered by WSAs, it made good sense in Report TT 432/4/10 3 to relate the findings from the modelling to the “budgets”, “skills” and “incentives” generic reasons for current unsatisfactory service in respect of some elements of water services delivery. Also, the findings from the modelling lend themselves to this classification.

## **Budgets**

Financially speaking, the situations that each of the three models addresses are very different:

- The schools sanitation model addresses a constituency (schools, mostly rural) that lacks a basic facility (sanitation) to an extent that varies from school to school. There are no financial savings to be had, and operation and maintenance budget will have to be found from the public purse.
- The caretaker model addresses leakage in low-income residential areas. This wastage of water is at the cost of the WSA. Hence saving, through leakage repair and subsequent maintenance, will accrue to the WSA – although implementation of a caretaker project would assist in encouraging a spirit of ownership on the part of consumers. (And for those who accept responsibility for paying for water taken, portion of the savings would accrue to them.)
- The pressure control model, in contrast, offers the WSA the opportunity for very rewarding to a savings, and it would be reasonable that part of this is paid to the WSA's private sector partner (PSP) that undertakes the work.

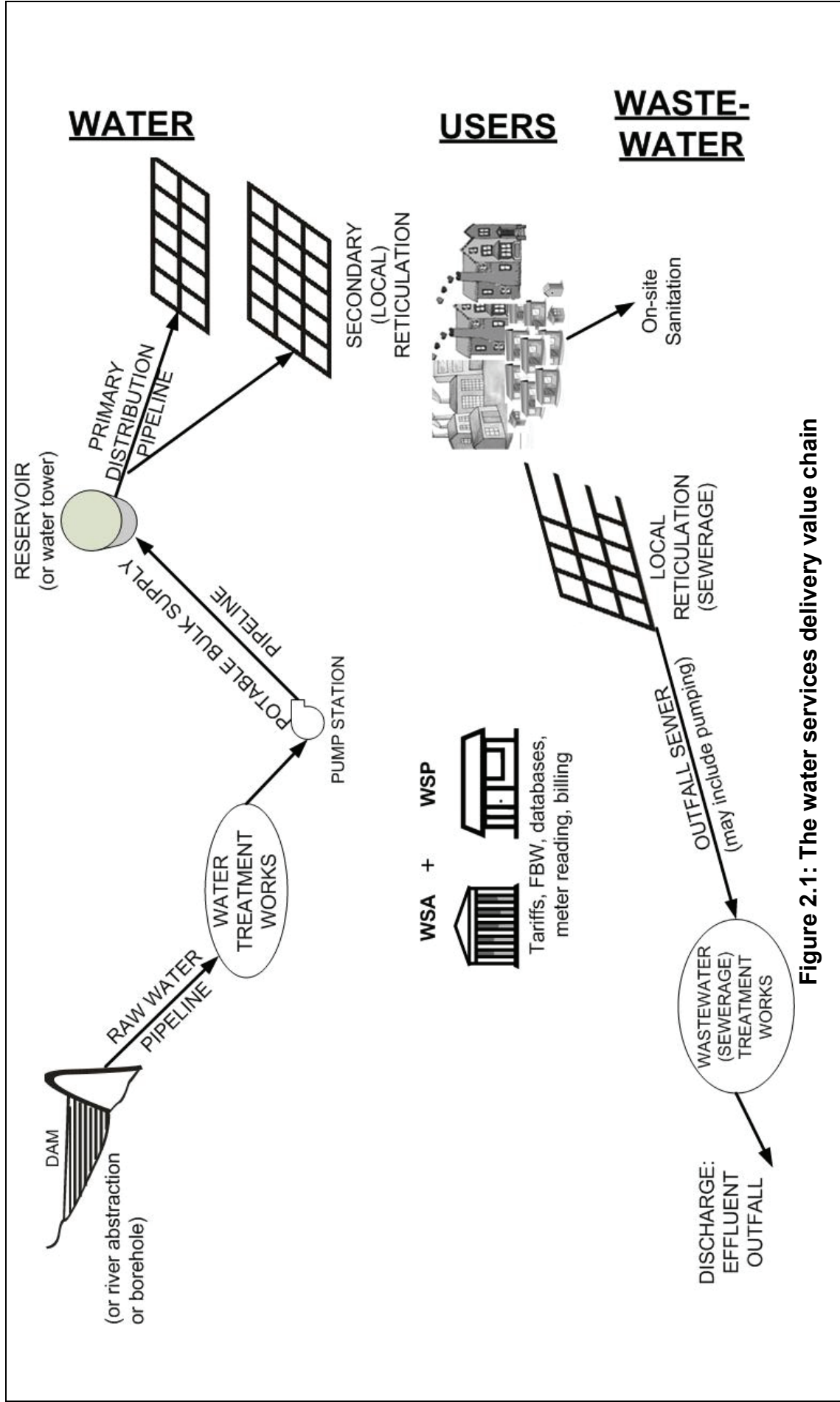
These situations are very material to the budget that the infrastructure owner may have available to pay for the necessary work – irrespective of who does the work, whether in-house or outsourced. If the budget cannot be found, the work will not be done. The private sector partner must of course be paid, if not from savings (to the school or provincial Education Department in the one instance, and by the WSA in the other two) from the work being undertaken, then from the infrastructure owner's other budget.

Whether franchising would be financially viable is subsumed into the larger consideration of whether budget can be found for the work, whoever does it.

It is important to note that outsourcing of the kind of service being considered here must not disturb financial relationships of the delivery model in current use. For example, 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.

## **Skills**

The water services operation and management situations that each of the three models addresses might be very different in levels of skills, but they are not much different in principle. The pressure control management situation is that which needs the highest level of specialist skills – neither of the other two is very demanding on technical skills.



**Figure 2.1: The water services delivery value chain**



Which leads to the obvious question – why, if the technical skills needed are commonplace, have they not been applied by the infrastructure owner? The short answer is that, basic as some of the skills might be, they exceed the skills levels available to the infrastructure owner.

Schools sanitation is a good illustration of this point. It may be that no one at the school knows how to operate and maintain the sanitation facilities (and/or does not see it as their responsibility – vide “incentives” below) or to repair or refurbish them. However the skills needed are not only technical. Skill (and budget) is needed to motivate budget, procure technical help (e.g., in the rural schools situation, a local builder or local plumber), arrange for delivery of materials, and so on.

The caretaker management model provides another good illustration. The skills needed might be commonplace in an urban area, but they are not being applied, or not being applied sufficiently, to the water services infrastructure in parts of that urban area.

The skills help that a franchisor could typically provide might best manifest in reduction of risk to the service at large and to the small PSP in particular. For example, in the caretaker model, compared to the caretaker being a standalone small or micro-enterprise;

- the franchisor can provide technical help on how to reduce wastage;
- the franchisor can, independently of the WSA, check the WSA's costing, and thus cost-benefit calculation, and thus the caretaker's remuneration;
- the franchisor can assist the WSA to create and maintain a customer database;
- the franchisor can take responsibility for monitoring of quality (and for rectification, thereby providing the WSA with additional assurance that the agreed quality of service will be provided); and
- the franchisor can take responsibility for selection and training of caretakers, and for their ongoing skills development (this is another measure that will reduce the possibility that caretakers are unable to deliver the expected service quality).

Summing up:

- Given that the reputation of SMME WSPs will so much depend on the quality of the service they provide, if they are franchisees the help from a franchisor will reduce the risk of quality failure. (It would do this inter alia by selection of franchisees, their training, monitoring of quality, and in some instances – an assurance to the owner of the infrastructure – the franchisor being the service provider of last resort.)
- Having a franchisor help the franchisee to provide the service is assurance just to the infrastructure owner but also to the franchisee. The greater (compared to a standalone franchisee) muscle of the franchisor enables the franchisor to more powerfully stand up to the WSA when the contractual rights of the franchisee are threatened (e.g. when the WSA is not paying in full and on time). This is a great comfort to a franchisee.
- Especially in areas away from the skills resource base that is in the mostly metropolises, franchising can bring to the franchisees, and hence to the benefit of the water service, the franchisors' expert guidance and quality assurance. Which, as pointed out above, does not always need to be that “expert” – but it has to be good enough to meet the need, and to better serve the infrastructure than might otherwise be the case.

All of these (with the possible exception of being the service provider of last resort) are the traditional functions of a franchisor, as applied to the franchising of fast food, printing, video stores, Pick 'n Pay family stores, and so many other familiar situations.

## Incentives

It is often in respect of the incentives that the advantages of franchising partnerships, as opposed not so much standalone SMMEs performing a service, but as opposed to in-house performance by a WSA, are most apparent.

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 water services authority personnel would usually have.

Pressure control management provides a good illustration of incentives so powerful that they could motivate (and have motivated) even smallish private sector providers to take out substantial (for them) loans in order to make capital investments in infrastructure that became the property of the WSA the moment they were installed. (The risk that the PSP would have to accept in these circumstances is substantial. Should the WSA renege on the contract between them, the PSP could lose its investment before a cent of revenue or of cost saving had been generated. But the potential rewards are also substantial.)

As an aside: it is a mystery to the current researchers that more WSAs do not make similar investments in cost-saving infrastructure in their areas.

Should the kind of pressure control management activity modelled in the report be franchised, a share of the incentive (and of the reward) would be assigned to the franchisees.

The incentive principle applies as much to the two other models, even though the rewards might not have as large an upside potential.

### 2.4.3 Conclusions from the modelling/business analysis

**To recap briefly.**

Franchising could in many instances bring to water services operation and maintenance the range of advantages that franchising is said to bring in other, non-water services, sectors, including:

- selection of the small or micro-enterprises, and then initial and ongoing training;
- ongoing monitoring, and assurance that corrective action would be taken when necessary; and
- when needed, a level of expertise that would not normally be available to that infrastructure in that situation.

Together, these should ensure improved quality and reliability of service.

In addition, the franchisor could, with likely more effect than the efforts of a small enterprise alone would achieve, intervene on behalf of a franchisee if the WSA is not fulfilling its contractual obligations. For example, if the WSA is delaying payments to a franchisee.

**Franchising can bring skills and incentives together. For example, skills may be geographically near at hand (vide the caretaker management model), but the owners of those skills may in a franchise arrangement have the incentive to bring them to bear where they are needed that would be lacking under other institutional arrangements.**

**Can these findings be extrapolated?**

For purposes of the first-time modelling of water services franchising, the researchers chose in Report TT 432/4/10 to model three situations where there appeared, even at a first level of examination, to be opportunities. It appeared from this modelling that franchising partnerships

would in these situations bring substantial and sustainable improvements to water services delivery. However there appeared on paper at least to be many other situations where the advantages of franchising would be of great value. 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. While franchising partnerships should therefore be preferred in appropriate situations, not all situations are appropriate.

### **On opportunities for small and micro-enterprise entrepreneurial development and for BEE**

Water services franchising can in many instances not only improve water services operation and maintenance, but it can also be an avenue for local economic development, and 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 enterprises in general and for BEE in particular.

The caretaker management model is a good example of that.

### **Caveats and cautions**

Caveats and cautions include:

- The client water services authority needs to have the competence to monitor performance and enforce contract compliance. The client must be sufficiently competent to ensure that in the first place a fair contractual deal is struck, and in the second place that the PSPs (franchisor and franchisee, or any others) live up to their contractual obligations. If necessary, the client should bring in outside help to enable it to do this.
- Franchisees are SMMEs with particular characteristics. In terms of size, they would invariably be towards the small and micro-size end of the range of typical SMMEs. Thus they would with few (if any) exceptions be unable to make capital investments in infrastructure (one possible exception being pressure control management). If, therefore, new infrastructure or refurbishment or replacement are 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, and MIG funding would be available for refurbishment or upgrading, this must not change, and the same subsidies and grants must flow should the WSP be a SMME.
- Procurement could present difficulties, as described at length in Report TT 432/3/10. This issue needs to be addressed, or application of even the best franchising partnerships models will be limited.

## **2.4.4 WRC Report TT 432/4/10 conclusions**

Through water services franchising, 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 partnerships 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.

Whereas a business based on a single element of the water services delivery value chain might not be viable, an entrepreneur might be able to make a viable business by offering several water-related services, thereby achieving dual objectives, viz.:

- economy of scale; and
- lessening the franchisee's dependence on one or a limited number of clients.

In practice, also, an entrepreneur could well, over time, expand service offerings without expanding the range of skills (again, exploiting economies of scale, and building up a critical mass around a specific set of skills). Thus, for example, that plumbing skills would be needed, and that visits to individual properties would be part of the duties of the business, might be found to be a common factor to the following elements, providing opportunity for expansion of the business to include:

- meter reading;
- investigating meter errors that have been reported to the WSA;
- fixing meters; and
- fixing on-site leaks.

Franchising is a concept intended to improve water services quality, coverage and efficiency through introducing a new (to water services) supply-side mechanism, and at the same time offering opportunities to the SMME sector.

All choices of delivery institution are between alternatives. Water services franchising might not, even on paper, be ideal, but it might in many situations offer something better than current institutional means do. WSAs need to keep an open mind.

Franchising aims to improve quality and meeting standards, and is a way of assisting WSA/WSPs to do this. In particular, many WSAs do not have staff or systems to deliver a reasonable service. A carefully designed set of WSA/franchisor/franchisee arrangements, competently implemented, could assist.

Note that the models described in Report TT 432/4/10 have been drawn up with close knowledge of the water services sector, but without direct experience to go on of running small businesses providing service in respect of each of the elements modelled. It would therefore be foolish not to be prepared to be flexible and to learn.

## **2.5 Emerging themes**

### **2.5.1 Introduction**

The strongest and most relevant to the project of the themes that emerge from the three first phase reports are presented in bullet point form in this Section 2.5.

To recall, **“the ultimate objective of the project is 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)”** (Section 1.2.2.)

The context throughout is of course South Africa.

The first and third reports come to firm conclusions. Among these, they share a common conclusion that water services franchising partnerships can in many instances improve water services infrastructure operation and maintenance, and it can also be an avenue for local economic development, and SMME and the development. Thus their main common recommendation is that the current project should proceed.

Only the second report contains a set of recommendations focused specifically on the material of the report – a set of actions in terms of legislation and regulation change and enforcement, policy recommendations, contractual recommendations specific to water services franchising, and related matters. These are not reproduced in Section 2.3 above, but are captured within the bullet points below.

That themes raised in the findings of one report were raised again in another report is not in the least bit surprising. Concerns, for example, emerging from say experience with like-franchising, could well also emerge from, say, the study of the procurement regime. Indeed, many issues did emerge that are common to two or even three of the reports.

The themes “strongest and most relevant to the project” can for convenience of listing be split into:

- the benefits of and opportunities presented by water services franchising; and
- issues that need to be resolved.

That the former can be set out in a quarter of the length of the latter reflects only that it can be more succinctly stated, and not that, say, threats overwhelm the opportunities.

## **2.5.2 Themes – the benefits of and opportunities presented by water services franchising partnerships**

- A franchising partnerships model for water services delivery can undoubtedly greatly contribute to resolution of the skills and incentives problems that are encountered by, or in, many WSAs and WSPs. As explained at length in Report TT 432/2/10 and Report TT 432/4/10, franchising partnerships could in many instances bring to water services operation and maintenance the benefits that franchising is reported to bring in other, non-water services, sectors, including:
  - ▣ selection of the small or micro-enterprises, and then initial and ongoing training;
  - ▣ ongoing monitoring, and assurance that corrective action would be taken when necessary; and
  - ▣ when needed, a level of expertise that would not normally be available to that infrastructure in that situation.
- In all instances, the result would be improved quality and reliability of service.
- In many instances, also, through its significant potential to deliver more reliable and sustainable water services, water services franchising would (for example through reduced wastage of water) result in cost savings to the WSA, thereby improving its financial situation.

- Water services franchising can in many instances not only improve water services operation and maintenance, but it can also be an avenue for local economic development, and 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 enterprises in general and for BEE in particular.
- The environment for emergent business in South Africa is not by any means what it should be, and for that reason alone being part of a franchise network rather than a standalone business is advantageous to both the franchisee SMME and its client.

### **2.5.3 Themes – issues that need to be resolved**

The main issues that need to be resolved lie in:

- the apparent reluctance of many WSAs to outsource operation and maintenance;
- 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 of these requires a three-step breakthrough.

- 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 NGOs or CBOs as well.)
- The second 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 than the idea of SMMEs that are standalone.)

The issues that need to be resolved can for convenience be listed firstly as those relating to outsourcing and procurement, and then as those relating to funding and contracts.

#### **Outsourcing and procurement**

- There appears to be nothing in national policy, legislation or regulations preventing outsourcing of water services operation and management. The policy, statutory, and regulatory regime with respect to water services franchising is a subset of the wider environment determining and controlling WSPs. Franchisees are SMMEs of a particular type, and SMMEs in turn are part of a wider private sector, so anything that affects outsourcing to the private sector would affect franchising partnerships as well. That franchising is not specifically mentioned in the procurement-related material that was reviewed in the first phase of the current project would seem to be only because national government has regarded it unnecessary to have specific provisions relating to franchising.
- The DWAF, National Treasury and DPLG legislation and regulations relating to outsourcing and procurement are aimed at transparent and equitable procurement and include anti-corruption measures. The team strongly supports this legislation. Nonetheless policies, legislation and regulation relating to procurement need to be harmonised.
- At present, the easy option for a municipality is to attempt to deliver services in-house, and to not consider outsourcing. Should it wish to consider outsourcing, it has to initiate processes such as the Section 78 process. While it would be going too far to recommend at this time that each and every municipality be compelled to demonstrate, through such a process, that the in-house option is better than any alternative (and should it fail to do that, then it would

have to outsource), there is a need to start a move away from the in-house option being the line of least resistance. At very least, municipalities should be compelled to assess the real costs of the in-house option, so that these costs can be better understood (and controlled).

- The bias evident in many municipalities against the procurement of private sector, NGO and CBO water services providers cannot be addressed through legislation or regulations – it can only be addressed by clear political leadership. National leadership should encourage every municipality to view outsourcing of operation of infrastructure as an opportunity to improve infrastructure service operation, and also as an opportunity:
  - ▣ to retain income in the local economy;
  - ▣ to develop human capital in the community (develop skills focused on the needs of the local infrastructure); and
  - ▣ to facilitate the participation of communities in using the opportunities and stimulating the establishment of new businesses or the growth of existing ones.
- DPLG, National Treasury and DWAF support will be required for the franchising approach.
- Whereas it is likely that municipalities will often require contractual recourse not only to the franchisee but also to the franchisor, contract provision must be made for this where necessary. Especially this is so if the franchisor's expertise or track record is a significant reason for contracting with the franchisee. This "closing of the contractual loop" requires further investigation.

## **Funding and contracts**

- Franchisees are SMMEs with particular characteristics. In terms of size, they would invariably be towards the small and micro-size end of the range of typical SMMEs. Thus they would with few (if any) exceptions be unable to make capital investments in infrastructure. If, therefore, new infrastructure or refurbishment or replacement are required, this would have to be funded by other parties.
- The client WSA needs to have the competence to monitor performance and enforce contract compliance. The client must be sufficiently competent to ensure that in the first place a fair contractual deal is struck, and in the second place that the institutions outsourced to (franchisor and franchisee, or any others) live up to their contractual obligations. If necessary, the client should bring in outside help to enable it to do this.
- 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, and MIG funding would be available for refurbishment or upgrading, this must not change, and the same subsidies and grants must flow should the WSP be a SMME.
- A key obstacle to successful franchising is the state of municipal financial accounting and cost recovery. The financial affairs of many municipalities are not in order. Many medium and low capacity municipalities are unable to report on their financial status. Inability to always follow acceptable accounting and payment procedures, including inability to process invoices and pay them on time, is much in evidence. Many municipalities are not able to recover all of the revenues due to them – sometimes they cannot even recover most of the revenues due to them. This does not bode well for the outsourcing of water services operation and maintenance.

- ▣ Furthermore, whereas municipal inability to process invoices and pay them on time presents considerable problems for outsourcing even to larger MSPs, it would very likely be fatal to SMMEs, which have much less (maybe minimal) financial resources and might be dependent on only a few clients or even on only one client.

#### 2.5.4 In conclusion

What is good or bad for SMMEs is good or bad for franchising. But the converse doesn't necessarily apply – or, putting it differently, a franchisee SMME, given the support it would receive from the franchisor, would in all likelihood find it easier to meet some regulatory and other requirements than would a standalone SMME, everything else being equal.

Whereas a business based on a single element of the water services delivery value chain might not be viable, a franchisee might be able to make a viable business by offering several water-related services, thereby achieving dual objectives, viz.:

- economy of scale; and
- lessening dependence on one or a limited number of clients.

Franchising is a concept intended to improve water services quality, coverage and efficiency through introducing a new (to water services) supply-side mechanism. In particular, many WSAs do not have staff or systems to deliver a reasonable service. A carefully designed set of WSA/franchisor/franchisee arrangements, competently implemented, could assist.

At the same time, franchising offers opportunities to the SMME sector.

**All choices of water services delivery institution are between alternatives.** 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. **Franchising might not, even on paper, be ideal, but it might in many situations offer the prospect of improved service delivery better than that from current institutional means. Given the deplorable state of operation and maintenance of much water services infrastructure under the current institutional regime, WSAs need to keep an open mind, and to give serious consideration to change.**



### **3. The current national-level environment for franchising of water services operation and maintenance**

#### **3.1 The purpose of Chapter 3**

Chapter 2 summarised, without discussion, what the first three reports have to say that is most relevant. The purpose of Chapter 3 is to review what this means for the prospects of franchising partnerships in water services operation and maintenance – and what the national-level environment for water services franchising would appear to be – bringing in the opinions of some significant roleplayers and also some observations from the current researchers.

With the conclusion of Chapter 2, the current researchers feel that the case for water services franchising in appropriate circumstances has sufficiently been made, and therefore the advantages of this franchising partnerships will not be punted again in the current report. The remainder of this report is thus given over to matters to do with getting the concept accepted and finding suitable and willing roleplayers.

#### **3.2 The structure of Chapter 3**

A suitable framework for the chapter is the “three-step breakthrough”, first set out in Section 7.1.2 of Report TT 432/2/10, viz.:

- 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 NGOs or CBOs as well.).
- The second 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.)

To which it is useful to add that the topic of funding of SMMEs undertaking water services operation and maintenance, an essential part of the environment, was covered in Chapter 6 of Report TT 432/2/10, but needs to be summarised here.

The sequence of Chapter 3 is:

- describe and discuss the environment around the first step, viz. the breakthrough to outsourcing (Section 3.3);
- describe and discuss the environment around the second and third steps, viz. the breakthrough to SMMEs and to franchising (Section 3.4);
- describe and discuss the environment around funding (Section 3.5); and
- draw conclusions (Section 3.6).

Thus the most contentious of the three steps is tackled first.

### 3.3 The environment around outsourcing

#### 3.3.1 Introduction

Report TT 432/3/10 has shown that there appears to be nothing in South African national policy, legislation or regulations that prevents outsourcing of the operation (and maintenance) of water services infrastructure owned by the public sector.

Outsourcing of some types of tasks, often (but not always) of a capital nature, is widespread. Thus it is common for a WSA to appoint a contractor to undertake a task of a specific construction, maintenance or refurbish nature, for a specific fee. Once the task is completed (e.g. a pipeline laid, or mechanical plant repaired or refurbished), the contract ends.

In contrast, not many instances can be found of outsourcing of water services operation and maintenance for a period. That is, for a WSA to appoint a contractor to operate or maintain (or both) some elements of infrastructure for an extended fixed period (a year or more). Other than in respect of small-scale operations (such as meter reading and water sampling and testing) and some specific fields such as vehicle and property maintenance, outsourcing accounts for a very small percentage of the total operation and maintenance activity of WSAs. (Statistics are not available.)

If there is nothing in policy, legislation or regulations that prevents outsourcing of water services operation and maintenance, how come is this outsourcing not more widespread?

A bias is evident in many municipalities against outsourcing operation and maintenance. It seems that this bias applies particularly against the private sector, but also, not much less so, against NGOs and even CBOs.

The local-level environment surrounding this issue is gone into in more detail in Chapter 5. Chapter 3 deals with the national-level environment. In other words, what there is at national level that influences acceptance by WSAs of outsourcing the operation and maintenance of infrastructure that they own.

Thus in Section 3.3 the national-level environment is described as follows:

- current DWAF policies;
- the current formulation of water services infrastructure reform strategy;
- the current revision of the Water Services Bill;
- other national-level considerations.

The private sector is certainly aware of the difficulties around its possible contribution to public sector infrastructure other than as a task-based contractor. Apart from the issues raised in Section 3.5 below, a major lender spelled out the following (most of which relate more to capital investment than to participation in operation and maintenance, but there is great similarity of difficulties faced):

- “Municipalities and water boards aren't coming to the lenders.” They have a “lot of reticence” – unwilling to come to the private sector, when so much public sector money is available – and it is generally cheaper, and has less strings attached.
- How do you reconcile on the one hand a three-year window from government (i.e. MTEF), as opposed to a 10-15 year loan period, and an asset life of more than 30 years?
- In terms of the Financial Sector Charter, R 25 billion must by December 2008 be loaned by the private sector to the public sector for infrastructure purposes. But the private sector lenders see difficulty in getting this amount of loan out – they have the money available, but they can't find suitable projects. (Note the R25 billion is for loans, not grants.)

- The private sector “would like to make unsolicited bids”, but is afraid of challenges to the legality of any contracts consequently entered into. And, when an unsolicited bid is made, the bidder's intellectual capital is put at risk. (King, 2006)

These are valid concerns.

### **3.3.2 DWAF policies**

The 2005 report on franchising summed up as follows the then current DWAF policies on outsourcing (in general terms – i.e. not specifically to SMMEs):

“In summary, the water services provider options set out in the [SFWS] above and in other literature cited (i.e. DWAF publications, policy documents, ministerial speeches, etc.) invariably comprise the municipality itself (either the district or the local municipality), other public sector or parastatal agencies, community-based organizations (CBOs), and combinations of these in the form of municipal service partnerships (MSPs). In special circumstances private sector WSPs will also be considered. But when MSPs are discussed in the literature, it is clear that, aside of community-level schemes, only public sector or NGO or CBO partners are envisaged at the moment.” (Wall, 2005, Section 2.3.3.)

Other than as described in the two sections following immediately below (which describe potentially substantial change, but in the future), there has been no change to the above to speak of during the intervening two years.

### **3.3.3 The formulation of water services infrastructure reform strategy**

The SFWS described a policy framework for the institutional reform of water services provision. (DWAF 2003b, pages 17-19):

- The motivation for reform is set out (including under-investment, lack of capacity and inefficiencies and economies of scale).
- The reform objectives are set out (including improving performance, using existing capacity better, and improving accountability).
- The reform principles and approach are set out (including that reform must be underpinned by a sound business case, and that reform will be on a case-by-case basis and there will be no “one size fits all” national institutional model).

The national institutional reform strategy will, stated SFWS (DWAF 2003, page 19), comprise inter alia guidelines and principles, allocation of roles and responsibilities, key priorities, and process plan and budget. It “will address the rationalisation of water services providers, particularly where regional infrastructure is involved, and the strengthening of public sector institutions providing water services where appropriate.” Thereafter it will be implemented in phases, viz.:

- Phase 1, getting cabinet approval of the strategy, setting up a national restructuring task team, and improving the governance and regulation of water boards.
- Phase 2, involving investigations into institutional reform on a case-by-case basis (to be followed by implementation of institutional reform).

The institutional reform strategy is at the time of writing (November 2007) in the course of preparation, overseen by a task team consisting of senior representatives of inter alia DWAF, DPLG, National Treasury, SALGA and the South African Association of Water Utilities.

Nokeri stated that, among the issues that the task team has taken most careful note of, are the “increasing evidence of widespread poor performance related to the operation and maintenance of water services infrastructure”, and “severe capacity constraints, especially with respect to

technically skilled and experienced staff, [that] are experienced by many water services providers". (Nokeri, 2006 page 5)

DWAF's three-pronged response to these challenges will continue to be:

- Creating incentives for improved performance through regulation and by, in particular, "revealing performance and enforcing ring-fencing as a pre-requisite for financial transparency".
- Supporting local government in their roles as water services authority and water services provider, as well as supporting local institutional reform processes such as support to the Section 78 process and direct operational support and interventions.
- Leading and guiding regional water services reform processes. (Nokeri, 2006 page 6)

The current researchers comment that nothing that the institutional reform strategy has so far had to say that is in the public domain would in any way hamper outsourcing, but nor would it promote outsourcing. All the right sentiments are expressed about what needs to be done on issues such as accountability, ringfencing, development of skills and regulation. However none of this is new, and the current researchers look in vain for stronger commitment to what has long been acknowledged as important (e.g. increased and more directed regulation). The researchers also look in vain for the commitment of resources that will make the desired improvements come about – which by definition will have to be a different order of magnitude of commitment compared to what has been the norm up to now. The current researchers also look in vain for new ideas, such as on forms of PPP.

However it is probably premature to judge the strategy, and DWAF and its task team need to be given more time, and the opportunity to formulate proposals in more detail, and for DWAF to by means of pilot projects demonstrate its commitment. Until that happens, the current researchers will be unable to assess how useful the strategy will be to assisting the first step of the three-step breakthrough in many more WSAs. Meantime, they hope that the work of the current project will be of assistance to DWAF and its task team.

Nokeri noted that "water service institutional reform is a lengthy process that could take up to a number of decades to come to full fruition". (Nokeri, 2006 page 12)

### **3.3.4 The revision of the Water Services Bill**

The November 2006 meeting of the WRC Reference Group for the current project was told that one aim of the then ongoing revision of the Water Services Act was to make for easier procurement by municipalities of external resources.

The team was invited to comment on the then latest draft of the Bill. (South Africa 2006)

The comment that the team made is highly relevant to discussion on the environment around outsourcing, and is therefore paraphrased below at some length. Even though some of it repeats points made elsewhere in this report, these points are made here again whenever the comment on the Bill would be more difficult to follow if they were not present.

It seems that legislation too readily permits municipalities to not seriously consider alternatives to in-house. Thus the easy option for a municipality is to attempt to deliver services in-house, and not to consider outsourcing.

However there is ample evidence of the widespread water services authority non-compliance of the type envisaged by Section 70 of the Bill – indeed there is evidence of the widespread "seriousness or repetitive nature of non-compliance". (Section 70 (2): "The Minister or the

provincial executive ... may take any actions provided for ... against a water services authority as may be necessitated by the seriousness or repetitive nature of non-compliance with the Act ... “)

Non-compliance on the part of a water services authority is usually because, despite its good intentions and sometimes even claims that it has in terms of Section 79(a) of the Municipal Systems Act allocated “sufficient human, financial and other resources necessary for the proper provision of the service”, it has demonstrably not done so. Given this, the team recommended that a clause be added to Section 71 “request to comply” (of the Water Services Bill). This clause should state that if the remedial actions to be taken in terms of Section 71 do not have the desired result within a defined time period, the Minister (of Water Affairs and Forestry) must order that a Section 78 (of the Municipal Systems Act) review process be conducted without delay by an independent team appointed by DWAF”.

The three main points of the team's comment were thus:

1. Make Section 78 processes the rule rather than the exception, so that municipalities are much more frequently forced to defend their choice of in-house.
2. Make Section 78 processes independent.
3. Make Section 78 processes compulsory should non-compliance be “serious or repetitive”.

Describing the second and third of these points in more detail:

2) Even if a municipality conducts a Section 78 investigation, it is far too easy for it to reach the conclusion that an “internal mechanism” is the most appropriate mechanism to provide the service.

Feasibility studies are inherently subjective. Outside costs are difficult to predict, while in-house costs can be underestimated or not fully counted, and in-house efficiencies and capabilities can be overestimated. There is much circumstantial evidence that, in these investigations, important factors are frequently downplayed or even ignored. Optimistic assumptions are made, in particular in respect of “the municipality's capacity and potential future capacity to furnish the skills, expertise and resources necessary for the provision of the service through an internal mechanism”. (Section 78(1)(ii), Municipal Systems Act)

All Section 78 investigations, or at least a selection of them at the Minister's discretion, need to be audited independently, or conducted by agencies appointed by the Minister, and not by the municipality.

3) Many water services authorities<sup>1</sup> demonstrably do not allocate “sufficient human, financial and other resources necessary for the proper provision of the service” (Section 79 of Municipal Systems Act) – yet they are not called to account.

In the opinion of the team, however, non-compliance, or, at very least, “serious or repetitive” non-compliance, must result without delay in a Section 78 investigation being undertaken by an agency appointed by the Minister.

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<sup>1</sup> (The comment's terminology switched from “municipality” to “water services authority” when the functions of municipalities primarily in respect of water services matters were considered.)

### 3.3.5 Other national-level considerations

Some of the national government departments other than DWAF are sympathetic to the need for a freeing up of the outsourcing environment, and have some feel for what is required. Others frankly do not, and this is an obstacle to reform.

For example, one of the current researchers was present at a seminar (on municipal infrastructure policy and strategy) of senior national government officials whose support would be important to reform. One of the most crucial of these officials (“crucial”, that is, to reform) made a statement to the effect that his department finds that the private sector is happy to be the construction contractor or the financier of public sector engineering infrastructure, but is not willing to be the “investor or operator”. The department, he said, is at a loss to understand the private sector’s unwillingness.

He seemed genuinely surprised when the current researcher responded that the private sector is generally not willing for the same reason that, for example, Pick 'n Pay would not be a willing investor in or operator of a major store:

- if they were given tenure of only a couple of years, and even then the contract for that could be broken with only a couple of months’ notice; or
- if they received no income for a couple of months because all of the customers at the same time had payment difficulties; or
- if they encountered other issues of the types that too often seem to face private sector investors or operators in public sector engineering infrastructure.

On the other hand, a representative of National Treasury has several times stated publicly that the fact that there is only one water project registered with the National Treasury public-private partnership or public-public partnership PPP Unit is symptomatic of severe “constraints to municipal water PPPs” that has to be addressed. (This is despite that “water is a priority sector” for the PPP Unit.) The context here of course is PPPs of substantial size, not at all what SMMEs would be capable of undertaking. But, as the current researchers are taking pains to point out, many of the same types of constraints exist whether the projects be large or small.

National Treasury, “in discussion with” DPLG, is reported to be formulating proposals for increasing PPPs. This entails addressing:

- the “legislative framework for municipal PPPs” which is “cumbersome” and shows “preference for public sector provision”;
- “labour opposition”, which is a “serious obstacle”;
- “poor bankability (lower tariffs, non-payment, poor billing and collection)”;
- “limited public sector capacity – good PPPs need competent public sector partners”. (Horton, 2006)

At the time of writing, the above-mentioned discussion between National Treasury and DPLG was still at an early stage. (Horton personal communication 2007)

Incidentally, the “three tests for a PPP are:

- affordability
- value for money
- appropriate risk transfer.” (Horton, 2006)

### **3.4 If given outsourcing, the environment around SMMEs (and CBOs) and around franchising**

#### **3.4.1 Introduction**

If outsourcing were a given possibility (which the preceding parts of Chapter 3 show is the case to a limited extent only), what would be the environment around SMMEs and around franchising that would then be encountered?

DWAF in the SFWS 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 2003b, page 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, page 25).

The 2005 report on franchising summed up as follows the DWAF policies on outsourcing to SMMEs then current:

“The thorough (but not exhaustive) search by the current author could not find evidence that DWAF was considering water services delivery by SMMEs, with the exception of the Department for International Development (of the UK government) DFID/DWAF [franchising] initiative [not proceeded with, as described in Chapter 7 of the 2005 report], and support in principle to the [franchising] concept (e.g. a letter in support of a Boutek CSIR November 2001 bid for study funding). Provision by SMMEs is not ruled out as an option, it is simply not mentioned. And it would appear from the literature search that no thought has been put into ways of supporting SMMEs. (A DWAF spokesperson commented that: “There is certainly nothing to preclude SMMEs, even though they might be private sector, from being WSPs, especially if it results in local economic development or empowerment. I suspect that the seemingly low level of DWAF support for the use of CBOs/SMMEs and the franchising concept is based simply on it being new and untested. It is easier to go with what you know.” (Sussens personal communication 2004)).” (Wall, 2005, Section 2.3.3)

#### **3.4.2 Environment around SMMEs**

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 that the flexibility that small service providers offer to a municipality to match its needs, 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, page 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, pages 6 and 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 (but not municipal) 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 Professional Water Management South Africa PWMSA (described at some length in Section 3.6.9 of Report TT 432/2/10). It has 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 Sonderwater 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 needed, 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. By all accounts, a service is being rendered that fully complies with all DWAF requirements. Furthermore, on each of a couple of visits paid by one of the current researchers, the works presented a neat and tidy appearance. (Figure 3.1.)

This example, while from the public sector, is not of a treatment works owned by a municipality.



**Figure 3.1: Sonderwater wastewater treatment works**



To sum up: outsourcing by municipalities of their water services infrastructure to the private sector and also to NGOs and CBOs is very much the exception rather than the rule.

Jones and Williamson 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 hardly at all 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 for a 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 and Williamson, 2005, page 29.)

Thus DWAF’s current apparently “hands-off” approach is not sufficient if it wants more CBO or SMME participation in water services provision. CBOs and SMMEs need DWAF to provide national leadership in order to change the environment, because the WSAs where “second step” obstacles crop up are clearly unable and/or unwilling to change it themselves. Mvula Trust reports that these obstacles typically include:

- difficulties with the competitive tendering environment of procurement;
- financial pressures, such as cash flow problems due to slow payment by the client; and
- “project approach instead of programmatic approach”, and in particular that commitment that a WSA may choose to give typically lasts for only one financial year.

As a result of these difficulties, “many CBOs have closed down”. (Naidoo and Klu, 2006)

DWAF has been attempting to address, for CBOs, the first of these three obstacles listed immediately above, i.e. the competitive tendering obstacle. It promised in the SFWS 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.” (DWAF 2003, page 20) The result of this promise is the proposed exemption, in the current revision of the Water Services Act, of non-profit CBOs from compliance with the competitive procurement requirements.

The team in its comment on that proposed revision (Section 19(3) Water Services Bill (South Africa 2006)) stated that it supported DWAF's proposal. However the team:

- asked that if there were a difference between the Municipal Systems Act and the Water Services Bill, which would prevail? Wouldn't the Act, existing procurement regulations, etc, prevail, with the result that water services institutions will ignore the new provision?
- cautioned that CBOs might not always be in the best interests of customers, and suggested that for-profit franchisees, with franchisor's support, might on occasions be better.

### **3.4.3 Environment around franchising**

The only recent indication of a national-level view of water services franchising has arisen from the initiative by Biwater and a German university to pilot franchising, initially in the Nelspruit area. (See Section 4.3.) The DWAF official liaising with Biwater indicated to one of the current researchers that he is giving support only in the sense that the Biwater initiative is regarded by DWAF as worth trying. The researcher did not gather that DWAF was being asked to do anything other than give space to the initiative. Certainly, the researcher did not hear the DWAF official say that DWAF has any view towards water services franchising other than in this specific circumstance.

## **3.5 The environment around funding**

### **3.5.1 Introduction**

In order to complete the scan of the environment for SMMEs undertaking water services operation and maintenance (and, within these, franchisee SMMEs), it is necessary to summarise the review in Chapter 6 of Report WRC/1/10 of the funding of SMMEs undertaking water services operation and maintenance, and to update it.

The next part of Section 3.5 describes and discusses funding streams for SMMEs generally. The third part describes and discusses funding streams for water services SMMEs. The last part draws conclusions.

### **3.5.2 Funding streams for SMMEs generally**

It is clear that there is no shortage of funding for small business development. Some 80% of the Department of Trade and Industry's budget for enterprise and industry development is spent on small, medium and micro enterprises. 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.

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.

“Financial Mail” put it 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 National Department of Trade and Industry DTI's development finance institutions (DFIs) whose task is to improve access to finance and develop business management skills. However the development finance institutions DFI landscape is full of institutions which, if not duplicating their mandates, have a patchy performance track record.” (Radebe, 2006 page 74)

### 3.5.3 Funding streams for water services SMMEs

The certainty and reliability that they will be paid for their services has to 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 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 microenterprise, 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 don't pay them 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.

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.

While this flexibility constitutes another strong argument for municipalities/WSAs to consider outsourcing, it threatens the viability of the small enterprises contracted to them.

Even if the municipal client meets its contractual obligations to the letter, another dimension is the problem that any funding by the municipality is assured for only one year – not even into the medium term.

One supplier put it as follows (paraphrased): “You can train plumbers, but next year they have no work to do. It is 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 also 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.”

Also, as Hesketh et al were quoted in Report TT 432/2/10 (Section 6.2), there is a need for “management, operation and maintenance” MSPs, especially if these “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 don't

have substantial resources, may be heavily dependent on one municipality for their livelihood, and other reasons.

### **3.5.4 Conclusion on funding**

Neither of the preceding (Sections 3.5.2 and 3.5.3) has been specific to franchising – both have referred to funding issues faced by SMMEs.

The current project has however amply demonstrated that franchising partnerships for water services have great potential to improve efficiency and provide municipalities with access to capacitated resources at the operational level. Thus ways to overcome the funding problems must be found – and they can be. Franchising, as pointed out before, gives franchisees an inbuilt advantage over standalone SMMEs. Franchisors can for example support franchisees in their attempts to be paid as contracted – by exerting pressure on clients to release unjustifiably withheld payments.

Importantly, the attention of national government has recently most forcefully been drawn to the budgeting for operations and maintenance, and to the stop-start release of these budgets. Government is considering addressing this by various measures. In particular, the National Water Services Infrastructure Asset Management Strategy of DWAF is starting to look at a range of measures that will improve funding and budgeting for infrastructure asset management – particularly the amount, prioritisation and assurance of that funding. (DWAF 2007, pages 15-17).

There is no shortage of ideas in respect of what some of these measures might be. For example, the last head of the Municipal Infrastructure Investment Unit stated that credit control, indigent policy and other issues of political risk should “remain with the public sector”, and that national government should “give comfort” to private sector partners, perhaps “in the form of institutional or management support to oversee a PPP, or ... financial support in the form of national grants to cover unitary payments or 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, 2006.)

## **3.6 Chapter 3 conclusions**

Report TT 432/3/10 found that procurement legislation and regulation is not a barrier to the outsourcing of water services operation and maintenance. Given that, WSAs need with serious intent to investigate alternatives to in-house performance. Alternatives must be judged fairly and on merit – both when choosing whether to outsource or not, and when (if it is indeed the outsourcing route that is followed) selecting which institution to outsource to.

In terms of the “three-step breakthrough” framework for this chapter that is set out in Section 3.2 above, Sections 3.3 through 3.5 above show that the biggest step that needs to be taken is the first one.

This has been recognised in the final report of the consultants charged with assisting DWAF to formulate the national water services infrastructure asset management strategy. “Priority Action 6” (of 10 priority actions), “Investigate water services institutional reform and generic institutional alternatives” is in part described as:

“Even if existing water services institutions are fulfilling their duties entirely as required (by no means generally the case), this Action recognises that there is a need to investigate the generic merits and demerits of alternative delivery institutions.

Some of these institutions could, under some circumstances if not others, more effectively or more efficiently undertake these duties, or could offer advantages such as greater consumer satisfaction, SMME development, or BBBEE ownership. Another reason for investigating alternative institutions is the knowledge that current institutions are often under great pressure and unable to fulfil all their duties – an option that enabled them to share the load with others could be welcomed.

#### Draft specification of the task.

Two institutional issues need to be assessed, and guidelines drawn up, viz.:

- Assessing the need and desirability of reform of existing water services institutions, and the advantages and disadvantages thereof – e.g. investigate ringfencing water services.
- Assessing the need and desirability of alternative generic types of institutions with potential to deliver part or all of the range of water services tasks, and the advantages and disadvantages of each of these. This could include investigating public and private sector alternatives, and SMME and BBBEE opportunities.

In respect of both these assessments, the primary interest lies in how infrastructure asset management may benefit.

Institutions [that are] not strictly speaking water services delivery institutions as such, but institutions that could provide support to other institutions, should also be investigated.

Procurement of alternative institutions needs to be in the interest of improved services. Procurement needs to be on reasonable grounds and undertaken in accordance with fair and transparent procedures. Thus current procurement rules and practices need to be investigated, and reformed if necessary. Section 78 issues would form part of this investigation – in particular, it needs to be considered if the alleged current preference of most water services institutions to perform all substantial operations and infrastructure management activities in-house whether they are able to undertake them satisfactorily or not, should be influenced, and, if it should be influenced, how it can best be influenced.

The building of capacity within public sector water services institutions to enable them to outsource should also be investigated.

#### Integrative statement – how this Action fits into the bigger infrastructure asset management picture.

Which institutions (and what they look like) are responsible for water services delivery, and in particular for infrastructure asset management, needs to be considered in the interests of sustainability of the service and service quality to the consumers.

#### Desired outcome.

The desired outcome is:

- that water services institutions with the responsibility for water services delivery have access to means to improve delivery by existing institutions (and they make these improvements);
- that they have within reason a choice of alternative delivery institutions, and means to access those institutions and procure their services if appropriate; and
- that they choose the institution that best from all reasonable points of view undertakes the responsibility.”

(DWAf 2007, pages 17-19).

Outsourcing of water services operation and maintenance to SMMEs is recognised by name in the above report. Outsourcing to franchisee SMMEs is recognised as a subset of outsourcing to SMMEs, even though the report does not explicitly say so.

The current researchers feel that there is little to be gained from pursuing an independent initiative that seeks to make the third breakthrough of the “three-step breakthrough” before the first breakthrough is made. Initiatives such as the current water services infrastructure reform process (Section 3.3.3 above), revisions to the Water Services Act (Section 3.3.4), the outcome of the discussions between National Treasury and DPLG (Section 3.3.5) and the national water services infrastructure asset management strategy’s set of initiatives will, the current researchers are confident, between them lead to the first-step breakthrough being more frequently made and in more WSAs.

Bear in mind that there appears to be nothing in national policy, legislation or regulations that prevents outsourcing of water services operation and maintenance, and therefore those water services authorities that are prepared to consider outsourcing of water services operation and maintenance at all are likely to be prepared to consider franchises on their merits. Mbombela is a case in point, as described in Section 4.3. In these instances, there is no first step that needs to be broken through.

In summary:

- national government needs to review the procurement regime of WSAs if it really wants to improve water services operation and maintenance; and
- national government needs to review the procurement regime and also the budgeting and funding of water services operation and maintenance if it really wants to encourage more participation by CBOs and SMMEs.

## 4. Potential franchisors

### 4.1 The purpose and structure of Chapter 4

Water services franchising would only work if, among other things, suitable institutions with the right experience and resources were willing and able to play the role of franchisors. Thus potential franchisors need to be approached, and their willingness in principle obtained.

The purpose of Chapter 4 is to identify potential franchisors, and gauge their interest in principle.

The crucial role of the franchisor is emphasised repeatedly in the literature on franchising. Without the interest of organisations competent to play the role of franchisors, there can be no further thought of franchising. (For example: “The franchise network cannot exist without the ongoing management and support from the franchisor.” And: “It may seem blatantly obvious, but .... should the franchisor fail, the survival of the network would be in jeopardy”. (FRAIN, 2003, page 6))

Two institutions (both undoubtedly, in the team’s opinion, very “suitable institutions with the right experience and resources”) are willing and able to play the role of franchisors to the extent that they are already committing resources to investigating franchising of services that they presently supply by other means. Thus they are both currently modelling the elements of the water services chain with which they prefer to start their franchising activities, and they are exploring possibilities with suitable clients (which might not be WSAs but could be other public sector owners of water services infrastructure).

The institutions in question are Amanz’ abantu Services and Biwater. Both, as it happens, are profit-seeking institutions, and clearly they see financially rewarding business opportunities for themselves and for future franchisees in the water services franchising concept. While in the short term they may not see significant profits, certainly they would not willingly embark on any venture if they anticipated making losses for any length of time.

Four other institutions “with the right experience and resources” were approached by the current researchers. They comprise:

- the foremost water services NGO in South Africa, viz. Mvula Trust;
- the two largest water boards, viz. Rand Water and Umgeni Water; and
- one other large profit-seeking water services organisation, viz. Water and Sanitation Services South Africa (WSSA).

To this list of institutions “with the right experience and resources” may be added two much smaller institutions that in the course of the Phase 1 research had expressed interest in, given the right circumstances, extending their current water services franchising activities into additional geographic areas and/or service elements and/or client groupings – particularly to infrastructure owned by the public sector. They are:

- The Drain Surgeon; and
- PWMSA.

Thus eight institutions in total, of different backgrounds and in different sizes, were approached.

No WSAs were approached with a view to ascertaining their interest in being franchisors, despite some suggestions from outside the team that approaches should be made. It is the strongly held opinion of the team that the client of the franchisee cannot also be the franchisor. The conflict of interest is obvious – when the client attempts to enforce its contract with the franchisee, if the

franchisee is not performing that could well be held to be at least partly the responsibility of the franchisor – which is the client! For the same reason, a municipal entity cannot be the franchisor – for example a municipal entity such as Metsi-a-Lekoa, owned by Emfuleni Local Municipality.

The sequence of Chapter 4 is thus:

- discuss further why WSAs cannot be franchisors (Section 4.2);
- gauge the willingness in principle of Amanz'abantu Services and Biwater (Section 4.3);
- gauge the willingness in principle of Mvula Trust, Rand Water, Umgeni Water and WSSA (Section 4.4);
- gauge the willingness in principle of The Drain Surgeon and PWMSA (Section 4.5); and
- draw conclusions (Section 4.6).

## **4.2 WSAs cannot be franchisors**

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

By law, only municipalities can be WSAs. It is, however, fair to claim that too few municipalities are likely to have the mix of skills, and in particular entrepreneurial skills, that a franchisor needs to have.

In the water legislation there is a clear difference and separation between the roles and functions of the WSA and WSP. This concept of separate roles, initially codified in the Water Services Act, was an important step forward in the industry for many reasons. The WSA carries the ultimate responsibility for water services delivery, and it has to contract one or more WSPs to operate a water system in its area, subject to the authority and policies of the WSA. If the WSP is a franchisee, the franchisor could be a co-signatory to the contract or a guarantor of the performance of the franchisee.

Finally: it is quite common for municipalities to approve small contractors of one or another sort, and to approve them for undertaking specific works. Plumbers, for example – the municipality might test the plumbers (it might even train them in the first place, or enhance their skills levels), and accredit them. One way (perhaps not the only way) in which the municipality then uses them is to directly supplement municipal staff – that is, if there is a call for a municipal plumber, and all the municipal plumbers who are direct municipal employees are currently occupied, then the municipality will assign the task to one of the accredited small contractors. If the need for a plumber is the result of a call from a ratepayer, say, that ratepayer will probably not even know that the plumber the municipality has sent is a contractor, and not a direct employee.

In a limited sense, therefore, the municipality is treating these small contractors as franchisees. However to call the municipality a franchisor would be very much stretching the point. The municipality is the client of the small contractor, and does not play the role of franchisor other than having accredited the small contractor and, in some but not all cases, trained the small contractor.



## 4.3 Amanz' abantu Services and Biwater

### 4.3.1 Amanz' abantu Services

[www.aserve.co.za](http://www.aserve.co.za)



#### ***Right experience and resources***

Amanz' abantu Services (Pty) Ltd, founded in 1997, is a private company whose shareholders include both Eastern Cape and nationally-based established and emerging companies and trusts. It operates out of offices in East London, Umtata and Queenstown.

The company has the range of skills and experience appropriate to implementing rural and peri-urban water supply and sanitation projects. It also has extensive experience in partnering with NGOs. Between 1997 and 2003 it was the Programme Implementation Agent for the Build-Operate-Train-Transfer (BOTT) programme of DWAF in the Eastern Cape, and more recently has been implementing DWAF and local government water and sanitation projects in that province. Amanz'abantu has tended to target projects supplying water services to rural and developing communities, and the company places great importance on ensuring that the delivery of hard infrastructure is accompanied by appropriate training and awareness creation programmes.

It is (as described in Section 3.6.6 of Report TT 432/2/10) the majority shareholder in the company that is providing strategic support to the municipal services entity created by Maluti-a-Phofung Local Municipality.

Without question, it has the right experience and resources.

#### **Willingness in principle**

Amanz' abantu Services has amply demonstrated its willingness in principle to be a franchisor. In the first instance, it is a member of the team undertaking the current project. In this role it has contributed considerable effort and expertise, for example modelling the schools sanitation business that is described in Chapter 6 of Report TT 432/4/10.

In the second instance, the company is currently demonstrating its willingness in that it has decided to investigate in depth the franchising of an element of the water services delivery chain, with a view to embarking on this commercially should the feasibility be proven on paper.

Moreover Managing Director Oliver Ive has over a number of years placed on record his interest in franchising partnerships. For example, some years ago he stated that one of the responsibilities intrinsic to the role of the Project Implementation Agent when implementing community-based operations and maintenance activities is in practice no different to that of a franchisor. Except, he said, for the fundamental differences that the agreement period is much shorter than would be normal for a franchise agreement, and the "franchisee" is not a SMME but an individual or group of individuals (usually in, or shortly to be in, the employ of the municipality). That is, the Agent trains local people to operate the water services infrastructure that it has built, and for a number of years continues to support them and to check on and guarantee the quality of the work they deliver. (Ive personal communication 2003)

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

While the range of possibilities under the banner of this form of partnership is very wide, some of the characteristics of a franchise arrangement are approached. For example, in that the private sector could in terms of the partnership agreement (which could have many characteristics in common with a franchise contract) provide typical franchisor skills such as business planning and quality control, and in that the three partners share responsibility for delivery. There is no question of this being the usual “client-contractor” relationship. (Ive, 2002)

Ive has reiterated his reasons for his preference of for-profit local WSPs. On the grounds that they have no incentive higher than to provide basic quality of service, he does not favour that CBOs act as WSPs. A committee both representing consumers and running the service will, he states, have no incentive to do more than will keep it out of trouble. He feels that non-profit forms of association will suffer from “lack of incentivisation”. (Ive personal communication 2007)

For his part, “I want the guys who want that job”, and whose jobs are on the line and who want to build a career in water services franchising. There may often still need to be a committee representing consumers, but he feels that there would be a conflict of interest if that same committee also operated the water services.

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

#### **4.3.2 Biwater**

[www.biwater.co.za](http://www.biwater.co.za)



##### **Right experience and resources**

Biwater is the UK-based private company (active in more than 30 countries, according to the website) that, as described in Section 3.6.4 of Report TT 432/2/10, is the main shareholder in the Mbombela Local Municipality concession contract, operating since 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, which has in practice used own equity and loans from the Development Bank of Southern Africa DBSA and others.

Cascal, a joint venture of Biwater with a Dutch company, 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 Local Municipality, which is the WSA.

GNUC has thus for a number of years been making use of SMME local contractors. It has trained some of these local contractors, in particular plumbers, and put them on a list of “approved contractors” that householders may use.

As an aside, GNUC, in procuring these local contractors, has followed normal municipal procurement rules. It is, in terms of its contract with the WSA, obliged to use municipal procurement rules, even though it isn't a municipal entity, but a privately owned company.

Without question, Biwater has the right experience and resources.

### **Willingness in principle**

The local contractors mentioned above are independent business entities, and not franchisees. However GNUC has clearly, in training these contractors and setting them up, created a pool of businesses some of which could readily become franchisees if both they and the franchisor saw mutual benefit in this.

Furthermore, in its track record of delivery, GNUC has built credibility with the local municipality and with consumers in the municipal area. It would thus not have the difficult task of building credibility that would be faced by another company that would attempt to set up a franchise arrangement in an area in which it was not known.

With that in mind, Biwater, in conjunction with a German university (Institute of Environmental Engineering & Management (IEEM)) at the Private University of Witten/Herdecke), is developing a water services franchising business plan. The current activity of the University is being funded by a World Bank grant of around \$ 200 000. (Rudolph and Harbach, 2006)

Rudolph and Harbach described the project as follows:

“In the approach of IEEM the franchisor will be an international experienced private water company (Biwater: [www.biwater.com](http://www.biwater.com)) while the franchisees will be recruited from Local Service Providers (LSP) like plumbers and other craftsmen. Once implemented, the system will work the following way: The franchisees will be in charge of operating and maintaining technologies of the water supply infrastructure (pumping stations, pipe systems, etc). The franchisor will instruct and regularly teach them how to best perform these tasks.

For these services the franchisees shall get paid by the South African Water Management Authorities (WMA). They are responsible for the supply of water in their area/community. The franchisor will receive a percentage share of the franchisees annual turnover for the courses and seminars held and potential administrative support. The customers still pay their water bills to the WMAs (as today). For them the only noticeable change will be the improved water service quality.

The advantages of this PSP approach are the combination of the experience of a private water company with the (comparatively) cheap labour force of Local Service Providers. Because the public only gets in touch with the LSP – who might be their neighbours – and not with an anonymous international water company, the acceptance of this PSP alternative will be very high.” (Rudolph and Harbach, 2006, page 4)

Note also that:

- “The estimated annual fee of an operation and maintenance contractor should not be much below R 1 million.”
- “Of greater importance is the willingness of the water consumers to pay for water and sanitation services. As the franchisees will get paid by the water consumers via the local authority in charge of the water supply (WSA/WSPs), the consumers should (already today) be willing to pay for their water. This ensures a level of financial sustainability for the project.” (Biwater and IEEM University undated, page 2)

While it is claimed that this will be “the first franchise concept in the water sector world-wide” (Development Marketplace and IEEM University undated), that is not true, as The Drain Surgeon, for one, will attest.

As noted in Section 3.4, there is support from DWAF in the sense that DWAF is giving space to this initiative.

Nel (General Manager of Biwater South Africa – based in Johannesburg) made it clear to the current researchers that Biwater, in entering upon franchising, is motivated by its perception that franchising will lead to “improvements within the water services sector”, and will also be “commercially viable”. He sees that its experience in water services positions it well to play the role of franchisor. Nel stated that Biwater has in its Mbombela concession a 6-year track record of developing a good relationship with the communities there, and also its developing and utilising small water services contractors has built the basis of potential franchisees. (Nel personal communication 2007).

The team's assessment of the prospects for this initiative can be summed up as follows:

- Nel is likely to be correct in that the experience of the company in water services, and in the credibility that it has built with the municipality and the community of Mbombela, makes it very suitable for the franchisor role in the area.
- Nel is also likely to be correct in suggesting that the basis for potential franchisees has been created.
- Biwater and the university will probably not need to make use of much of the research already done in terms of the current project. It is not that they need to reinvent any of it, but simply that they can arrive relatively quickly at what they specifically need, whereas the current project is attempting to deal with a more generalised situation, and furthermore is having to “sell” the concept to often sceptical potential franchisors and WSAs. For example, the current project had had to investigate procurement and other legislation, whereas, Biwater, thanks to its track record with the municipality, would presumably not need to do this at all.

Therefore (this is the team's assessment) the combination of Biwater and Mbombela would likely be as good a set of circumstances for a pilot project in water services franchising as might be found anywhere in South Africa.

Biwater, Nel noted, also had good relationships with Marble Hall, Groblersdal and Bronkhorstspuit municipalities, and these could be other places for future pilots.

The team has offered to work with Biwater and the university under suitable circumstances.

In terms of the funding from the World Bank, Biwater and the university are committed to deliver by September 2007 a business plan for a pilot project on water services franchising, and also draft contract documents. The current researchers have without success tried to ascertain their timetable for the pilot project thereafter.

## **4.4 Mvula Trust, Rand Water, Umgeni Water and WSSA**

### **4.4.1 Mvula Trust**

[www.mvula.co.za](http://www.mvula.co.za)



#### **Right experience and resources**

Founded soon after 1994, with technical support from the World Bank and others, Mvula Trust is the largest water and sanitation NGO in the country. It operates from a national office in Johannesburg as well as from seven regional offices, in North West, Limpopo, Kwa-Zulu Natal (2 offices) and Eastern Cape (3 offices). Full time staff is over 100, and in addition it contracts consultants, local entrepreneurs, emerging consultants, trainers and facilitators as and when required.

The Trust offers specialist services in terms of developing capacity within the water services sector. Whereas most of its funding comes from DWAF, it has some access to donor funding, which enables it to undertake research, pilot new approaches and influence policy development.

Its speciality is implementing and supporting the delivery of water services in rural and peri-urban areas. Included in this are the establishment of community based water services providers and also supporting local authorities to create an enabling environment for sustainability.

Mvula Trust is (as described in Section 3.6.3 of Report TT 432/2/10) one of the institutions appointed by Chris Hani District Municipality to play a support services agent role in support of the village water services operation and maintenance programme in a local municipality. Indeed, Mvula Trust can claim to have been instrumental in the development of the support services agent concept, as described in Section 3.6.2 of the same report.

Without question, it has the right experience and resources.

#### **Willingness in principle**

Following an approach by the team, enquiring after its willingness in principle, the management of Mvula Trust is at the time of writing still considering its position.

Indications are that Mvula would not wish to be the franchisor of for-profit franchisees, but, if franchisees (and itself as the franchisor) were non-profit, they might be interested.

Not that Mvula does not see a role for profit-seeking franchising of water services – just that they feel it is not for them. (Smith and Davids, personal communication 2007)

#### 4.4.2 Rand Water

[www.randwater.co.za](http://www.randwater.co.za)



##### **Right experience and resources**

Established in 1903, Rand Water is by far the largest of the water boards, supplying 62% of the treated water that comes from all the water boards put together. With over 3000 staff, it is the largest (in terms of presence in South Africa) of the eight organisations considered in Chapter 4. It serves a population of the order of 10 million, including South Africa's industrial heartland, being most of Gauteng, and much of the more industrialised parts of Free State, North-West and Mpumalanga provinces. (DBSA 2006, page 83; Rand Water website)

Rand Water has for much of the last dozen years been active outside of its primary role of bulk supplier. It has been working with a wide range of towns, mostly in Gauteng, the Free State and Mpumalanga. The scope of this work covers a very wide range. At the one extreme, Rand Water is to many intents and purposes (but not including in name) the WSP. In respect of others, Rand Water's commitment is only to give the municipalities "pointers to assisting themselves". Range in between includes:

- operating wastewater treatment works on behalf of municipalities;
- billing and revenue collection for municipalities; and
- preparing business plans for municipalities. (Duvel personal communication 2005)

Without question, it has the right experience and resources.

##### **Willingness in principle**

When the research for the first WRC/CSIR report (Wall, 2005) was being undertaken, Rowan Duvel, then the Retail Manager of Rand Water, was interviewed. He expressed the opinion that water services franchising had much potential. (Duvel, personal communication. 2003) However, even before that, as noted earlier in the current report, Rand Water had shown an interest in getting involved in franchising of water services.

Duvel noted at the time that the major difference between franchising and some of the assistance measures listed above, is that Rand Water's current commitment is specific and short term, and the "franchisee" is not a SMME but a municipality.

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

Since 2003, however, a number of changes have taken place at Rand Water, and Duvel, franchising's protagonist at managerial level, no longer works for the organisation.

Accordingly, the interest on the part of Rand Water is currently being reviewed, facilitated by Mr Mare.

#### **4.4.3 Umgeni Water**

[www.umgeni.co.za](http://www.umgeni.co.za)



##### **Right experience and resources**

Umgeni Water is the second-largest of the water boards, nearly double the size of the next largest. It supplies approximately 19% of the treated water from all water boards, and serves a population of the order of 4.8 million, including eThekweni Metropolitan Municipality and Msunduzi Local Municipality. It was established in 1974. (DBSA 2006 page 83; Umgeni Water website.)

Like Rand Water, it is also involved in its hinterland in a role other than that of bulk supplier. It, too, has been active in infrastructure development (primarily rural water and sanitation infrastructure, and school sanitation), in utility management, and in other related areas. (Umgeni Water website)

Without question, it has the right experience and resources.

##### **Willingness in principle**

At one stage, Umgeni Water was keenly interested in water services franchising. This is best illustrated in that the original form of the proposal submitted to the WRC, which eventuated in the current project, had Umgeni Water as the “lead organisation”, with CSIR as the principal “collaborating organisation”. Late in 2004 WRC approved the project on that basis, for commencement in April 2005, and a 24-month contract period.

However early in 2005 it became apparent that managerial and directional changes in Umgeni Water were leading to the water board rethinking its role. Umgeni Water's principal protagonist of water services franchising, David Stephen, then got assigned to other duties. In due course of time Umgeni Water officially withdrew from the project. The project was reconstituted, with CSIR as the lead organisation – and work on this, the current project, began well after what should have been the start of the project as originally conceived.

Stephen reported in 2006 that it is not that Umgeni Water has considered franchising and rejected it. Simply, Umgeni Water has decided that its priorities for the time being lie elsewhere. (Stephen, personal communication 2006)

The team in 2007 made a more formal approach to Umgeni Water. Indications are that Umgeni Water has no present interest in franchising. Not that they are opposed to water services franchising – just that it is not an activity that they are currently prepared to put resources into.



#### 4.4.4 WSSA

[www.wssa.co.za](http://www.wssa.co.za)



##### **Right experience and resources**

WSSA is a private sector profit-seeking organisation that has been in business for more than a decade. Until recently it was partly owned by one of the largest civil engineering contractors, viz. Group Five. However the international water services operator Suez Environment (part of the Ondeo group) has retained its ownership share, and WSSA benefits from Suez's backing and its research and development programmes.

The company notes that it is active through the entire water management cycle – “drinking water production and distribution, wastewater reticulation treatment as well as customer management”. It currently operates in six of the nine provinces. (WSSA website)

WSSA is (as described in Section 3.6.3 of Report TT 432/2/10) one of the institutions appointed by Chris Hani District Municipality to play a support services agent role in support of the village water services operation and maintenance programme in a local municipality. It is also (as described in Section 3.6.6 of the same report) the minority shareholder in the company that is providing strategic support to the municipal services entity created by Maluti-a-Phofung Local Municipality.

Without question, it has the right experience and resources.

##### **Willingness in principle**

Following an approach by the team, enquiring after its willingness in principle, the management of WSSA is at the time of writing considering its position. (Sanders, personal communication 2007)

#### 4.4.5 The Drain Surgeon and PWMSA

[www.drainsurgeon.co.za](http://www.drainsurgeon.co.za)

[www.pwmsa.com](http://www.pwmsa.com)



##### **Right experience and resources**

There is nothing that needs to be added to the descriptions of The Drain Surgeon and PWMSA in Report TT 432/2/10 (in Sections 3.3 and 3.6.8 respectively), but salient points may be summarised as follows:



Both organisations started as a one-man businesses, and their original founders are still very much in control. From their small local beginnings they have over the years grown nationwide franchises, and have expanded their range of services. Each is keen to expand not so much geographically nor in terms of adding services elements, but rather in terms of servicing new types of clients. Both seek profits for themselves and for their franchisees.

In the case of The Drain Surgeon the preferred new client type is the owner or municipal tenant living in the low-income residential townships (see Section 3.3.5 of Report TT 432/2/10). In the case of PWMSA the preferred new client type is the municipality itself as the owner of wastewater treatment works and selected other infrastructure.

Both organisations are undoubtedly very “suitable organisations with the right experience and resources”.

### **Willingness in principle**

Thus they are willing and able to play the role of franchisors – indeed, they both play that role very effectively (and profitably for themselves) already. But they are for a number of reasons reluctant to venture to serve what they have identified as the preferred new client types. The reasons that each gives for this are more or less the same reasons that have been raised time and time again thus far in the reports of the current project.

PWMSA stated its firm interest in franchising in areas other than where it is currently active, and, in particular, as noted above, as a preferred means for the involvement that it wishes to have in municipal infrastructure operation and maintenance. The reasons for its reluctance to offer the service under current conditions were captured in the following list. (Abbreviated from Section 3.6.8 of Report TT 432/2/10) (Although the list is that of PWMSA, the reasoning of The Drain Surgeon is pretty much the same.

- i) In the common forms of franchising, the franchisee provides a service to the end user of the product or service. The water services franchising partnership as contemplated in the current report would be different in that the contract would be with an entity other than the end user – i.e. the end user is the household, but the contract is with the WSA. This disjuncture can, and does, lead to complications such as those arising from one party (the household) receiving the service but another party (the WSA) having to pay the supplier for it.
- ii) Income must be predictable within close limits – that is essential. Another necessity would be guarantee of being paid in full and on time. The problems envisaged here have been well covered in this report – slow payment (even non-payment) and budget changes, are characteristic of many WSAs.
- iii) 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.
- iv) 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. WSAs as such, and/or key individuals within WSAs, often lack of the will to outsource.

Thus, to sum up:

- both institutions have the right experience and resources, and good track records, and are very suited to playing the franchisor role each in the elements of the water services value chain wherein its expertise lies;
- both institutions are willing to play that role and to assist WSAs and other public sector owners of water services infrastructure to better operate and maintain that infrastructure, but only if specific issues are resolved.



**Figure 4.1: The Drain Surgeon at work**

## **4.5 Chapter 4 conclusions**

The first six of the institutions approached (i.e. excluding The Drain Surgeon and PWMSA) are six of the largest of the water services institutions, other than municipalities, municipal entities and DWAF itself, operating and maintaining water services infrastructure in South Africa. All thus, not surprisingly, have “the right experience and resources” to play the franchisor role.

The other two institutions approached already offer water services franchising services, but wish to extend their market.

Of the six:

- two are willing in principle, and are exploring the franchising opportunities that they perceive; and
- the other four, having been approached by the current researchers, are interested, but consider that becoming a franchisor is outside their business focus.

It is still early days in the development of the water services franchising partnerships concept, but it is likely that all of these six could make an operational and financial success of franchising if they chose to make the attempt. And, bearing in mind the wide range of their current activities (i.e. the many elements of the water services chain that they undertake), and their depth of skills, each of them could be the franchisor for any one of several elements.

The “big six” are the largest of their type, but are not the only organisations of their type – other water boards, for example, could also be franchisors.

Many organisations offer more limited elements and more specialised services than the “big six” do, but nevertheless could be franchisors of those services. Some do this already – The Drain Surgeon and PWMSA are cases in point.

The Drain Surgeon is, of the eight institutions discussed above, that which offers the most limited range of services. It may be “the largest provider of complete maintenance plumbing in the Southern Hemisphere”, as its website states, but nevertheless its range of services is restricted compared to that of the water boards and other organisations such as Amanz' abantu. However its success amply demonstrates the suitability of the franchising partnerships concept to many applications (but by no means all applications) where the franchisor and franchisees alike can focus on providing quality and reliability in delivery of selected elements of the water services value chain.

Future franchisors could be any entities that choose to offer services and that are able (if they desire, by contracting in required skills) to develop packages embracing the relevant business method elements.

Finally:

- The discussion in Annexure A of this report as to can and/or must water services franchisors and franchisees be for-profits, is of interest. This discussion, which goes back to basic definitions of the characteristics of franchising, concludes that there could be of room for both.
- Possible regulation of franchisors is discussed in Annexure B.

## **5. Potential WSAs**

### **5.1 The purpose and structure of Chapter 5**

The purpose of Chapter 5 is to identify potential WSAs, and gauge their interest in principle.

In effect, this chapter assesses the current local-level environment for franchising of water services operation and maintenance.

The backbone of the chapter is the substantial primary research that the team has undertaken, being the visiting of more than a dozen municipalities and interviewing their key officials.

The sequence of Chapter 5 is thus:

- report of the findings of the primary research (Section 5.2);
- updating of the description in Report TT 432/2/0 of the eThekweni latrine pit emptying project (Section 5.3);
- drawing conclusions (Section 5.4).

### **5.2 Findings of the municipal survey**

#### **5.2.1 Selection of municipalities, and structure of interviews**

Key water services officials were interviewed in municipalities selected on no scientific basis other than they were known to members of the team or their subcontractors, that the officials concerned had the capacity to appreciate the significance of the questions put to them, and that it would be reasonably convenient for the team to schedule the visits and conduct the interviews. Thus several of the interviews (but by no means all) of them were scheduled for times when members of the team (or subcontractors) would have business to conduct in the municipality anyway.

Despite these shortcuts, a very good mix of municipalities was obtained. Some of them are close to metropolitan areas, some are mostly rural in nature. While all are WSAs, some are local municipalities and some are district municipalities. Some are well resourced, and some are not well resourced. They include the heavily urbanised Tshwane Metropolitan Municipality, Mangaung Local Municipality (the former Bloemfontein metropolitan area) and Sol Plaatje Local Municipality (the former Kimberley), but also the heavily rural Chris Hani and O R Tambo District Municipalities in the Eastern Cape.

The original intention was to conduct the interviews in such a way as to elicit the opinion of each municipality on each step in turn of the “three-step breakthrough” set out in Chapter 3. However, as described below, little if any progress was made beyond the first step. (To recall, 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 NGOs or CBOs as well.)”)

#### **5.2.2 Findings of interviews**

Key water services officials were interviewed at the following 14 municipalities:

- Chris Hani District Municipality
- Drakenstein Local Municipality

- Ekurhuleni Metropolitan Municipality
- Emfuleni Local Municipality
- Mangaung Local Municipality.
- Matjhabeng Local Municipality (includes Klerksdorp)
- Metsimaholo Local Municipality (includes Sasolburg)
- Mogale Local Municipality
- O R Tambo District Municipality
- Potchefstroom Local Municipality
- Saldanha Bay Local Municipality
- Sol Plaatje Local Municipality
- Stellenbosch Local Municipality
- Tshwane Metropolitan Municipality.

The officials are those key to the water services delivery process in their municipality. Their titles vary widely, and include “Manager of Infrastructure”, “Director of Technical Services”, “Head of Water Services” – and similar. Their names may be found in “Acknowledgements”.

The responses from the officials are not separately identified. They were spoken to “off the record” (especially when it came asking them to describe their councillors’ opinions on private sector participation etc), and replies are not allocated to individuals, as that might unfairly prejudice them with their superiors.

As background on capacity: Most of the municipalities are understaffed by approximately one third – a couple have only half of the staff positions filled.

The purpose of the interviews was twofold:

- to ascertain whether they outsource the operating of infrastructure – and, if not, what is the reason; and
- to understand how some municipalities have broken through some of the obstacles to outsourcing operation and maintenance to the private and NGO sectors.

Responses, summarised, were:

- Every one of the municipalities has used the private sector for design and construction of water services infrastructure.
- With one or two possible exceptions (where planning has not yet been done) all have used the private sector for planning.
- Several outsource small routine tasks such as meter reading, billing and water and wastewater sampling. Two mentioned specifically that they use CSIR or the private sector to do monthly testing of residual chlorination in reservoirs where the water is supplied by a water board.
- Ekurhuleni uses the private sector (IT consultants) to develop their computerised integrated billing system. Matjhabeng and Saldanha use the private sector for GIS – the latter also use the private sector to install and regularly update a GIS/telemetry IT system that is linked to their billing system.
- Apart from Chris Hani, none of the municipalities use the private sector to operate infrastructure, although Potchefstroom does use two employees of a private sector firm to operate their water treatment works – but these are seconded personnel operating as if within the municipality, and the work is not contracted out to the firm.
- Sol Plaatje felt that it has sufficient capacity and has no need for private sector operators.
- Chris Hani regards its 2003-2006 appointment of external service providers (four in number – see Section 3.6.3 of Report TT 432/2/10) to have been successful, and at the time of writing

was calling for tenders for new three-year contracts to provide the same service. Part of the new brief will be to capacitate and strengthen the existing community-based structures, and ensure that they will be sustainable and business-oriented by the end of the new contracts.

- Six options were developed during the Section 78 study for Mangaung, three of these for private sector involvement. The official then interviewed councillors individually. When interviewed by the team, he reported that the councillors quickly rejected outright all the options that included private sector involvement.

The reason for officials not using private sector for operations is split roughly 25% “it is not Provincial policy” to 75% “it is not acceptable to the councillors”.

### **5.2.3 Summary of interview findings**

Once-off or project type work (planning, design, construction, IT programme development) can be contracted out as a matter of course – and it is. Certain monitoring activities such as water sampling and meter reading are also easily outsourced, as are IT maintenance activities (GIS, billing, telemetry).

However it is council policy in all but one (Chris Hani) of the 14 municipalities surveyed that all other operation of water services infrastructure shall be performed in-house.

Mbombela Local Municipality (which includes Nelspruit) is clearly also not unsympathetic to outsourcing.

The majority of councillors of the municipalities surveyed clearly do not support private sector, NGO or CBOs involvement, but choose the route where the municipality creates or retains internal jobs.

The reasons given for not outsourcing do not appear to be based on financial, efficiency or quality considerations. Which reinforces the conclusion from Phase 1 of the current project that whilst there is no national statutory or regulatory reason not to proceed with outsourcing operation of water services, there is strong local resistance to outsourcing beyond that which the public sector organisation might already be committed to.

Most of the officials interviewed stated that it was their councillors who were not supportive of outsourcing of infrastructure operation. However officials in two of the municipalities said that they were in addition aware of a broader province-wide political agreement amongst the councillors of the majority party that outsourcing was not acceptable. The result however remains the same. It is the councillors that generally do not support outsourcing the operation of infrastructure, and the staff are obliged follow the political directives.

If there are indeed province-wide agreements among these councillors, that would help to explain why so many municipalities have the same policy.

Officials do not push for the outsourcing of activities perceived by their councils to be “normal operations”, as they are aware of their councillors’ preference in this regard.

## **5.3 Additional to the survey**

The findings of the survey are broadly in line with other evidence accumulated by the team. For three examples:

Many of the experienced engineers participating in the South African Institution of Civil Engineering SAICE-organised ENERGYS project (“Engineers Now to Ensure Roll-out by Growing Young Skills”) and the DBSA programme of skills deployment to municipalities are known to the researchers. These engineers are assisting municipalities in many parts of South Africa, but they with few if any exceptions report great reluctance – often total resistance – on the part of nearly all municipalities to outsource more than IT, planning, design and construction, or short-term operational tasks. This despite the inability of most of the municipalities to perform all of their duties properly.

Others have made similar observations. Jones and Williamson have already been quoted (in Section 3.4.2 above) to the effect that 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. [In addition,] Section 78 legislation makes it very difficult not only to engage the private sector, but any external provider including NGOs. ... ” (Jones and Williamson, 2005, page 29.)

Many private sector firms, including those that have in the past provided the kinds of operational services that some municipalities have from time to time outsourced, report that outsourcing is on the decline. For example:

“There is a distinct trend of deprivatisation taking place at local government level, points out Des Gordon, MD of waste management company Enviroserv. Under pressure from labour, municipalities tend not to renew outsourcing contracts as they expire, but rather resume a municipal service – often to the detriment of service delivery and at the expense of private sector companies, which employ thousands of people.

Ten years ago domestic waste management constituted half of Enviroserv’s revenues and profits, with industrial waste management making up the balance. That ratio has since declined, with domestic waste making up less than 10% of revenue, while it generates no profits for Enviroserv.” (Le Roux, 2006)

## **5.4 EThekweni pit emptying project**

The EThekweni Metropolitan Municipality VIP pit emptying project, described in Report TT 432/2/10 (Section 3.4.5) as a near-franchising undertaking, had promised to be a most useful learning experience for franchising. At the conclusion of that description, it was stated:

“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).

That this had taken so long, and was still not resolved, was a bad sign. Here were nearly all if not all of the ingredients for success – viz.:

- a needed service (getting more urgent as time passed),
- skilled officials in the municipality who in addition were keen to see the project get going,
- a pilot project already completed and the lessons assimilated,
- potential contractors (nine tenderers!) and subcontractors already interested,
- good documentation and a competent tender procedure; and
- (it was thought) Council’s wholehearted commitment.

Despite that, what is now going ahead is a much watered-down version of the original proposal.

“There were delays in the adjudication process due to technicalities relating to the requirements of the Municipal Finance Management Act (MFMA) and due to the fact that no tenderers complied with the contractual requirements related to performance guarantees. Ultimately, a decision was made in November 2006 by the relevant standing Supply Chain Management Committees that no award be made in respect of the tender.

The line department was then directed to re-evaluate the model such that the cost of the franchisor portion was significantly reduced, and that the project be developed directly as an Expanded Public Works Programme (EPWP) project.

However, given the delays in implementing the project, intense political and community pressure required that some form of pit latrine emptying be commenced in the interim. Therefore in February 2007 a small contract (R200 000 value) was awarded on a conventional contractor basis (with the proviso that local labour be utilised). This has successfully emptied 150 pits, and a recent extension to the contract will see a further 150 pits being emptied. This is due to be completed by the end of March 2007.

On evaluating the modelling of a large scale project as an EPWP programme, what became clear was that the current EPWP model would not fit this project seamlessly, and therefore there would be a significant amount of remodelling and discussions/negotiation with various role-players DPW (Department of Public Works), DOL (Department of Labour), the Banking Sector, and consultants required before implementation.

As a result, a strategic decision was taken that as the Municipality could not afford to delay the project any longer, that the project be split into 2 contracts, the first being on a conventional managing contractor basis, utilising SMMES, with an EPWP project being the second which would follow once the model had been developed and approved.

This first contract has taken elements of the Franchisor contract, but has the following fundamental differences.

1. The contract is for the managing contractor for a 3 year period only with no option of extension as opposed to the previous 5 year contract.
2. The purchase of vehicles does not form part of the contract, allowing for more flexibility.
3. The SMMES (5 in number, as the project scope has been halved) will be in the project for only 18 months, with a further 5 new SMMES being brought into the project thereafter, thus increasing access to the project for emerging contractors.
4. Performance guarantees are only required for the Managing Contractor's portion of the work.
5. The responsibility of the Managing Contractor has been significantly reduced, with more of the project management and overall oversight being borne by the Municipality's project managers. This elements of social facilitation have also been removed from the contract, being undertaken now directly by the Municipality.
6. The scope of the contract has been halved due to development of the parallel EPWP Project.

This first contract was advertised on Friday 9<sup>th</sup> March 2007, and is due to be adjudicated through a fast- track process, with the award anticipated (after an appeal period) by 6<sup>th</sup> April 2007.

The second EPWP contract is still in the development stage and no specific time scale has been set for this, but will be focused on once the first contract is up and running.

Details of how this will be structured and function will only be available once the model has been finalised.” (eThekweni 2007)



The current researchers will as the contract rolls out stay in touch with the principal eThekweni municipal official (Davis – Manager: Wastewater Network), in anticipation that value to water services franchising will be learned. Nonetheless it is disappointing that the franchising elements have been watered down so much.

## **5.5 Chapter 5 conclusions**

Few municipalities use the private sector beyond IT, planning, design and construction, and (in the water services sector) a few other tasks such as meter reading and water sampling and testing. The reason is clear – it is the councillors' choice.

It takes a bold official to suggest outsourcing of more water services operation than that, despite that procurement legislation is permissive of outsourcing. The national statutory and regulatory environment might be enabling, but the local-level political environment for outsourcing of water services operation is disabling.

Franchising is a subset of outsourcing. If outsourcing is opposed by a council, that opposition, wittingly or not, will rule out franchising partnerships.

The implication is that if WRC seriously wishes to see franchising implemented at scale in many WSAs, i.e. go beyond a few pilot studies in addition to where circumstances have created what could be unusually favourable conditions (e.g. Biwater's track record in Mbombela), then councillor resistance will need to be addressed.

If the evidence of the findings of this chapter is anything to go by, only a small minority of water services authorities would be willing in principle to contemplate outsourcing of the operation of their water services infrastructure – by franchising or any other means.

Which by no means shuts the door on franchising of public sector water services infrastructure. If a few pilots can be started up in those municipalities that are willing, and those pilots in due course deliver improved services, are BBBEE and SMME success stories, and are commercial successes for the WSA, franchisor and franchisees alike, then the perceptions of some of the other WSAs may begin to shift.

Successful franchising could also be undertaken of operation and maintenance of public sector water services infrastructure not owned by WSAs, but by provincial government (e.g. schools sanitation franchising) and by water boards. This could also be valuable in changing WSA perceptions.

Finally: The suggestion has been made to the team that a name other than “franchising” should be found for the water services institutional arrangements that adhere to the principles of franchising – and that simply changing the name might make the concept more acceptable to WSAs. Given that franchising is a familiar concept, but in the context of fast foods and the making of profit, many people would not find it easy to transpose to the water services sector the image of franchising that they already have. Also, that franchising is associated with the profit-making private sector sometimes leads to the common knee-jerk reaction against any forms of “privatisation”.

The officials of the Eastern Cape district municipalities that were interviewed suggested that councillors and officials in that area are already comfortable with “support services agents”, and are familiar with the role of the private sector support services agents. A new name that involved similar terminology – such as using the word “support” – might be more acceptable.

At the WRC reference group meeting in November 2006, Mr Bhagwan mentioned the analogy with “shallow sewers”, now no longer called such, but rather “Nkoko”, which means something like “condominiale”.

The team has not considered this matter further, other than to come up with the thought of “distant support agents”.

## 6. Other possible institutional roleplayers

The 2005 WRC/CSIR report suggested that, in addition to franchisors per se, or what is provided by franchisors or by groups of them, there would need to be at least four other institutions or groupings of skills and/or interest, viz. institutions or institutional groupings or networks that would be responsible for:

- industry sponsorship;
- franchise package development;
- ongoing support and training; and
- commercial support. (Wall, 2005, Section 7.1.4)

It was not suggested as such in that report, but these could arise in a variety of ways. For example a network could voluntarily spring up as a result of a shared perception of value, or a body could be formally set up by a regulator or industry association.

The four institutions or grouping of skills and/or interest were in the 2005 report described as follows:

- “Industry sponsorship: An industry sponsor may give grants or concessionary loans, and/or give comfort to investors. (Conventional franchising does not have industry sponsors as such. The franchisors played that role in their start-up days, accepting the business risk (and of course some failed).) The sponsor could be a parastatal and /or a commercial sector body with specific interest in the development of the industry. If DWAF establishes a utility parastatal, it could play a role. The Association of Water Utilities could become involved. The commercial component could come from an Association of Pipe Manufacturers, for example. SMME support entities such as Khula may also have a role to play, as they do in the commercial franchise sector.
- Franchise package development: This could be by the franchisor or consultants (legal, management, operations, engineering, accounting, HR, training – in consortium) and/ or an experienced private sector operator. The British multinational water companies offer services similar to this and are less negative to the development concept than are the French multinationals, which tend to see this as giving away their commercial technologies and market advantages.
- Ongoing support and training (these two aspects could be housed separately): A structure is necessary to ensure continuous development and refinement of the product as well as auditing performance in conjunction with the industry sponsor. The CSIR could play a role here.
- Commercial support networks: Within targeted groupings and possibly also in the broader regional and national contexts, linkages with other commercial organisations would be desirable (for example with the relevant Chamber of Commerce).” (Wall, 2005, page 76)

While no harm would be done by speculating on the form of these, and on which institutions might lead or constitute them, any thought of starting to set them up would be very much premature – if indeed they would be needed at all.

The work on the current project has shown clearly where the main priorities lie if the operation of public sector water services infrastructure is to be franchised other than in a few places. The priorities are threefold, and are listed below. The first two relate to the first step of the “three-step

breakthrough” – only the third relates specifically to franchising. But all three need to be addressed, and to be addressed simultaneously, not in some kind of sequence:

- Ensure that the necessary steps are taken to allow the private, NGO and CBO sectors to compete on even terms with in-house providers. At very least, this must be done where in-house operation and maintenance is readily showing “serious or repetitive nature of non-compliance” – see Section 3.6 above.
- Address funding stream and municipal financial stability issues. (See Section 3.5 above.)
- Ensure that a limited number of water services franchising partnership pilots are up and running as soon as possible, and that through their success they demonstrate the potential of water services franchising.

None of the above is going to happen overnight.

Given that the focus must be on these three main priorities, is there any need to (or energy left over to) in the short term follow up on any of the suggestions made in the 2005 report, and listed above? To, for example, attempt to find an industry sponsor?

The answer must surely be “no need to premeditatedly follow up”. The current researchers trust that some of the results similar to those that the 2005 report had in mind will start to flow from developments already underway. At this stage it cannot be seen what good would be achieved from trying to proactively influence these developments or to replicate them.

However addressing the three priorities is going to require action from time to time on the part of those with a current interest in water services franchising – i.e. the WRC, the CSIR and the companies noted in Chapter 4 to be franchisors already or thought to be pursuing an interest in franchising. For example, as opportunities arose, they would need to lobby government departments on issues to do with these main priorities.

Consider for example “**franchise package development**”, i.e. developing a package embracing the relevant business method elements around the provision of a particular service.

In the established franchising industry, franchise package development is done by franchisors motivated by profit-seeking – sometimes with the assistance of consultants. Or it is done by institutions offering services not currently on a franchising basis, but they are seeking to franchise their businesses. This is how franchising has over the decades grown to the size that it is.

There could in time be many water services franchisors in South Africa offering services related to a small selection of elements in the water services value chain (current examples of such franchisors include The Drain Surgeon and PWMSA).

Despite there not being any current examples of these, there could also in time be many water services franchisors in South Africa offering services related to a much broader selection of elements in the water services value chain.

It would be no more than speculation to predict which organisations other than those already mentioned in Chapter 4 would see the franchisor opportunity, and take it up.

Whether the franchisors would act in concert, or compete, cannot be foretold. There is room for competition to be introduced in the medium to long term future between franchisors and between franchisees, and further innovations and cost savings would be an eventual outcome. This would probably be most rapidly and effectively achieved within the ambit of the private sector where competition is a way of life, rather than in the NGO sector or in the public sector where it is not.

Franchise package development can therefore, for the time being, safely be left with those organisations that firstly understand the business, and secondly have the incentive to franchise it because they see opportunities (which would not necessarily just be the seeking of profit) for themselves. On the first of these, it is as well to recall the comment of Glenn Pratt (Section 3.3 of Report TT 432/2/10) that he wouldn't contemplate setting up a fried chicken franchise because he has never fried a piece of chicken, but he knows plumbing backwards, and has learned through first-hand practical experience which plumbing operations are both viable and franchisable!

**“Ongoing support and training”** can, like franchise package development, safely be left to the franchisors themselves. They will in their own interests “ensure continuous development and refinement of the product”. “Auditing performance”, if commercial performance, they will also take care of. As to auditing services performance, it is the duty of the clients of the franchisees to do this in terms of the services contract between the client WSA or WSP and the franchisee – and it is the duty of DWAF to regulate the WSA’s performance.

**“Commercial support networks”** will arise of their own accord when they are needed.

In terms of **“industry sponsorship”**, as the 2005 report itself pointed out, “conventional franchising does not have industry sponsors as such – the franchisors played that role in a start-up days, accepting the business risk (and of course some failed)”. Potential franchisors that saw opportunities put their own money at risk and also persuaded commercial lending institutions to advance funds on the basis of business plans.

Those franchisors and potential franchisors that the current researchers have spoken with have not asked for special financial deals or for sponsorship – rather, they ask that the first two of the three main priorities listed on the previous page be addressed. They see opportunities to provide services and to do it profitably for themselves and for franchisees alike. They are investigating these of their own accord, using their own or borrowed funds.

The commercial lending institutions repeatedly say that they want to invest loan finance in both the capital and operational elements of public sector infrastructure. They state that issues to do with for example municipal financial stability stand in the way of them investing more. Franchising of public sector infrastructure operation is not something they have given thought to, but they would consider such franchisors’ plans as are brought to them.

Some donors are just beginning to recognise the merits of the franchise approach, and the first of these are funding or proposing to fund aspects of pilot franchising partnerships schemes in specific geographic areas (i.e. Mbombela, and another area that cannot yet be named).

There is however something to be said for national government to do more than play its role in addressing only the first two of the three main priorities. If DWAF, for example, is as concerned about water services performance at local government level as it says it is, it should consider proactively supporting feasible solutions. Among these should surely be franchising.

If DWAF were of the opinion that water services franchising is a valuable option, it should be seeking ways to nurture franchising partnerships. (Note that DWAF has given no such indication on water services franchising. Nor can it be expected to do so in the short term – it has too recently been introduced to the concept.).

## **7. Conclusions and recommendations**

### **7.1 On the objective of the current report**

The preceding chapters (to an extent through summarising the three first phase reports) describe and discuss the national-level and local-level environment for water services franchising. They also identify potential franchisors and WSAs and gauge their interest in principle. Finally, they discuss the need for and role of other possible institutional roleplayers.

It emerges that three main priorities need to be addressed simultaneously if the operation of public sector water services infrastructure is to be franchised other than in a few most favourable circumstances. As follows:

- Ensure that the necessary steps are taken to allow the private, NGO and CBO sectors to compete on even terms with in-house providers. At very least, this must be done where in-house operation and maintenance is readily showing “serious or repetitive nature of non-compliance”.
- Address funding stream and municipal financial stability issues.
- Ensure that a few water services franchising partnership pilots are up and running as soon as possible, and that through their success they demonstrate the potential of water services franchising.

National government is the key roleplayer in terms of addressing the first two of these.

It would appear that municipalities are for the most part unlikely to wish to change anything in respect of the first of these priorities. If, therefore, national government wishes to effect change, it is going to have to take the leadership itself. However, the comments from a small number of officials (for example Horton of National Treasury PPP Unit) aside, it has not thus far indicated even that it wishes to see significant change effected.

It would appear that municipalities are for the most part unable to bring about of their own accord significant change in respect of the second of these priorities. Again, therefore, national government is going to have to take the leadership itself. In this instance, it has shown some commitment to change, but much more needs to be done.

Section 7.2 takes this discussion a little further forward.

The difficulty with the third main priority is that, apart from selected instances identified in previous chapters, the scope for pilots has a finite limit. This needs to be addressed, because the absence of good role models is probably one of the biggest factors militating against the use of franchising to support SMMEs in providing services in the water sector. Until it is proven to work, many peoples’ minds are closed to the opportunities, and they cannot see the benefits. The need for successful examples to overcome these negative perceptions, many of which were built up over generations, is clear. However, the Catch-22 nature of the situation does not bode well for an early large-scale breakthrough in this regard.

### **7.2 Role of national government**

National government plays several roles highly pertinent to the current project. These include particularly its roles in:

- setting service delivery standards, and regulating performance;
- promoting and enforcing legislation;
- funding infrastructure delivery; and

- enforcing funding accountability.

This section suggests examples of some directions in which national government could, in the interests of service delivery, be more influential than it presently is.

Dissatisfaction of national government spokespersons with some or other aspect of local government performance of service delivery is periodically reported. For example this comment by DWAF on the rollout of free basic services:

“Municipalities were seen to be the major obstacle preventing the estimated 40% of South Africa's population from receiving government's allocation of 6 000 litres of free water to each household, as they were held back by a lack of capacity and a poor understanding of how to implement government's plan .... The serious issue here was that the municipalities in poor, rural communities had showed the slowest progress, and these catered for the people that needed the free water the most, DWAF national resources deputy director-general Dr Cornelius Ruiters said ...

“We have a serious problem with municipalities implementing the programme,” he stated. “The National Treasury has made the funding available to provide the free water, but many municipalities lack the capacity and understanding to interpret what is required of them.”

However, he said that DWAF was working “flat-out” with the Department of Provincial and Local Government in assisting the municipalities to roll the programme out, as well as identifying where bottlenecks could be. “By the next fiscal year, we hope to make sure that all municipalities are implementing the plan,” stressed Ruiters.” (Hill, 2006)

Given that municipal lack of capacity has long been identified as a major obstacle to water services delivery, it is surprising that national government is not showing more interest in widening the choice of delivery institutions.

To refer again to the final report of the consultants charged with assisting DWAF to formulate the national water services infrastructure asset management strategy, quoted in Section 3.6 (in part):

“Even if existing water services institutions are fulfilling their duties entirely as required (by no means generally the case),... there is a need to investigate the generic merits and demerits of alternative delivery institutions.

Some of these institutions could, under some circumstances if not others, more effectively or more efficiently undertake these duties, or could offer advantages such as greater consumer satisfaction, SMME development, or BBBEE ownership. Another reason for investigating alternative institutions is the knowledge that current institutions are often under great pressure and unable to fulfil all their duties – an option that enabled them to share the load with others could be welcomed. (DWAF 2007, page 17).

As noted at the end of Chapter 6, there is something to be said for national government to do more than play its role in addressing only the first two of the three main priorities. If it is as concerned about water services performance at local government level as it says it is, it should consider proactively supporting feasible solutions. If therefore DWAF is of the opinion that water services franchising is a valuable option, it should be seeking ways to nurture franchising.

One way it could assist would be by supporting specific proposals put forward in the form of sound business plans. There would be no need for it to commit to “industry sponsorship” as such. If pilot schemes are needed (and they are) and further concept development is needed (and it is), then DWAF should consider at least partly funding this on a case-by-case basis. From what the current

researchers understand of Masimbambane, that programme would be a very suitable funding vehicle for pilot scheme implementation.

This report is not about infrastructure asset management, but the returns from improving operation and maintenance of water services infrastructure neglected by WSAs can be substantial – returns, that is, measured in terms of for example water loss reduction, improved wastewater treatment works effluent quality, and more reliable water supply. Funding that would enable the trying out of promising new ideas (and franchising of water services operation is one) would be money well spent.

National government should also assist with focused initiatives to address the second of the three main priorities. Potential franchisors are inhibited by the fear that, contractual commitments notwithstanding, municipalities may make due payments late or not at all. Ideas need to be found, and measures put in place, to remove the cause of these fears. One possibility, as yet unexplored, could be the setting up of financial guarantees that would link national government as a funder, private sector funders, municipalities and private sector services providers. For example, could a deal be structured whereby The Drain Surgeon and its franchisee would provide their service, confident that if the municipality defaulted on its obligation to pay (from the appropriate portion of equitable share, or other municipal resources), ABSA (say) would underwrite the payment? Thus, if the municipality defaulted, the small businesses that The Drain Surgeon would have set up would not go under.

At the WRC project reference group meeting in November 2006, when this issue was discussed, Mr Davis of eThekweni said that the banks had initially been unwilling to finance the small businesses that, had the municipality's pit emptying franchise project gone ahead, would have been set up. However eThekweni promised to underwrite loans that banks made that it (eThekweni) would approve of, and the banks then agreed to make the loans. (Davis personal communication 2006)

Thought will have to be given to these and other innovative measures. If SMMEs (including franchisees) are to be made use of, assurance of being paid for the services they render is essential.

To sum up: the main plea from advocates of franchising of the operation of public sector water services infrastructure is that national government improve the current environment for this purpose. And in particular the plea is:

- for an enabling WSA procurement environment, and
- for an enabling WSA budgeting and funding environment.

The team does appreciate that DWAF needs to consult with its sister departments on resolving these issues. For example, it could well be that DPLG and National Treasury would have as much or more influence. However the team looks to DWAF, as the department responsible for water services, to drive the process. The team looks forward to being invited by DWAF to assist it in this regard.



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## Website addresses

Amanz'abantu Services:	<a href="http://www.aserve.co.za">www.aserve.co.za</a>
Biwater:	<a href="http://www.biwater.co.za">www.biwater.co.za</a>
Department of Provincial and Local Government:	<a href="http://www.dplg.gov.za">www.dplg.gov.za</a>
Department of Water Affairs and Forestry:	<a href="http://www.dwaf.gov.za">www.dwaf.gov.za</a>
Department of National Treasury:	<a href="http://www.treasury.gov.za">www.treasury.gov.za</a>
Drain Surgeon, The:	<a href="http://www.drainsurgeon.co.za">www.drainsurgeon.co.za</a>
Franchise Association of Southern Africa (FASA):	<a href="http://www.fasa.co.za">www.fasa.co.za</a>
Group Five:	<a href="http://www.g5.co.za">www.g5.co.za</a>
Mvula Trust:	<a href="http://www.mvula.co.za">www.mvula.co.za</a>
PWMSA:	<a href="http://www.pwmsa.com">www.pwmsa.com</a>
Rand Water:	<a href="http://www.randwater.co.za">www.randwater.co.za</a>
Small Enterprise Development Agency (SEDA):	<a href="http://www.seda.org.za">www.seda.org.za</a>
Water Research Commission:	<a href="http://www.wrc.org.za">www.wrc.org.za</a>
Umgeni Water:	<a href="http://www.umgeni.co.za">www.umgeni.co.za</a>
WISA:	<a href="http://www.wisa.org.za">www.wisa.org.za</a>

The website of FRAIN ([www.frain.org.za](http://www.frain.org.za)) has been closed, but searching for it opens up the SEDA website.

The website of NAMAC ([www.namac.co.za](http://www.namac.co.za)) has been closed.

## **Annexure A: Can and/or must water services franchisors and franchisees be for-profits?**

Chapter 4, and in particular the response by Mvula Trust, raises the question as to can and/or must water services franchisors and franchisees be for-profits. The following discussion, which goes back to basic definitions of the characteristics of franchising, concludes that there could be room for both.

What precisely is franchising? Apart from that it has to exhibit the “business method” elements of franchising of (see Section 7.1.2 of Report TT 432/2/10), the franchise (in the strict definition of “franchise”) would have to have a SMME as the franchisee, and a larger or more expert private sector company as the franchisor. Also, the franchisor would have to fit the description noted in Section 3.3.2 of Report TT 432/2/10, to recall, that “a franchisor is an entrepreneur who has:

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

These business method elements are derived from a process such as the third of those in the set immediately above (“fine-tuned the systems ...”), to which process water services delivery is readily amenable. With respect to the second factor, yes, water services product features or methods of delivery are sufficiently unique. With respect to the first factor, yes, it can be argued that water services delivery is clearly defined, and the “market” for its sustained delivery is growing. However it is questionable to what extent water supplied through a tap, or sanitation, can be branded.

So, although the first phase of the current project concluded that “franchisee” must be added to any list of WSP types, there is still scope for discussion as to what precisely is meant by franchising.

And it could with much justification be argued that restricting franchisor and franchisee to for-profit (profit-seeking) entrepreneurs is unnecessarily limiting in view of the great need for innovations aimed at improving access to basic water services, and sustaining that improvement.

To proceed further, it is necessary to break up the question “is franchising a feasible method for water services infrastructure operation in South Africa?”, and to create from it two separate questions. As follows:

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

The conclusion of the current researchers is that, although the prospects for profit-seeking franchising would look promising if the “three-step breakthrough” can be made, the jury is still out. It all comes down to if profits can be made and if willing and competent entrepreneurs can be found, which will not be known until some pilot projects are mounted and have been given time to prove themselves.

Second question: “Can a coherent package of the aspects of franchising (the package to include at least the business methods, but also the “clearly defined and growing market” and “unique product features or methods of delivery”) be adopted by others, not profit-seeking entities?”

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

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

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

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

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

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

- the prospect of profits will attract competition, which should, however imperfectly, counter excesses; and
- tariffs could be regulated by the WSA.

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

## **Annexure B: Regulation of water service franchisors**

At the WRC project reference group meeting in November 2006, the team was asked to pay some attention to possible regulation of water service franchisors.

The team responded that the onus should be placed on the WSA to ensure that the work of the WSPs was competent – which the WSA should be doing anyway in terms of enforcing the contract that it should have with the WSP. In terms of current legislation, DWAF is obliged to regulate water services delivery performance by the WSA. For it to attempt to regulate the WSPs as well would be duplicating what the WSA is supposed to be doing. If the WSPs were franchisees, or franchisees were subcontractors to the primary WSPs, and DWAF took upon itself the responsibility to regulate franchisors, that would be a recipe for duplication of effort and/or division of responsibilities – and hence for confusion.

Given that DWAF already has a regulatory responsibility that it cannot cope with, the team strongly recommended that water service franchisors not be regulated.

Registration of franchisors would not be a bad idea, if only to give some assurance to municipalities and others looking to choose a franchisor. There is no need however to consider this until a much larger number of franchisors enter the field.