CORPORATISATION OF MUNICIPAL SERVICES PROVIDERS

Report to the
WATER RESEARCH COMMISSION

by

Palmer Development Group
in association with the
School of Government,
University of the Western Cape

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Executive Summary

Introduction

In the white paper on local government, and in many other subsequent policy statements, the South African government makes a strong argument for new approaches to municipal service delivery.

Corporatisation is generally understood to involve a process of transforming existing public sector service providers into companies, which are owned (at least partially) by government. Corporatisation generally also entails a process of progressive financial ring-fencing and commercialisation. Corporatised entities remain under the control of their public sector shareholders, but hopefully offer the benefits of flexibility associated with private sector companies.

In fact, as it turns out, decisions to corporatise service provision can also be associated with the establishment of public-private partnerships (especially management contracts). But this need not necessarily be the case. Corporatisation may be a step towards greater private sector involvement, or it may be an end in itself.

Corporatisation may also be a used to establish co-operative service provider arrangements between neighbouring local authorities. Such an approach would allow smaller local authorities to benefit from economies of scale and to attract better quality management.

At the time of commencing this research project South African municipal experience of corporatisation was very limited. This project report is one small attempt to address that gap. In no way did the project aim to promote corporatisation, but rather to provide decision makers with information as to the nature of this option.

Defining corporatisation

The research has shown that the concept of 'corporatisation' is not clearly defined, and that national and international definitions differ to some degree. For the purpose of this project the following working definition of municipal water service corporatisation was established:

> The creation of a separate, legal, 'corporatised' entity, owned and governed by one or more municipalities, with the explicit objective of providing water services to some or all of the municipality's water users. The corporatised entity may enter into a range of contracts with private or public partners to facilitate service delivery.

We have noted that this definition leaves considerable uncertainty around the issue of *control*, as manifested by the regulatory relationship between the municipality, the corporatised utility and any subsidiary partnerships.

International case studies

The project reviewed a range of international case studies, drawn from low, middle and high income countries. Key insights arising from these reviews are that:

1. Corporatised water service utilities exist world-wide. In fact the use of separate legal entities is a fairly common approach across low, medium and high income countries.

2. The corporatisation of water services does not, however, guarantee success in its own right.
3. Utilities succeed or fail for a wide variety of reasons. Success requires a combination of factors, especially good governance, managerial independence – and a measure of luck.
4. The regulatory framework is important, but will not in itself ensure a positive outcome. For instance Botswana has a very weak regulatory environment while Melbourne has a very strong regulator yet both are successful utilities. Both attribute their success, in part, to sound management practices.
5. A trend amongst with corporatised utilities is improve service delivery through increasing involvement of the private sector. This partnerships are more likely to entail service outsourcing and organisational development through the adoption of advanced management techniques then long term leases or outright asset transfers.

Governing and regulating corporatised utilities – International perspectives

The diversity of international experience and opinions on the governance and regulation of water services utilities makes it difficult to extract decisive lessons for the South African context. Nonetheless, the following insights were arrived at:

- That the South African regulatory system clearly still has to undergo considerable development, with national regulators likely to move from a mode of 'assisting' to a mode of 'regulating' over time;
- That as regulators in their own right South African municipalities are expected to engage with complex economic and governance issues relating to the price and quality of water services – no matter whether these services are supplied by public or private companies. These functions are likely to tax even the most competent of municipalities;
- That in common with all regulators South African municipalities will face the problem of accessing adequate information on which to base decisions. Present day municipal accounting practices are likely to prove a major hindrance in this regard.

The South African environment for corporatisation

The project has undertaken an exhaustive review of the legal framework applicable to water services corporatisation, leading to the conclusion that South African municipalities wishing to corporatise their water services face an enormously complex legal environment. Not only are there limited precedents available, but the legal framework has shifted fundamentally during the last five years. The learning experience from Johannesburg's corporatisation will assist other municipalities, but even so a considerable investment will be required to fully understand Johannesburg's experience and to interpret and apply these lessons.

The report notes that the policy/legal framework represents just one dimension of the environment for corporatisation. The political/stakeholder environment, the financial/economic environment and the technical environment must also be considered. For instance, organised labour has expressed strong reservations about the motives behind, and the risks associated, with corporatisation.

The Erwat case

The relevance of the Erwat case is limited, since the utility was created in a very different legal and organisational context to that which currently applies. For instance, shifts in municipal boundaries have rendered the original rationale largely irrelevant.

Nonetheless, the Erwat case demonstrates that a corporatised utility may be a sensible option for cases where multiple municipalities are able to realise economies of scale by merging their bulk waste water treatment operations.

The Johannesburg case

The research found that the process followed in setting up the Johannesburg Utility was influenced by the general transformation of the public service and local government, and by the *Igoli 2002* process in particular. Caution is therefore required in generalising from the Johannesburg experience.

The Johannesburg experience clearly indicates that some legislative changes are required to facilitate the corporatisation process. The new Municipal Systems Act has addressed this problem to some extent.

The case study also indicates that clear leadership and decision-making processes are crucial for success.

As the new utility begins to operate, the terrain of interest is shifting to the Utility-Council relationship. Many battles have still to be fought in the process of defining 'management autonomy' and the Council's 'regulatory role'.

In the course of the process of corporatising water and sanitation services the Johannesburg team generated a vast amount of documentation and learning. Attention needs to be given to transmitting this learning to other local authorities.

Process considerations

The Municipal Systems Act contains significant processual provisions to safeguard the interests of stakeholders such as labour and focuses mainly on the choice between internal and external service providers. The workability of this Act still to be tested in practice. One significant flaw may be the lack of attention paid to defining the concept of a 'municipal service'.

A World Bank toolkit is available which provides detailed insight into the complexity of taking decisions on municipal service provision and the establishment and regulation of service delivery agreements. An American Water Works Association toolkit resource provides similar insights. Although both of these toolkits deal mainly with public-private options they contain much material which is relevant to a corporatisation process.

All in all the lesson from these reviews is that a decision to corporatise is not to be taken lightly. Getting to the decision, and then implementing the decision, could take very significant financial, managerial and political resources.

Tentative conclusions

The research team is of the view that it is not possible to reach definitive conclusions on the suitability of corporatisation for the delivery of water and sanitation services, outside of the particular circumstances of each individual municipal case. Nonetheless, the research does point to the following general findings:

The environment for corporatisation

1. The current environment for corporatisation in South African is not particularly favourable and transaction costs can be very significant. Despite advances in national government policy a considerable amount of uncertainty remains. Further legal reforms are still necessary.

2. Existing corporatisation initiatives have lead to a high level of politicisation, with stand-offs between government and labour, and even between different spheres of government.

The motives for considering corporatisation

1. Motives for examining the corporatisation option are likely to vary between municipalities. Some may wish to improve governance and financial reporting, whilst others may focus on service performance or some other factor. It is very important that municipalities define clear problem statements and a clear basis for a decision to choose this route.

2. The research team is of the view that corporatisation in itself will not *guarantee* performance. Whilst a shift in legal form from a municipal department to a stand-alone legal entity can make a difference this is not the only or major determinant of performance. Various objective factors and broader governance factors are likely to have a *greater impact* than simply legal form.

3. Where service performance is a consideration it will generally be sensible to consider the option of entering into some form of partnership (with either the public or the private sector) in conjunction with a corporatisation exercise. The scope of the partnership could take various forms.

The suitability of corporatisation as an option for municipalities

1. The research team is of the view that the corporatisation of municipal water services may be a suitable option for some municipalities. For capacity reasons corporatisation is only likely to be feasible within the large metropoles at this stage. As the experience base grows within South Africa, and transaction costs diminish, corporatisation may become feasible for smaller local authorities.

2. A possible exception to this conclusion may be the cases of multiple local authorities merging as a result of the demarcation process, or where the Structures Amendment Act has resulted in water functions being shifted from local authorities to District Councils who have previously held water service responsibilities. These radical, policy-induced organisational changes may create a one-off opportunity to consider corporatisation options which might not otherwise have arisen.

3. Another possible exception may be the case where a local authority requires a partner to invest in a defined component of the water services system (such as waste water treatment plants) and establishes a corporatised utility as a vehicle for the partnership. In a case such as this the issues of ownership and control would be particularly important.

The implementation process

1. Before embarking on a corporatisation process municipalities should assess whether they have sufficient financial, managerial and political capacity to see the process through.

Further work

The research team would like to point to the following issues as areas of potential further work:

Documenting learning: the Johannesburg experience has considerable learning opportunities to offer national policy makers and interested municipalities. Consideration should be given to documenting the whole process in greater detail and to building up a resource bank for other municipalities.

Interpreting the Municipal Systems Act: The implications of the process envisaged in chapter 8 of the Municipal Systems Act need to be better understood. Consideration could be given to developing a definition of 'municipal services' and to developing a deeper understanding of application of the various criteria defined in the Act.

Improving the regulatory framework: The regulatory framework for water services in South Africa is somewhat fragmented and confused. Overlapping and sometimes contradictory legislation and policy covering local government, water services and public finance matters all contribute to the regulatory framework. National government could do more to clarify this framework.

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Case studies

The authors of the case studies would like to thank the following people:

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This project was undertaken by the Palmer Development Group, in association with the School of Government, University of the Western Cape.

Researchers

The following researchers contributed to the preparation of this report:

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Mark Pickering: was the project leader and contributed the sections on defining corporatisation; governance and regulation of corporatised utilities (partial); the South African environment for corporatisation; the minor South African case studies; process considerations; the conclusions; and the overall editing of the report.

Ian Palmer: contributed the sections on international case studies; and the governance and regulation of corporatised utilities (partial).

Debbie Newton: was sub-contracted to Palmer Development Group and contributed the Johannesburg case study.

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Archival of data

All data stemming from this study has been archived within Palmer Development Group's library and archive services, and may be accessed at the following address:

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1 Introduction

1.1 Background

In the white paper on local government, and in many other subsequent policy statements, the South African government makes a strong argument for new approaches to municipal service delivery. The government notes that under apartheid, systematic under-investment in municipal infrastructure in black areas deprived millions of people of access to basic services, including water and sanitation services. Local government is unambiguously tasked with taking the lead responsibility in addressing these backlogs – "the central mandate of local government is to develop service delivery capacity to meet the basic needs of communities" (DCD 1998:99).

The white paper goes on to identify a wide range of service delivery options for municipalities to select from. In keeping with global trends these options almost invariably involve partnering with private sector players to some degree. This trend is somewhat at odds with the historical experience of local government service delivery in South Africa, where the role of the private sector has largely been restricted to non-core responsibilities – such as meter reading – and well-defined capital construction projects. The shift towards partnering with private sector service providers has not been quick or easy – as the slow rate of progress with so called Municipal Service Partnerships (MSPs) has demonstrated over the last few years. To some extent this can be attributed to a simple clash of cultures. Municipal officials are used to doing things in a certain way. Their world is dominated by legislation, rules, regulations and mandates. Company law and competition is, by contrast, a rather foreign environment. Neither world can make sense of the others' financial statements. Yet, ironically, the idea of becoming 'more businesslike', of running services according to 'business principles', has been a long-standing dream amongst municipal officials.

Given this apparent contradiction – the desire to escape bureaucracy, contrasted with the slow establishment of MSPs – the option of *corporatisation* may be an attractive compromise.

Corporatisation is generally understood to involve a process of transforming existing public sector service providers into companies, which are owned (at least partially) by government (one or more municipalities in the South African case). Corporatisation generally also entails a progressive process of financial ring-fencing and commercialisation. Corporatised entities remain under the control of their public sector shareholders, but hopefully offer the benefits of flexibility associated with private sector companies.

Given the politicised nature of the debate around MSPs in South Africa, with labour offering staunch resistance to the perceived 'privatisation' of essential services, the corporatisation option appears to offer 'the best of both worlds'.

In fact, as it turns out, decisions to corporatise service provision are often associated with the establishment of public-private partnerships (especially management contracts). But this need not necessarily be the case. Corporatisation may be a step towards greater private sector involvement, or it may be an end in itself. As the international case studies show there are many examples of successful, public sector, corporatised entities around the world.

At the time that this research project was proposed some of South Africa's largest municipalities (Johannesburg Metro, Cape Town Metro and Durban Metro) were considering

the option of corporatising their water services, some with private sector partnerships and other without.

Corporatisation may also be potential mechanism for establishing co-operative service provider arrangements between neighbouring local authorities. Such an approach would allow smaller local authorities to benefit from economies of scale and to attract better quality management. Erwat (an East Rand sanitation utility) is the best known example of this approach. In fact, at the time that this research commenced, Erwat was the only known long-standing example of water sector corporatisation in South Africa.

In summary then, despite government's determined policy push towards new approaches to municipal service delivery, it is clear that South African municipal experience of corporatisation is still very limited and that an urgent need exists for information on 'how to go about it'. This research project represents one small attempt to address that gap. In no way did the project aim to promote corporatisation, but rather to provide the information to decision makers on the nature of this option.

1.2 Project methodology

1.2.1 Project steps

The WRC research contract specified the following project steps:

1. Undertake a *literature review* using library and internet search facilities.
2. *Interview national organisations* to gather information on current *policy* thinking, legislation, stakeholder positions etc.
3. Select a *local case study* in the case of corporatisation and *international case studies* of both options, and work closely with relevant organisations to describe the process of forming the water services provider, institutional arrangements and key lessons.
4. Draft a *research report* and *guideline*.
5. Hold a *national workshop* to discuss the options.
6. Finalise the report and guideline.

The research team divided the research into three areas of work:

1.2.2 International comparative review

The international review sought to distil general lessons from the experiences of municipalities in other countries. The was conducted as a desk-based study relying on published materials and personal contacts. Key resources included:

- Academic journals
- Corporatised utilities
- Consultants
- Multinational development agencies, such as the World Bank

1.2.3 Review of the local environment

The review of the local environment sought to identify the peculiar issues relating to corporatisation in the South African environment that municipalities may need to be aware of. This work entailed both desk-based study and interviews with key stakeholders. Key resources and contacts included:

- Legislation
- National government departments (DPLG, DoF, DWAF, DTI)
- The Municipal Infrastructure Investment Unit (MIIU)
- Unions (Samwu, Imatu, Cosatu)
- Salga
- Water service providers (Durban Metro Water, Rand Water)

1.2.4 Local case studies

The review of local case studies sought to strengthen insights into the local environment. Potential case studies were seen to include:

- Erwat (regional utility, well established)
- Johannesburg Water Utility (existing corporatisation and management contract exercise. Possible lessons from water, electricity, gas and other services)
- Cape Town Metro (bulk water investigation)
- Durban (water investigation)
- Umgeni, Durban and Pietermaritzberg (merger investigation)
- Non-water corporatised utilities (Durban transport?)

In consultation with the project steering committee the Erwat and Johannesburg options were selected.

1.2.5 Capacity building

In line with the WRC's commitment to building the capacity of Historically Disadvantaged Institutions the lead consultant, Palmer Development Group, entered into a partnership with two researchers from the School of Government, University of the Western Cape to complete this project. The project budget was divided on a 70/30 basis.

Separate reports on work progress have been provided to the project steering committee.

1.2.6 Research questions

To guide the research team's work a number of research questions have been defined.

The overall research question remains 'whether corporatisation is a suitable option for municipal water service provision in South Africa'. Subsidiary research questions addressed in this report include:

Q1. What is corporatisation? How might we define it? How does it compare to other service provider options?
Q2. What is the international experience of corporatised municipal water service providers?
Q3. What factors in South Africa may help or hinder corporatisation?
Q4. What forms may corporatisation take in South Africa?
Q5. What are the advantages/disadvantages of corporatisation in the South African context?
Q6. What process should a municipality follow to determine whether or not to corporatise water services? What factors should be considered? Who should be involved? How long should it take? What might it cost?
Q7. Once a decision is taken, what steps have to be taken to corporatise municipal water services?

Q8. What municipal responsibilities remain following corporatisation?
Q9. What is the experience of corporatisation in South Africa to date?

2 Defining Corporatisation

2.1 Introduction

This section of the report attempts to answer the first research question:

> Q1. What is corporatisation? How might we define it? How does it compare to other options?

Corporatisation of water services is but one of the many organisational options available to a municipality. In practise corporatisation is often used in conjunction with other organisational options, thus making it difficult to provide a precise definition. This section of the report therefore provides a range of perspectives on the concept of corporatisation, including dictionary definitions, various expert perspectives, technical definitions, and legal definitions. The section concludes with a proposed working definition for the purpose of the project.

2.2 Dictionary definitions of corporatisation

The word 'corporatisation' does not appear in the dictionary. Nonetheless, the following useful definitions are available:

> **Corporate** *adj.* **1.** forming a corporation; incorporated. **2.** of or belonging to a corporation or corporations: *corporate finance*. **3.** Of or belonging to a united group; joint. [C15: from Latin *corporātus* made into a body, from *corporāre*, from *corpus* body] (Collins, 1995:358).

> **Corporate** *adj.* **1** forming a corporation. **2.** Of, belonging to, or united in a group. [Latin: related to CORPORAL] (Oxford, 1992:188).

> **Corporation** *n.* **1.** a group of people authorised by law to act as an individual and having its own powers, duties and liabilities. **2.** Also called: **municipal corporation.** The municipal authorities of a city or town. **3.** A group of people acting as one body. **4.** See **public corporation. 5.** *Informal*. A large paunch or belly (Collins, 1995:358).

> **Corporation** *n.* **1.** group of people authorised to act as an individual, esp. in business. **2.** municipal authorities of a borough, town or city. **3.** *Joc* large stomach. (Oxford, 1992:188).

> **Public corporation** *n.* (in Britain) an organisation established to run a nationalised industry or state-owned enterprise. The chairman and board members are appointed by a government minister, and the government has overall control (Collins, 1995:358).

The dictionary definition thus clearly implies that corporatisation should involve a degree of *managerial independence*, but within a *framework of public ownership and control*.

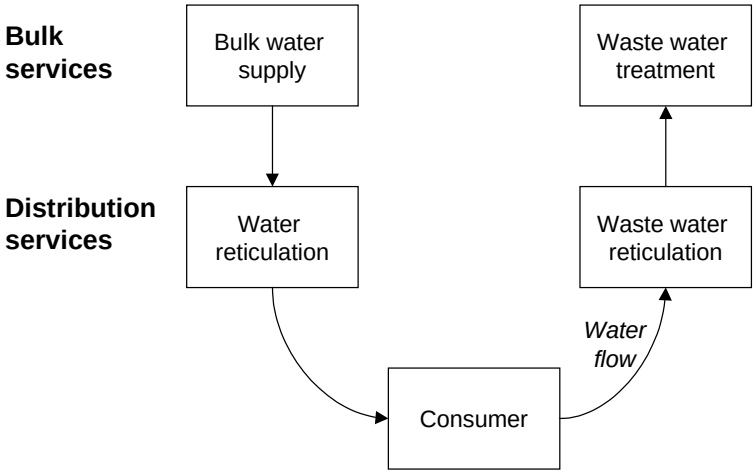
2.3 Water service components

Should a municipality elect to corporatise its water services it will have to select which components of the water service to include within the corporatised entity.

2.3.1 Physical components of the water services

For the purpose of this definition municipal water services can be considered to consist of the following major physical components.

Figure 1 Major water service components.



Each of these service components can be subdivided into sub-components, as follows.

Table 1 Service sub-components.

Bulk water supply service sub-components	Wastewater treatment service sub-components
▪ Water impoundment (dams); ▪ Raw water conveyance (canals, pipelines); ▪ Water treatments works; ▪ Pump stations; and ▪ Bulk supply pipelines.	▪ Treatments works; and ▪ Effluent outfall.
Water distribution service sub-components	**Wastewater reticulation service sub-components**
▪ Distribution reservoirs and water towers; ▪ Connector pipelines; and ▪ Internal reticulation pipelines.	▪ Sewerage reticulation; ▪ Pumps stations and rising mains; and ▪ Outfall sewers.

2.3.2 Non-physical components of water services

In addition to the physical processes associated with delivering water services there are a wide range of 'non-physical' activities required to support the physical processes, including at least:

- Governance arrangements
- Corporate services
- Strategic planning services
- Technical/scientific services
- Financial services
- Human resource services
- Information technology services
- Customer relations management services
- Billing and treasury services

Corporatisation of municipal water services thus requires clear decisions as to which of these physical and non-physical components are to be included within the corporate entity. The outstanding components must then be retained within the municipal administration – or provided for through some other means, such as a private partner.

2.4 Corporatisation in relation to the continuum of partnership options

Corporatisation is just one option within a broad spectrum of organisational responses available to a municipality. The last decade has seen a vast amount of literature dedicated to describing these options, much of it focussing on the 'privatisation' of water services. Whether corporatisation is undertaken as part of the process of establishing a private sector partnership or not, many of the organisational challenges are similar. The 'privatisation' literature is therefore very relevant to the topic of corporatisation.

Two of the more comprehensive and useful of the privatisation guidelines available are the World Bank's three volume *Toolkit for private sector participation in water and sanitation* (1997) and the American Water Works Association's multi-media toolkit entitled, *Balanced Evaluation of Public/Private Partnerships* (2000). Extracts from each of these are presented below to demonstrate the diversity of institutional options available to municipalities, and to assist with locating a corporatisation response in relation to these other options.

2.4.1 World Bank Toolkits

The World Bank toolkits were prepared in recognition of the massive challenges facing developing countries in providing access to safe drinking water and sanitation. They explore options for involving the private sector in the operation, rehabilitation and extension of water service systems. As such they have a declared bias towards private sector involvement and do not consider other options for improving public sector performance.

The Bank's toolkits were not specifically designed with municipalities in mind, since other tiers of government are frequently responsible for water services in developing countries. Nonetheless the toolkits still have considerable relevance for South African municipalities.

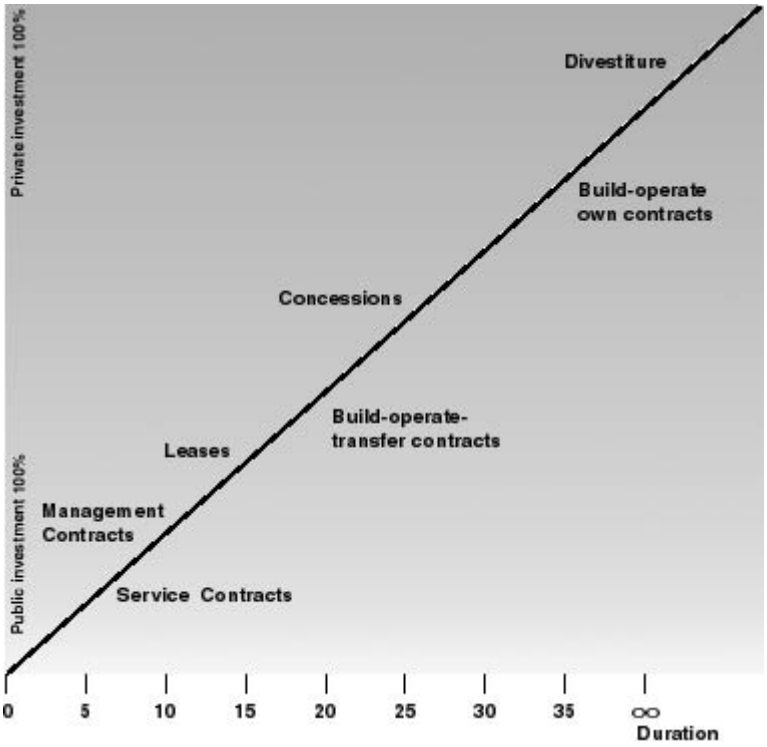
The toolkits cost US$100 and consist of three booklets of approximately 50 pages each, entitled:

***Toolkit 1**: Selecting an option for private sector participation (World Bank 1997a).*
***Toolkit 2**: Designing and implementing an option for private sector participation (World Bank 1997b).*
***Toolkit 3**: What a private sector participation arrangement should cover (World Bank 1997c).*

The spectrum of organisational options considered within the toolkits does not actually include the option of corporatisation. Nonetheless, the spectrum is useful in that most or all of the options could be utilised *in conjunction* with a corporatised entity.

The spectrum is defined in terms of two axes:
1. The degree of private sector involvement (from 0-100%); and
2. The length of the partnership (less than 5 years to permanent).

Figure 2 Private partnership options (World Bank, 1997a:1).



A brief description of each of these options is presented below.

Service contracts secure private sector assistance for performing specific tasks—installing or reading meters, monitoring losses, repairing pipes, or collecting accounts. They are typically for short periods, from six months to two years. Their main benefit is that they take advantage of private sector expertise for technical tasks or open these tasks to competition. They leave the responsibility for co-ordinating these tasks with the public utility managers. They also leave the responsibility for investment with the public sector.

Management contracts transfer responsibility for the operation and maintenance of government-owned businesses to the private sector. These contracts are generally for three to five years. The simplest involve paying a private firm a fixed fee for performing managerial tasks. More sophisticated management contracts can introduce greater incentives for efficiency, by defining performance targets and basing remuneration at least in part on their fulfilment. To be worthwhile, these more complex management contracts must produce efficiency gains large enough to offset the regulatory costs of establishing targets and monitoring performance against them.

Lease arrangements provide for a private firm to lease the assets of a utility from the government and take on the responsibility for operating and maintaining them. Because the lessor effectively buys the rights to the income stream from the utility's operations (minus the lease payment), it assumes much of the commercial risk of the operations. Under a well-structured contract the lessor's profitability will depend on how much it can reduce costs (while still meeting the quality standards in the lease contract), so it has incentives to improve operating efficiency.

Concessions give the private partner responsibility not only for the operation and maintenance of a utility's assets but also for investments. Asset ownership remains with the government, however, and full use rights to all the assets, including those created by the private partner, revert to the government when the contract ends—usually after 25 to 30 years. Concessions are often bid by price: the bidder that proposes to operate the utility and meet the investment targets for the lowest tariff wins the concession. The concession is governed by a contract that sets out such conditions as the main performance targets (coverage, quality), performance standards, arrangements for capital investment, mechanisms for adjusting tariffs, and arrangements for arbitrating disputes.

Build-operate-transfer (BOT) arrangements resemble concessions for providing bulk services but are normally used for greenfield projects, such as a water or wastewater treatment plant. In a typical BOT arrangement a private firm might undertake to construct a new dam and water treatment plant, operate them for a number of years, and at the end of the contract relinquish all rights to them to the public utility. The government or the distribution utility would pay the BOT partner for water from the project, at a price calculated over the life of the contract to cover its construction and operating costs and provide a reasonable return. The contract between the BOT concessionaire and the utility is usually on a take-or-pay basis, obligating the utility to pay for a specified quantity of water whether or not that quantity is consumed. This places all demand risk on the utility. Alternatively, the utility might pay a capacity charge and a consumption charge, an arrangement that shares the demand risk between the utility and the BOT concessionaire.

Divestiture of water and sewerage assets—through a sale of assets or shares or through a management buyout—can be partial or complete. A complete divestiture, like a concession, gives the private sector full responsibility for operations, maintenance, and investment. But unlike a concession, a divestiture transfers ownership of the assets to the private sector, so the nature of the public-private partnership differs slightly. A concession assigns the government two primary tasks: to ensure that the utility's assets—which the government continues to own—are used well and returned in good condition at the end of the concession and, through regulation, to protect consumers from monopolistic pricing and poor service. A divestiture leaves the government only the task of regulation, since, in theory, the private company should be concerned about maintaining its asset base (World Bank 1997a:3-9).

The key features of each of these options are described in the following table.

Table 2 Allocation of key responsibilities under the main private sector participation options (World Bank, 1997a:2).

Option	Asset ownership	Operations and maintenance	Capital investment	Commercial risk	Duration
Service contract	Public	Public and private	Public	Public	1-2 years
Management contract	Public	Private	Public	Public	3-5 years
Lease	Public	Private	Public	Shared	8-15 years
Concession	Public	Private	Private	Private	25-30 years
BOT/BOO	Private and public	Private	Private	Private	20-30 years
Divestiture	Private or private and public	Private	Private	Private	Indefinite (may be limited by license)

Returning to the dictionary definition of corporatisation then, we see that all of these options, and particularly the options of service contracts, management contracts, leases and concessions, meet the criteria of falling under *public ownership*, whilst the BOT/BOO and divestiture options become a little less clear. In terms of the criteria of *public control*, however, it is far harder to draw the line. The World Bank framework compares the options in terms of responsibility for operations and maintenance, capital investment, and commercial risk, but do these three area constitute 'control'?

2.4.2 Further World Bank definitions

Mary Shirley, a leading policy analyst on the topic of governing state owned enterprises, defines *corporatisation* as,

> Corporatisation is defined … as efforts to make SOEs [State Owned Enterprises] operate as if they were private firms facing a competitive market or, if monopolies, efficient regulation. This definition includes not only incorporating SOEs under the same commercial laws as private firms, but other steps to put state firms on a level playing field with private firms by removing barriers to entry, subsidies and special privileges, forcing SOEs to compete for finance on an equal basis with private firms, and giving state managers virtually the same powers and incentives as private managers (Shirley 1999:1).

By contrast she defines *privatisation* as,

> Privatisation is defined … as the sale of state-owned assets; thus, a company is no longer state-owned when management control (measured as the right to appoint the managers and board of directors) passes to private shareholders.

Another World bank publication defines a *management contract* as,

> … an agreement between the government and a private party to operate the firm for a fee (usually a success fee, but sometimes for a fixed fee as well) (World Bank, 1995:134).

The Bank notes that this definition of a management contract does not encompass contracts in which the private contractor provides working capital or owns a minority equity share.

2.4.3 The American Water Works Association: Balanced Evaluation of Public/Private Partnerships

The AWWA's Research Foundation has produced an extremely comprehensive toolkit to assist municipalities with decision-making around public-private partnerships (generally referred to as P3s within the American literature). This toolkit is specifically designed for municipal decision-makers within the United States, and tends to assume a very high level of capacity. The toolkit costs approximately US$200, is delivered in CD-ROM format and includes multi-media presentations, sophisticated decision-making tools, financial evaluation spreadsheets, case studies and useful literature references.

Although the AWWA toolkit is also largely concerned with promoting public-private partnerships (termed 'privatisation' or P3s) it also includes a much broader definition of public private partnerships and privatisation than the World Bank toolkit,

> **Public/private partnerships** are business relationships between public and private entities for the design, financing, construction, ownership, and/or operation of a facility or service.

> The term **privatization** is frequently used in reference to P3s. Herein, the term public/private partnerships (P3s) is used because it more accurately reflects a range of alternatives and connotes mutually beneficial collaboration, rather than private "consumption" of public utilities (AWWA, 2000).

The AWWA note that although the water service industry in the United States is witnessing a general trend towards public-private partnerships this is not the only organisational phenomenon. Four other trends are defined as follows:

Service expansion. Providing services and/or assets to other public or private water utilities to increase revenues. Examples include laboratory services, meter reading, and billing.

Public/public partnerships. Similar to insourcing but on a larger scale - for example, mergers and service agreements. In one such agreement, the Metropolitan Water District of Southern California is purchasing water from Imperial Water District and has entered an agreement to wheel the water through San Diego County's canal system. Another example is the agreement of Lodi, New Jersey, to lease its water system to the Passaic Valley Water Commission.

Municipalization, or publicization. The opposite of privatization - moving service delivery back into the public sector. The City of Scottsdale, Arizona privatized its water utility and later repurchased it. Reasons vary from political to perceptions of poor service and high costs. To date, municipalization is more common in areas such as solid waste collection and stormwater management than in the water industry.

Regionalization. A merger of adjoining utilities into a single, larger organization can provide economies of scale via common operations and management. To date, regionalization has been more prevalent in smaller communities than in large metropolitan areas (AWWA, 2000).

Within the so-called 'P3' spectrum of alternatives the AWWA toolkit identifies six main options, ranging from total public ownership, on the left side of the spectrum, to total private ownership, on the right side of the spectrum.

Figure 3 Public-Private alternatives for water utilities (AWWA 2000).

A brief description of each of the options is extracted below.

Organization development refers to a suite of methods or actions an organization can take to improve itself (borrowing from or benchmarking with others), without entering into a P3 that involves the transfer of services or functions. Organization development techniques, originated by private business, are increasingly used in the public sector. Utilities often retain consultants, or partner with other utilities, for assistance in identifying and achieving performance improvements; in utilities with unionized labour forces, labour/management co-operation is another key component. Utilities have reported substantial savings from organization development; according to AMSA, "it is not unusual to generate 20 to 25 percent net savings utility-wide by implementing an appropriate mix of reengineering

techniques". Organization development is not a quick fix: AMWA indicates that a thorough competitiveness process takes three to five years to complete.

Outsourcing entails contracting with an outside entity for the provision of specific services. For this application, as a general rule, this category refers to contracting out of services that individually account for 5 percent or less of a utility's operating budget. (Outsourcing of core operations and maintenance services are included in a separate category.) Services that are often outsourced include: meter reading, meter installation and replacement, billing, laboratory services, customer services, janitorial services, warehousing, accounting, and building maintenance.

Project delivery refers to a suite of approaches to the delivery of capital projects, via public/private partnerships or contracts. Using the traditional project delivery method (design/bid/build), the owner secures separate contracts for design and construction. The US market has developed a broad and flexible array of alternatives to traditional project delivery including:

Partnering. A step toward alternative project delivery, partnering became popular in the 1980s. It involves establishing working relationships through a formal, mutually developed strategy of commitment and communication, with the goal of resolving difficulties during construction.

Program management. This entails integrated management and delivery of a defined set of projects. The projects are typically part of a Capital Improvements Plan, interrelated and with interdependent technical, political, timing and funding requirements. Most large water system programs are created to deliver major infrastructure improvements to address regulatory needs, growth, or other policy drivers. Program management can be performed within a utility's organisation, but a utility often contracts with a private firm for program management services. Often, the utility and program management firm's staff can be integrated to deliver a major CIP.

Construction management (CM) or *Third Party/Agency CM*. As the owner's agent, the CM works on the owner's behalf, for a fee, during design and/or construction. The owner normally holds all of the contracts associated with the work. The CM essentially functions as the administrative extension of the owner's staff and manager of the construction process (e.g. scheduling, bid packaging, bid analysis, etc.) and usually does not take the financial or schedule risk for the project.

CM at-risk. This approach is identical to CM, except the CM takes on additional risk with regard to cost and schedule guarantees to the owner. The CM normally holds the construction subcontracts and assumes similar liabilities normally taken by the General Contractor on a Design/Bid/Build project. CM usually reserves the right to self-perform work. The most significant potential advantage of this approach is the ability of the private partner to guarantee price and schedule.

Design-CM/General Contractor (D-CM/GC). In this more recent approach, the designer and GC are united on a single team, offering design and construction management services on a lump sum or guaranteed maximum price basis. These fees, and their component parts, can be determined at any time during the evolution of the project but normally are negotiated at 60-70% design completion. Construction trade subcontracts and equipment/material purchases usually are awarded by competitive bid although flexibility exists for the owner to negotiate certain elements of the work depending upon the project circumstances.

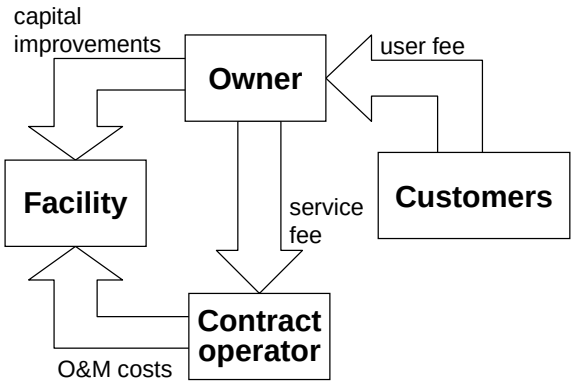
Design/build (DB). The owner prepares, or retains a consultant to prepare, a thorough preliminary design document (criteria package), establishing project scope and expected

quality standards. This predesign is the basis for DB team selection for final design and construction. The owner and consultant have the flexibility to prequalify DB firms capable of proposing on the work. The designer and contractor work as a team to meet the client's needs.

Design/build/operate (DBO). DBO delivery brings all three functions together into a single contract. The contractor builds new facilities which will be owned by the municipality, but which the contractor will commission and then operate the facility on behalf of the municipality for an operating term of perhaps 3 to 20 years. In an alternative form of this method, the contract is primarily for O&M rather than involving the delivery of a major new capital facility, but also involves heavy maintenance and replacement. In this case, the principal contractor is likely to be the O&M contractor, but with a committed relationship with a water/wastewater engineer and constructor for major maintenance.

Contract operations refers to the short- or long-term outsourcing of facility operations and/or maintenance (O&M) to a third party. Under this arrangement, the contract O&M provider is paid a service fee, and the utility retains control over facility capital investment, rate setting, fee collection, and regulatory interaction.

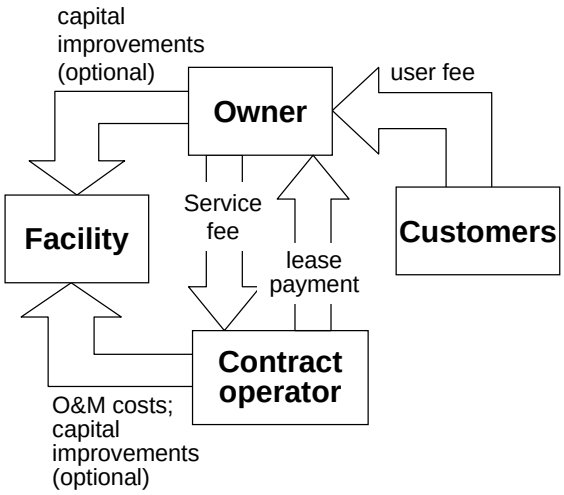
Figure 4 Contract operations (AWWA 2000).



Under ***private financing*** arrangements, a private entity makes a payment to the utility in exchange for the ability to operate and maintain facilities and collect service fees, either from the utility or directly from customers. Alternatives include:

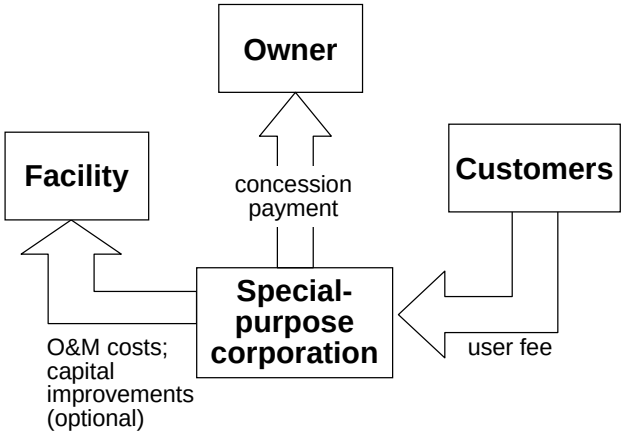
Facility leases. A utility enters into a lease with a private entity, often a newly formed special-purpose corporation, for a defined period (typically 20 to 30 years). The lessee provides services for the duration of the lease; ownership and responsibility for rate-setting and fee collection remain with the utility. In some cases the lessee also has responsibility for implementing (including financing) capital improvements as required over the lease term. Lease payments to the utility can be structured with up-front payments. The utility makes payments to the special-purpose corporation that have three components: Fixed capital payment to compensate for the cost of the fixed assets; Fixed O&M payment to compensate for operating costs that are not dependent on the volume of water treated (such as labour); and Variable operating component, tied to the volume of water treated (e.g. chemicals; power). At the end of the lease term the utility has four options: renew the lease; operate the facilities; competitively bid for another lessee, or implement another option.

Figure 5 Lease agreements (AWWA 2000).



Concession agreements. A utility enters into an agreement with a third party, again often a special-purpose corporation, to operate and maintain an existing water system. As compared with a lease, a concession agreement typically includes all assets of a water or wastewater treatment system and responsibility for billing and collection; in effect, the contractor becomes the utility responsible for all aspects of the water system. These agreements are long-term - typically 20 to 30 years. The contractor also has responsibility for any capital improvements required to achieve certain specified performance objectives. Concessions are therefore often broader in scope than a typical contract operations arrangement. Payments under this contract are similar to a lease and have three components: one for capital recovery and two related to operations. A concession arrangement can also be structured to transfer an up-front payment to the municipality.

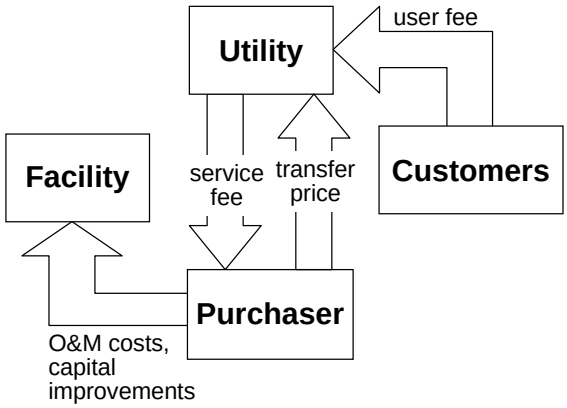
Figure 6 Concession agreements (AWWA 2000).



Build/own/operate/transfer (DBOOT). With D/B and DBO delivery, project financing remains with the utility. A public utility may prefer (or may be politically compelled) to obtain "off-balance-sheet" financing for a project, rather than adding to the municipal bond debt load. In that event, service providers are able to provide a more complex solution, which includes project finance.

Asset transfers entail the utility selling certain assets to a private party and simultaneously entering into a service agreement with the same entity to provide services for a 20- to 30-year period. Proceeds from the sale must be used to pay off any outstanding debt secured by the assets sold. Payments under the service contract are structured similar to those for lease and concession agreements, with both fixed and variable components. Asset sale can range from a single facility to the sale and transfer of all a utility's assets, functional responsibilities, and customer base to another organisation, for operation under the US system of state Public Utility Commission regulatory control.

Figure 7 Asset transfer (AWWA 2000).



The AWWA toolkit includes detailed discussions of the potential advantages/disadvantages of each of these options, the main 'drivers' behind the selection of each option, a variety of case studies on each option, and lastly a useful reference list of academic literature and suitable management guidelines. The depth of resources and options available to US decision makers and utility managers is truly breathtaking.

In essence then, the AWWA spectrum of P3 options is somewhat broader and more diverse than the World Bank's spectrum. Its focus is, however, very specifically on the US municipal arena.

2.5 Australian definitions of corporatisation

The Australian Queensland Government has pursued a major corporatisation programme over the last decade. In their 1992 white paper they spell our the basic policy guidelines for corporatisation, defining the process as follows,

> Corporatisation is a structural reform process which changes the conditions under which GOEs [Government Owned Enterprises] operate, so that they are placed, as far as practicable, on a commercial basis in a competitive environment while allowing the Government, as owner, to continue to provide board direction by setting key financial and non-financial performance targets and community service obligations (Queensland, 1992:5).

Government owned enterprises are in turn defined as,

> … organisations which produce goods and services that are either sold or are capable of being sold in the market place (Queensland, 1992:5).

The Queensland white paper spells out a major reform process, across a wide range of GOEs. The aims of corporatisation are stated to be:

- To provide incentives;
- To enhance efficiency;
- To improve economic performance; and
- To improve public accountability (Queensland, 1992:8).

2.6 South African definitions of corporatisation

2.6.1 Cape Metropolitan Council

In a report for the Cape Metropolitan Council PricewaterhouseCoopers (PwC) provide detailed definitions of both *business units* and *corporatisation*.

> A Business Unit is a section or division of a Council that is responsible for providing a defined service within specified financial parameters. In many respects it is the equivalent of an internal contractor and thus many of the requirements of contracting out also apply to the operation of Business Units (PwC 2000:6).

PwC go on to define the "principles of contracting out" as:

- Specification of the required service;
- Determination of performance monitoring standards;
- Independent monitoring of performance;
- Identification of the resources required to deliver the service;
- Commitment to the identified service and associated resources for a specified period of time;
- Freedom for the provider to determine their own method and means of operation without interference;
- Responsibility on the provider for all aspects of the service and for all associated costs – including overhears;
- Separate financial recording to ensure that the service is delivered for the agreed price; and Responsibility on the provider to deliver the required service within the agreed price.

The PwC report notes that,

> … the issue of penalties and rewards can be problematic as Business Units are still part of the Council(s) and as such payment cannot simple be withheld in the case of unsatisfactory performance, as it can with an internal contractor. However, failure to deliver the required service within the agreed level of financial and other resources can be progressively penalised through less work being allocated to the Business Unit and more work being done by others (PwC 2000:6).

PwC do not dwell on the practicalities of how other business units will take up the responsibility of providing an essential service like water.

The report goes on to define corporatisation as:

> Corporatisation means establishing a Council activity as a corporate body that is [a] separate legal entity from the Council. This is usually by means of a Section 21 (Not for Profit) Company. Corporatised service providers operate at arm's-length from the Council(s), with explicit operational and financial objectives against which the performance of the Company, and hence its managers, will be monitored and assessed (PwC 2000:6).

PwC later contradict this definition slightly, by suggesting that,

> … the usual legal structure is a company, which would be a *profit distributing company*, in which the Council is the sole shareholder, whereby the Council would receive an annual income in the form of a dividend/or other fees/income based on the company's profits after tax (PwC 2000:7, emphasis added).

PricewaterhouseCoopers (PwC) identify seven possible legal vehicles for the corporatisation of water services[1]:

1. Association Incorporated under section 21 of the Companies Act – commonly known as a Section 21, or non-profit, company;
2. A private company ((Proprietary) Limited/ (Pty) Ltd)
3. A public company (Limited/Ltd)
4. Water Board
5. Service agreement
6. Management agreement
7. Concession (PwC 1999:2).

Table 3 Evaluation of CMC legal options.

Option	Corporatisation definition
1. Section 21 (non-profit)	Separate legal entity owned and controlled by municipality
2. Private company ((Pty) Ltd)	Separate legal entity owned and controlled by municipality
3. Public company (Limited/Ltd)	Separate legal entity owned and controlled by municipality
4. Water Board	Separate legal entity owned and controlled by national government. Therefore outside the definition.
5. Service agreement	Refers to a contract rather than a separate legal entity. Outside the definition. May be utilised in conjunction with a corporatised entity.
6. Management agreement	Refers to a contract, rather than a separate legal entity. Outside the definition. May be utilised in conjunction with a corporatised entity, although the issue of control is debatable.
7. Concession	Refers to a contract, rather than a separate legal entity. Outside the definition. May be utilised in conjunction with a corporatised entity, although the issue of control is debatable

Applying the normal definition of corporatisation immediately excludes options 4-7, since they do not constitute 'separate legal entities owned and controlled' by one or more municipalities.

PwC note that this is not an exhaustive list of legal options, and that it excludes the option of an in-house unit. In fact the list also excludes a number of other options, which will be considered below in the section dealing with the South African policy environment for corporatisation.

Commenting on the ownership of a corporatised utility PwC note that:

> It is not unusual for other parties to share in the ownership of a corporatised local government entity and/or to have representation on its' Board, although the Council(s)

[1] The 1999 PwC report goes on to analyse the various legal models in terms of the issues associated with: Governance; Management; Applicable legislation; Industry examples; and Financial implications.

> would normally retain a majority of the shareholding and overall control through either a majority on the Board or through the structure of voting powers (PwC 2000:7).

PwC do not provide any examples of cases where ownership is shared, either in South Africa or in other countries.

2.6.2 Durban Unicity Committee

A Durban Unicity Committee document *The changing role of local government as a service provider* defines corporatisation as,

> Corporatisation refers to the establishment of separate organisations for the delivery of specific services by turning a current public authority function into a business unit with a separate legal identity, private company or close corporation (Durban Unicity Committee 2000:21).

The Durban Metropolitan Water department has undertaken an extensive investigation into the option of corporatisation. This report is not, however, publicly available.

2.6.3 Johannesburg Greater Metropolitan Council

The GJMC has probably undertaken the most extensive investigation of the corporatisation option in South Africa to date and will, from 1 January 2000, have corporatised its water services and simultaneously implemented a management contract to operate these services. The findings from this process are far too extensive to include in this section on definitions, and follow in the section on the South African environment for corporatisation and the section on the Johannesburg case study.

2.6.4 A Dutch perspective on corporatisation

IHE is an independent foundation, established in 1957 under Dutch law. It has a vision to be 'the centre of a global network for the generation and sharing of knowledge in integrated and sustainable water and environmental systems relevant to the developing world' and is presently the IHE-UNESCO institute for water education. IHE is located in Delft and has 160 staff, 300 guest faculty, 460 postgraduate students in Delft, 200 at 10 partner institutes in developing countries, and 12 000 alumni in over 100 countries.

IHE recently presented a workshop at the South African Department of Water Affairs and Forestry (DWAF) on the topic of 'public sector delivery options' which placed particular emphasis on the 'missing mode' of water utility management, the Public Water PLC. Although the terminology differs, this mode corresponds exactly with the South Africa understanding of corporatisation.

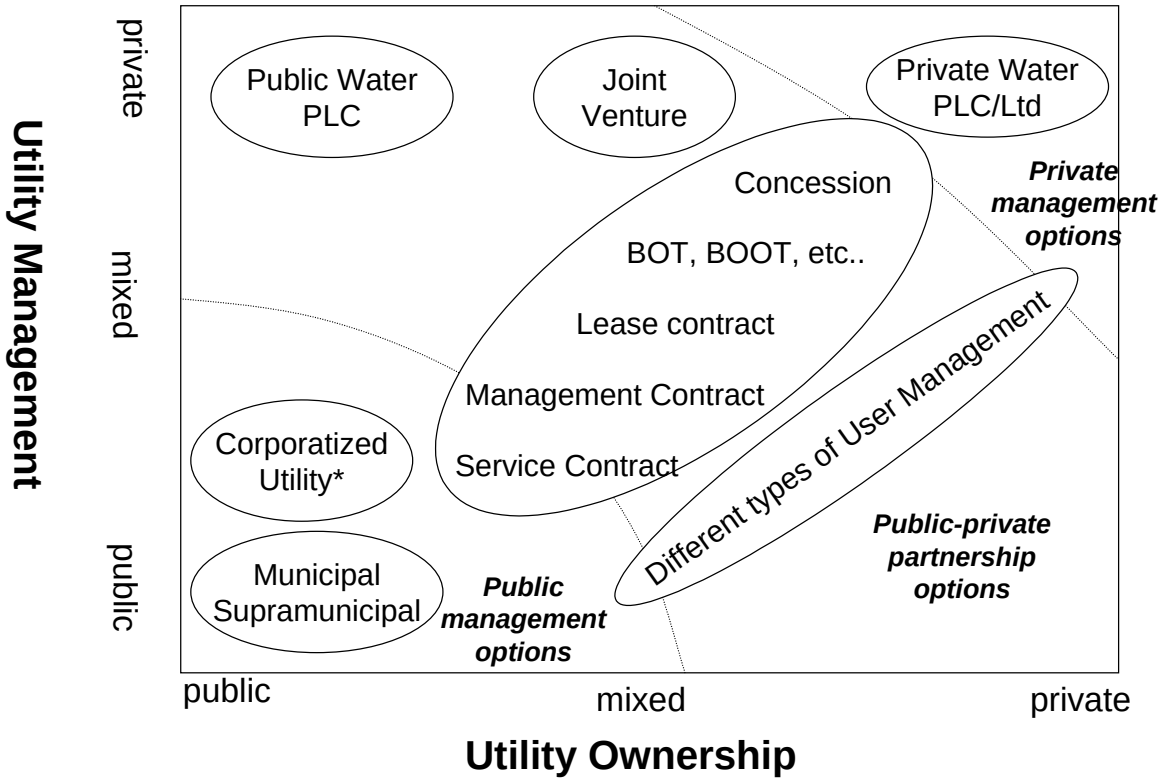
The IHE taxonomy of organisational modes is described in the following table and diagram.

Table 4 Water supply sector organisation: Five basic modes

Mode of organisation	Who owns infrastructure?	Who operates infrastructure?	Legal status of operator	Legal framework	Who owns the shares
Public Utility – local	Local (municipal) government	Municipal administration	Municipal department	Public law	Not applicable
Public Utility – supra-local	National and provincial government	National and provincial administration	National and provincial department	Public law	Not applicable

Mode of organisation	Who owns infrastructure?	Who operates infrastructure?	Legal status of operator	Legal framework	Who owns the shares
Corporatised Utility*	Government or utility	The corporatised utility	Parastatal, usually defined by special law	Public law	Not applicable
Public-Owned PLC*	Government or utility	A PLC as permanent concessionaire	Public Limited Company	Company law	Local/provincial government
Delegated Private Utility	Any combination of government agencies	Government and temporary private concessionaire	Public Limited Company	Company law	Private shareholders
Direct Private Utility	Private agents	Private company	Public Limited Company	Company law	Private shareholders

Figure 8 Basic modes of water sector organisation (IHE, 2001).



* The IHE term for 'corporatised utility' corresponds with the South African use of the term 'parastatal'. The IHE use of 'Public-owner PLC' corresponds with the South African 'corporatised entity', generally as a Pty. (Ltd) under the Companies Act.

The IHE defines a *corporatised utility a*s a "management mode whereby a direct public utility operates as a quasi-corporation. The corporatised utility is variously called a water board, a corporation, or authority, and is known in Africa under the generic name of parastatal. The essence of a corporatised utility is that the utility enjoys autonomous corporate status under a special law or act drawn up specifically for the utility in question. The corporatisation act normally specifies the tasks and responsibilities as well as the powers vested in the utility. In practice, these utilities can be more accurately described as quasi-corporations. For one, they are not constituted as stockholding entities but tend to be governed by boards composed of senior government officials. For another, the fact that they are subject to public law means that they remain firmly rooted in the public sector" (IHE, 2001:7).

The IHE defines a *Public Water PLC* as "a mode of organisation where the utility is incorporated as a limited company under company law, but where its stocks are owned by local, provincial, or, less frequently, national government representatives. The essence of the Public Water PLC is that it uses company law as a buffer, shielding the water services business from burdensome public sector rules and regulations" (IHE, 2001:12).

2.7 A working definition of corporatisation

For the purpose of this project then, we take as a working definition that corporatisation of municipal water services entails:

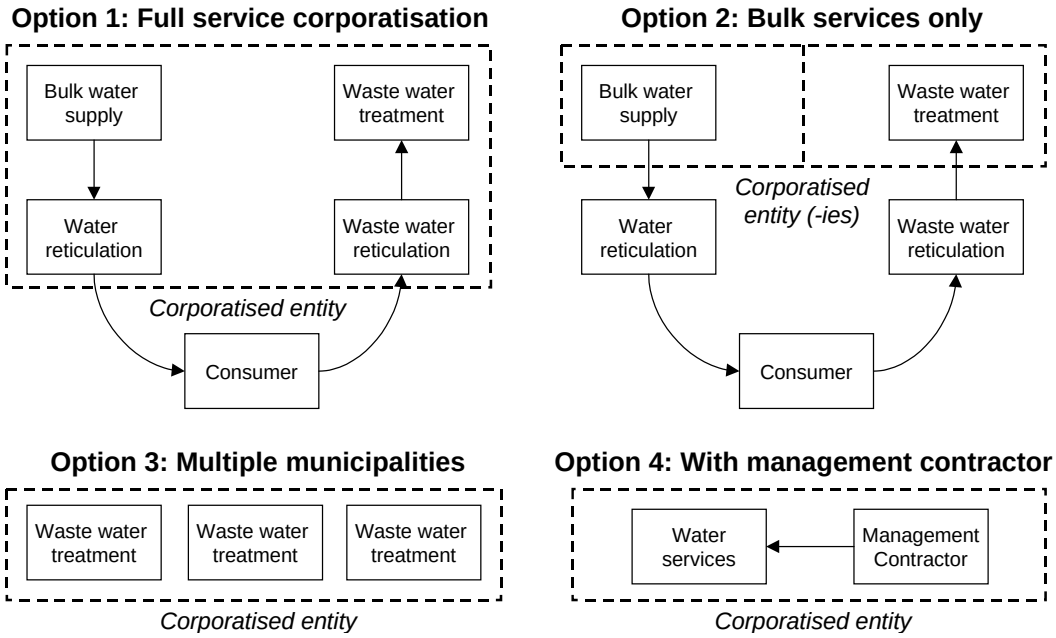
> The creation of a separate, legal, 'corporatised' entity, owned and governed by one or more municipalities, with the explicit objective of providing water services to some or all of the municipality's water users. The corporatised entity may enter into a range of contracts with private or public partners to facilitate service delivery.

Perhaps the greatest area of uncertainty within this definition is the issue of *control*, as manifested through the regulatory relationship whereby the municipality governs the actions of the corporatised utility and its subsidiary partnerships.

2.7.1 Simplified corporatisation options

For the purpose of introducing the concept of corporatisation it is useful to consider four broad options as follows.

Figure 9 Simplified corporatisation options.



Option 1: involves the corporatisation of the full water service. A South African example of this option would be Johannesburg's water company (although it actually receives bulk water supplies from Rand Water Board).

Option 2: involves the corporatisation of a single element of the water service (or perhaps two elements). A South African example of this option would be the Cape Metropolitan Council's (unimplemented) decision to corporatise its bulk water and wastewater services.

Option 3: involves the corporatisation and merger of water service elements across a number of municipalities. A South African examples of this option would be Erwat, the East Rand wastewater treatment utility.

Option 4: involves the use of a management contractor with the corporatised water service. A South African example of this option would be Johannesburg's water company. This option need not differ in legal terms from options 1-3, but is worth considering since it is distinctly different from the other options.

Many other combinations are of course possible. These four simplified models are presented to demonstrate the wide range of forms that corporatisation can take.

This then completes the section on what corporatisation may be *defined* as. The next section reviews international *experience* with corporatised water services.

3 International Case Studies

3.1 Introduction

This section of the report addresses the second research question:

> Q2. What is the international experience of corporatised municipal water service providers?

The following review of international case studies describes examples of corporatised utilities reported in the water service and local government literature, in order to generate insights into the factors which lead to success or failure of corporatisation initiatives, as the case may be. It should be noted that 'success' and 'failure' are relative and subjective judgements, and that these case studies have been written on the basis of limited information.

Case studies were selected from a range of countries and continents, with the deliberate intention of including a sample of low, middle and high income countries.

Table 5 Selection of international case studies.

Low income countries	Middle income countries	High income countries
▪ Uganda ▪ Ghana	▪ Botswana ▪ Eastern Europe ▪ Chile	▪ Australia ▪ United States

A summary of the key learning points from each case study is presented at the end of this section.

3.2 Uganda

3.2.1 Sector overview

Uganda is largely rural, with only about 12% of the population urbanised. About 33 of the largest urban centres display truly urban characteristics, whilst the remaining are typically small urban core centres surrounded by low density settlements. This makes the urban water sector small in comparison to other countries, with approximately 46 000 active water connections and a total revenue of about $16 million per annum. (Consult 4, 2000).

The country is poor with a GNP per capita of $900 per annum in 1997 (compared to $3300 for South Africa).

The National Water and Sewerage Corporation (NWSC) is a public utility (parastatal) 100% owned by government. It was formed over a decade ago, initially to manage the water services in Kampala and a few of the other large towns in Uganda. Currently it is responsible for water supply and sewerage services for 12 towns. The NWSC is managed by a board of directors who are appointed by the Minister of Lands, Water and Environment (MWLE). The NWSC is nominally regulated by MWLE but there is not a strong emphasis placed on regulation at present.

3.2.2 Performance

Key performance indicators are given in the following table:

Table 6 Key performance indicators for Ugandan National Water and Sewerage Corporation.

Performance Indicator	Value
Population served	1.8 million
Volume produced	45.6 million m^3 per annum
Volume billed	24 million m^3 per annum
Unaccounted for water	47%
Average tariff	US$ 0.70
Number of customers	36,000
Metering ratio	80%

The performance of NWSC is poor when compared to best-practice in Africa. Key operational indicators for NWSC in relation to African best practice are highlighted in the following table. The estimated operational savings which could have been achieved through increased efficiency in the last few years are $10 million per annum.

Table 7 Operational indicators compared to African best practice.

Performance Indicator	Unit	Best practice A	Uganda B	% inefficiency compared to best practice	Estimated current cost of inefficiencies (US$ million)
Operations					
Billing efficiency	%	75%	50%	**33%**	8
Collection efficiency	%	95%	61%	**35%**	5
Operating costs	US c/m^3 sold	35	59	**69%**	3
Sub-total (operations)					10
Investment costs	$/connection	600	1160	**93%**	37 (cum total) 1.8 to 3.6 (pa)
Staff	per 1000 connections	6	23	**283%**	

3.2.3 Advantages of corporatised structure

Notwithstanding the poor performance of the NWSC relative to best practice, the corporatised structure does have a number of advantages:

- It captures *relative economies of scale*: scare management skills are concentrated and applied to the whole urban sector
- It allows for a certain amount of *transparency*: the performance of NWSC is reported for all to see and finances are ring-fenced (although some of the interest-rate subsidies from government are not that transparent.
- It allows for the establishment of a *clear contract* between government and the utility (although this has not been well done in the case of NWSC).

3.2.4 Disadvantages of corporate structure

Not all of the potential advantages of the corporatised NWSC have been realised. Appointments to the NWSC board, and within NWSC itself, have been subject to political interference. The board has not acted in the best interests of consumers. Managers have not been given effective incentives to perform, resulting in a situation where the NWSC is poorly managed and over-staffed. Although, in theory, these shortcomings can be addressed through public sector reform (for example by putting a performance contract in place between government and NWSC) a recent policy review concluded that some form of privatisation (through a lease or concession contract) was much more likely to succeed in improving

performance than public sector reform. The key advantage of private sector involvement was seen to be the requirement that clear governance relationships are established. These allow managers to manage within a defined mandate and incentive structure, and free them from undue political interference.

3.3 Ghana

3.3.1 Sector overview

In 1965 the then Water Supply Division of the Ministry of Works and Housing was transformed to a public utility called the Ghana Water and Sewerage Corporation (GWSC). The GWSC was made responsible for planning, constructing and operating water supply and sewerage systems in the country, and revenue collection. (Consult 4, 2000).

Water supply systems deteriorated rapidly during the economic crisis of late 1970s and early 1980s, and by the mid 1980s the economic recovery programme included the reform of public enterprises. Since the early 1990s the government has undertaken a number of studies and rehabilitation projects, focussing mainly on the institutional strengthening of GWSC and restoring lost capacity.

In 1994 further steps were undertaken to restructure the sector, with a particular focus on Private Sector Participation (PSP). The drivers of this initiative were poor sector performance, limited access to funds, and donor pressure.

In the last few years, a number of measures have been taken in the water sector:

- A change in legal status of the GWSC into a limited liability company, now known as Ghana Water Company Limited (GWC).
- The establishment of the Community Water and Sanitation Agency (CWSA) to address the water and sanitation needs of the rural population.
- The transfer of systems to local communities within District Assemblies. This process has been completed.
- The establishment of the Public Utilities Regulatory Commission (PURC), which is responsible for tariff setting and the regulation of utility companies.
- The establishment of the Water Resources Commission to be responsible for the management of water resources.
- A decision to pursue Private Sector Participation in the urban water sector in order to improve the efficiency and financial viability of the sector.

Currently, the responsibilities vested in the original GWSC are being devolved, with the result that:

- GWC has become accountable for water in about 110 urban systems (initially they had 250 systems classified as urban but many have been transferred to rural).
- Responsibility for sewerage has been given to local government, with a number of different providers active in this sector.
- The CWSA has become responsible for overseeing supply to communities of under 5 000 population and supporting both small settlements/towns and rural water. A Water Restructuring Secretariat has been established to oversee the process of reform.

3.3.2 Ghana Water and Sewerage Corporation

In 1999, GWSC operations reflected the following:

Table 8 Key performance indicators for the Ghana Water and Sewerage Corporation.

Performance Indicator	Ghana (GWSC)	Uganda (NWSC)
Population Served	8.2 million	1.8 million
Volume produced	192 million m^3 per annum	45.6 million m^3 per annum
Volume billed	86.5 million m^3 per annum	24 million m^3 per annum
Unaccounted for water	55%	47%
Demand	222 million m^3 per annum	
Average tariff	US$ 0.43	US$ 0.70
Number of customers	250,700	36,000
Metering ratio	46%	80%

3.3.3 Regulatory environment

The Public Utilities Regulatory Commission (PURC) was established in 1994, driven mainly by the needs of the electricity sector with water supply included later. The main functions of the PURC are to:

- Provide guidelines on rates chargeable for provision of utility services.
- Examine and approve rates chargeable for provision of utility services.
- Monitor standards of performance for the provision of services
- Protect the interests of consumers and utility providers.
- Promote fair competition among public utilities.
- Conduct studies relating to economy and the efficiency of public utilities.

3.3.4 Key learning points from Ghana

- Multi-sector regulation is possible and appears to be working.
- The separation of water services from sanitation services is a matter of debate, with the risk that sanitation will not receive adequate attention.
- Asset ownership must be clear.
- Financial sustainability seems more possible in the large urban centres, as well as for community (point source) level, but remains problematic for small piped water systems.
- Service planning needs to be undertaken together with local authorities and must aim to achieve appropriate integration with other services.
- To succeed, organisational reform requires a strong independent reform unit, with a clear mandate, adequate funds, and with the standing and influence to implement the necessary actions. Reforms must be undertaken with due consideration for stakeholder management, communication, public relations, and the building of maximum consensus. Although the reform unit may be accountable for facilitating and co-ordinating reform, it really acts as a mandated agent of the stakeholders, and will only succeed if it gives top priority to working with stakeholders – and especially key opinion leaders (political and bureaucratic).
- Reform requires a political champion, with a clear vision for the future, who transcends the immediate stakeholders, and who fully appreciates the commercial and social imperatives of the reform.
- Plan, but do not underestimate the effort it will take to implement changes.

3.4 Botswana

3.4.1 Sector overview

The Water Utilities Corporation (WUC) was established in Botswana to provide water supply services to the major urban areas of the country: Gaborone, Francistown, Jwaneng, Lobatse and Selebi-Phikwe (PDG, 1994).

3.4.2 Characteristics of the WUC

Based on information from research undertaken in 1994 the WUC statistics are as follows:

Table 9 Key performance indicators for Botswana's Water Utilities Corporation.

Performance Indicator	Botswana (WUC)
Population Served	0.28 million
Volume produced	23 million m^3 per annum
Volume billed	19 million m^3 per annum
Unaccounted for water	13%
Employment	713 (24 per '000 connections)
Number of customers	29 000

It is notable that the WUC deals only with water supply to areas considered to be viable. Sanitation is the responsibility of local government. The Corporation runs a 'source to tap' service and is responsible for the development of water resources (primarily dams), transfer of water for relatively long distances and distribution to consumers.

3.4.3 Governance

The WUC is owned by the state and has a board which is appointed by the state, including a mix of business people and politicians. It has strong management with 8 of the 10 senior positions, including the CEO, being Batswana.

3.4.4 Financial aspects

The WUC applies a rising block tariff which, in relation to South African tariffs, was high in 1994. It is speculated that this relates partly to the water scarcity in the country and partly to high operating costs (high levels of employment).

The WUC applies a very strict credit control regime, with users cut off if they do not pay monthly bills and with relatively high re-connection charges. This assists in maintaining a strong financial position. For example, net surplus in 1991/92 was 11%. The Corporation raises its own loans on the international market.

3.4.5 Regulatory environment

At the time (1994) the WUC was regulated by national government. There was no specific regulatory unit established and regulation could be considered to be weak.

3.4.6 Key learning points from Botswana

A state-owned enterprise can be successful in providing urban water supply services, even in a small country with a weak regulatory environment. However, controls over tariffs and limits to operating expenditure appear to be weak.

External factors which promote success can be identified as:

- the existence of a strong economy;

- a stable political environment; and
- the availability of good managers.

Internal factors which seem to be important include:
- a board which supports a business-like approach; and
- sound management practices.

3.5 Chile – Santiago

3.5.1 Sector overview

Santiago provides a good case study for the purposes of this report as it has been served by a public enterprise known as EMOS, for several decades (Shirley *et al*, 2000a, is the primary source for this case study).

There have been considerable changes over this period which have impacted on the way EMOS functions and in fact there is now an initiative to privatise the entity. However, the best experience in relation to this study on corporatisation comes from the post-1990 era after major sector reforms were implemented.

3.5.2 Characteristics of EMOS

Table 10 Key performance indicators for Santiago's EMOS.

Performance Indicator	Santiago (EMOS)
Population Served (water)	4.8 million (1990)
Unaccounted for water	20% (1996)
Collection rates	>80%
Employment	1.76 per '000 connections (1996)
Number of customers (water)	1 040 000 (1996)
Metering ratio	> 95%

EMOS provides both water supply and sanitation services and the coverage with connections is high (>95% in both cases). However, it is notable that in 1990 only 1% of the wastewater flow was being treated, leading to strong environmental concerns. It is also notable that Santiago has access to relatively low cost water which facilitates the financial sustainability of the water supply operation.

EMOS is state-owned and it is not clear what it's relationship is with the municipality. It has a board which is appointed by the state.

3.5.3 Characteristics of reform

In order to understand the substantial improvement in EMOS' performance over the 1990s it is necessary to understand the process of reforms which were introduced in the early part of the decade.

- There was a clear commitment from the government to reform public utilities with an emphasis on coverage, quality of services and sustainability.
- The reforms were driven by changes in the regulatory environment (see below). They resulted in improved coverage and reduced unaccounted for water.
- Reforms lead to rapid tariff increases, accompanied by subsidies for poor households (60% of the cost of the first 20 kiloliters for qualifying households).

- EMOS achieved better accounting systems, greater competition (with the expectation of privatisation) and better supervision systems. Management performance improved, partly due to bonuses incentives relating to increasing rates of return. Workers bought into reforms due to commitments to secure positions.

3.5.4 Regulatory environment

The regulatory environment has been central to stimulating reform within EMOS. This environment is characterised by:

- A regulatory system designed for a private firm but applied to a state owned enterprise. (Shirley et al point out that while this is not a panacea it has worked in Chile).
- An independent, sector-specific, regulatory agency, the Superintendency of Sanitary Services (SSS).
- A contract between the regulatory agency and EMOS.
- Good quality professional staff in SSS, arising from their ability to offer competitive remuneration, which has given them the confidence to relate to water companies on a equal footing.
- The regulatory contract provides for neutral and automatic enforcement. There is a right of appeal against a decision by regulator.
- A sound system of setting tariffs – tariffs are based on a marginal cost analysis with a target rate of return. There is little regulatory discretion with regard to tariff calculations – a financial model is used to set tariffs and this can not be easily manipulated. Tariff setting is undertaken every five years and the tariff increases are capped for the five year period.

3.5.5 Key learning points from Santiago

- By the standards of corporatised entities in middle income countries the performance of EMOS has been exceptional. This is due to a large extent to the sound regulatory arrangements and to incentives that management have to perform in order to delay the intended introduction of privatisation.
- Other factors which have played an important role are the norms and traditions of professionalism and honesty in Chile's civil service. EMOS has a history of good performance prior to the 1990 reforms.
- The freedom given to a good CEO to recruit managers.
- The strong emphasis the organisation has placed on outsourcing.

3.6 Eastern Europe

3.6.1 Sector overview

Eastern European countries are of interest in that they are in a similar national income group to South Africa. However, it has not been possible to locate an adequately documented case study in Eastern Europe. A brief overview of the approach to 'corporatisation' in the region is provided by Kingham (personal communication, 2000).

> The general trend in Eastern Europe (though it varies in detail from country to country), has been a transfer of responsibilities from centrally funded and managed services, to municipalities. The management of services is typically in the hands of municipal water companies (non profit making).
>
> In *Bulgaria* for example these companies (or ViKs) have been set up as limited liability companies owned 51% by the Ministry of Regional Development, and the rest by the municipalities served by the ViK. This is called "privatisation". The municipalities can

agree to sell part or all of their holding in the ViK. In Sofia, the capital, the ViK claims to have been established in 1884, and until recently was said to be a joint stock company wholly owned by the Municipality (with no state government ownership). This year they set up a water services company 49% municipal owned through ViK and 51% private shareholding.

In *Romania*, the water services companies are wholly financed and the assets owned by the municipalities, but with the possibility of establishing companies in which a private partner brings new capital to secure at least 51% of the value of the company. There are few examples where this has happened due, in part at least, to the fact that significant EU investment finance is now available and it is a lot easier to secure the needed transparency over the use of this taxpayers money where ownership remains in public hands.

In *Poland* the route seems to be to set up joint stock companies with the prospect of part private ownership, though with the exception of Gdansk 8 years ago (51% ownership by Saur), the level of private ownership is mostly zero, or at a very low level. In the *Czech Republic* there are 30 or more such companies".

3.6.2 Key learning points from Eastern Europe

The key point emerging from this brief overview is that a strong emphasis is being placed on local water service entities with part public/private ownership. The extent to which the private partners have a positive influence is not clear, although it would be anticipated that they would bring expertise and finance to the municipal water sector.

3.7 Australia

3.7.1 Sector overview

Since the mid 1990s Australia has undertaken a substantial overhaul of its water services system. This has involved the establishment of publicly-owned water and sewerage utilities overseen by new state (sub-national) regulatory bodies. The focus of this brief review is on Melbourne (Victoria Regulator, 1999 and PDG, 2000) and Western Australia (Patrick and Meinck, 1997).

3.7.2 Melbourne re-structuring

In Melbourne public sector reforms saw the restructuring of metropolitan water services in 1994 when the Victoria Government launched a program to transform the water industry in order to increase efficiency, maximise benefits to consumers and reduce the State's debt burden.

As of early 1995, Melbourne water was split into five government-owned businesses, including the Melbourne Water Corporation, Melbourne Parks and Waterways, and three retail water and sewerage companies. The three retail water and sewerage companies include City West Water, South East Water and Yarra Valley Water. Each of these companies is government-owned and has a customer base determined by its allocated geographical area. Each company is required to operate on commercial principles and is responsible for retail water supply to customers and sewage collection and treatment. The companies do not compete directly for each other's customers but they do compete by comparison.

Melbourne Water Corporation is responsible for water collection, storage and wholesale activities and for the operation of major sewage treatment and drainage facilities.

3.7.3 Characteristics of Yarra Valley Water

Table 11 Key performance indicators for Melbourne's Yarra Valley Water.

Performance Indicator	Yarra Valley Water
Volume billed	489 000 Ml/yr
Unaccounted for water	17%
Employment	320 (0.6 per '000 connections)
Number of customers (water)	523 000
Metering ratio	>95%

It is notable that Yarra Valley Water undertakes retail water supply and sewerage activities and does not provide bulk services. The utility's financial results are good, with a profit before tax of 23%. The high level of performance achieved by Yarra Valley relates partly to the regulatory environment it operates under but, more importantly, to the application of effective management systems with strong emphases placed on outsourcing, employee incentives and comprehensive information.

3.7.4 Regulation in Melbourne

The Office of the Regulator-General, Victoria was established as an independent regulator in 1994. The objectives of the Office include:

- Promoting competitive market conduct;
- Preventing misuse of monopoly or market power;
- Facilitating entry into the relevant market;
- Facilitating efficiency in regulated industries; and
- Ensuring that users and consumers benefit from competition and efficiency.

The Regulator-General is independent of the government and of the industries regulated by the office. This independence is protected by an Act of Parliament. The Office covers a range of sectors including electricity, water, grain, ports, gas, and rail. The Office is empowered by legislation to issue licences. These licences include conditions that require the water companies to observe standards and conditions of service and supply which enable the Office to regulate the companies' market conduct. Each customer of a retail company is deemed to have entered into a contract with the company. The regulator, along with the retail companies and customer representatives have developed a Benchmark Customer Contract and a Benchmark Customer Charter (a summary of the former). The retail companies report to the regulator annually against these benchmarks.

A feature of the regulatory framework in Melbourne is the notion of 'Competition by Comparison'. The aim of this process is to stimulate competition and to inform customers about the service levels they receive.

A performance report is published annually by the regulator comparing the performance of Melbourne's three retail water and sewerage licensees. The performance report focuses on the key customer service issues of :

- Water and effluent quality;
- The reliability of water and sewerage services; and
- The affordability of services.

The report is largely based on two sources of information, performance data reported by the licensees against performance indicators specified by the office, and the findings of

operational audits. The operational audits provide independent expert assurance that the licensees are complying with the performance requirements and are reporting reliable performance data to the regulator.

3.7.5 Western Australia

The Water Authority of Western Australia is included because it is a corporatised water services provider and because it operates over a wide geographic area. An overview of its situation is quoted from Patrick and Meinck.

> Until January the Water Authority of Western Australia had many similarities and some differences from a typical North American water utility. Up to then, the authority was responsible for managing the entire water cycle for Western Australia. This included water resource allocation, water treatment and distribution, and wastewater collection and treatment. However, the water utility functions were virtually the same as a typical North American water utility.
>
> The authority was and remains a publicly owned enterprise and a competent supplier of water and related services. It serves a population of 1.7 million, covers a geographic area of 2.6 million sq. km and has total revenues of US$600 million. It is organised into geographic regions that deliver services to customers and corporate divisions that supply centralized services, such as finance and planning.
>
> Like many North American water utilities, the authority in the mid-1990s was under pressure to improve its performance. During the previous few years, reforms had been implemented steadily, especially with regard to labor productivity. For example, international benchmarking had been used to identify potential efficiency improvements of between 12 and 30%, and their implementation was in progress. Being under direct control of elected officials, however, placed limitations on the authority's freedom to set aggressive, customer-focused agendas for change.
>
> The state government was convinced that the authority still had room to substantially improve its efficiency, and the government desired greater involvement of the private sector in the water industry. It demanded more far reaching and rapid reforms (Patrick & Meinck, 1997).

Patrick and Meinck's opening statement contains some ambiguity regarding the role of owners. However, the main point is that the owners (the state government) were committed to re-structuring the organisation on commercial lines. A major initiative was undertaken to achieve this transformation. This has been based primarily on the application of advanced management techniques, with a strong emphasis on outsourcing and good information.

The role of the regulator in Western Australia is not well documented. Nonetheless, Patrick and Meinck note the important role the regulator needs to play. It is also notable that the water utility is not directly responsible for implementing social objectives. This is done through subsidies from the state or municipality.

3.8 United States of America

The United States is a particularly fruitful country for assessing the relative merits of different forms of water services providers since there are a large number of active water service providers, with a wide variety of ownership and governance forms, and extensive public reporting systems. At the same time it must be acknowledged that whilst a lot has been

written on the comparative benefits of privatisation little research appears to have been published on the relative merits of public ownership models.

A 1998 survey carried out by the American Water Works Association of all its members is the most instructive resource located by the survey (AWWA, 1998). Responses to specific questions are listed below:

Table 12 AWWA survey – Utility type.

What is the utility type?	% of Total
City Department	**34**
Special Authority or District	**11**
Metropolitan Authority or District	**3**
County Department	**11**
Independent Municipal Corporation Chartered by the State	**31**
Private (investor-owned)	**3**
Co-operative	**0**
Other *(Specify)*	**9**

It would appear that at least 31% of utilities fall into the category of independent municipal corporations.

Table 13 AWWA survey – Utility governance.

Which of the following best describe the utility's governing body?	% of Total
Strong mayor	**9**
Strong city or county manager	**9**
City council	**11**
County commission	**3**
Independent elected board	**9**
Elected board	**17**
Other (Specify*)*	**43**

Unfortunately, from this point of view of this study, there is no indication of what the rather large 'other' category includes. It may well include appointed, rather than elected, boards or some combination of these options.

The respondents were also asked about the private partnerships (P3s in some US literature) that the utility was engaged in. Responses indicated that some 71% of utilities had employed a partnership of some sort, with the following spread.

Table 14 AWWA survey – Partnerships.

If yes, which type(s) of P3 was involved?	% of respondents
Organisational development	**43**
Outsourcing of administrative services	**29**
Outsourcing of operations	**17**
Outsourcing of maintenance	**40**
Alternative project delivery (e.g., design/build)	**29**
Transfer of specific utility assets	**0**
Full transfer of all utility functions	**9**
Other *(Specify)*	**-**

The strong response to 'organisational development' relates to the extensive use made in the US of new management techniques to improve performance. It is evident from this response

that a wide variety of techniques are employed in the US to utilise the private sector for improved performance, but generally under the control of the utility.

With regard to future trends, a question was asked about the perceived ability of partnerships to achieved improved performance:

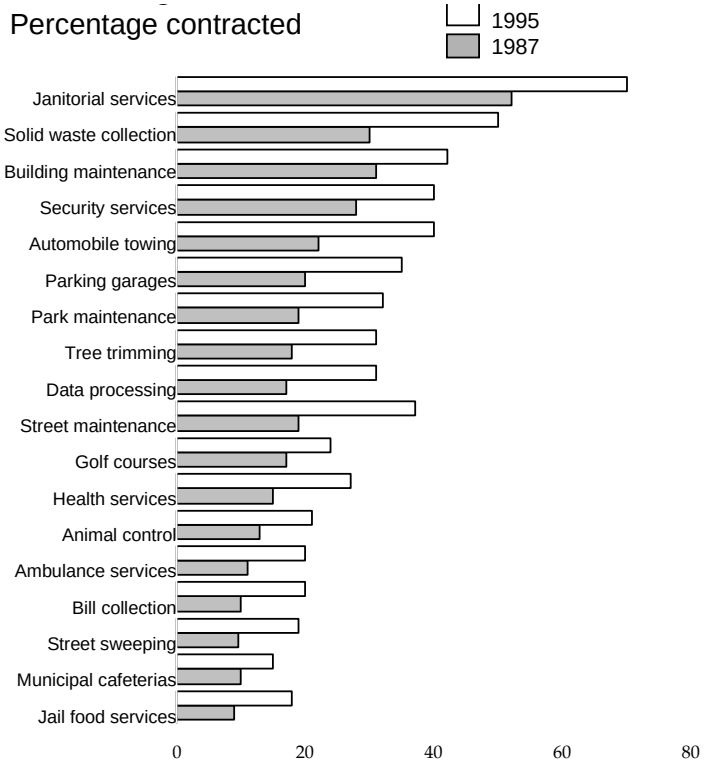
Table 15 AWWA survey – Perceived partnership benefits.

Rate the following P3 alternatives, in terms of their ability to help water utilities remain competitive: ***(Rating from 1 to 7)***	**Average Rating**
Organisational development	**5.0**
Outsourcing of administrative or maintenance services	**4.8**
Outsourcing of operations	**4.5**
Alternative project delivery (e.g., design/build)	**5.0**
Asset transfer	**3.0**
Full privatisation	**3.4**
Other *(Specify)*	**-**

Again there is clearly confidence in the benefits of organisational development techniques and the outsourcing of various activities. The positive response to the outsourcing of operations is also notable, as is the relative lack of interest in asset transfer and full privatisation options.

The AWWA toolkit presents further evidence of the trend to contracting out public services within the USA (in all service sectors, not just water services).

Figure 10 Contracting public services (AWWA, 2000).



Source: Mercer Group; "The Privatization Advisory Report for the Mayor-Elect Rudolph Giuliani," December 1995; Reason Foundation

3.8.1 Competition strategies for publicly owned entities

An approach to improving the performance of publicly owned entities by subjecting them to competitive pressures has been reported by Pontek & Wehmeyer (1997) and Gullet & Bean

(1997). This approach entails putting the responsibility for the provision of all or part of a service out to public tender and requiring the existing (publicly owned) utility to bid against private sector competitors. In both of these cases the public utility won the bidding, a process which provided a major catalyst for performance improvement.

3.8.2 Regulatory framework

Gray (1996), in an important reference comparing regulatory practice internationally, notes that in the USA local utilities 'accept some form of regulation in exchange for their monopoly status'. This regulation is exerted by 46 state public utility commissions. These commissions exert control over water rights and price setting. Some of them also control issues such as ownership. They may require reporting by the water utilities.

Due to the variety of conditions in the US, and the constraints of this study, it is not possible to be specific about the effectiveness of regulation in that country. However, it is speculated that the requirements of owners and management's own drive for improved performance play a stronger role in promoting efficiency that the regulators.

3.8.3 Key learning points from the USA

Corporatised utilities are utilised widely in the USA. While there is a trend towards greater use of the private sector in water service provision it is evident that there a large proportion of water utilities are publicly owned and are functioning effectively. The factors which influence performance are complex and, while ownership and legal form are important, they are clearly not the only factors nor necessarily the most important. Of course it must be recognised that the USA has a very competitive business environment and that the standard of management is high. Lessons from the USA will therefore have limited application in middle to low income economies.

3.9 IHE perspective on corporatised entities

The IHE has undertaken extensive research into corporatised entities (referred to as Public water PLCs in IHE terminology). The following sections summarise their findings on the distribution and experiences of this mode of water utility management.

3.9.1 Distribution of corporatised water service utilities

The IHE reports that corporatised water service utilities are quite common in Western Europe, where they can be found in Germany, the Netherlands, Belgium, as well as in the Scandinavian countries. They also occur in the United States where the term Municipal Stock Corporation is used.

For reasons which are unclear to the IHE, corporatised water service utilities are only sparsely distributed in the developing world, with the Water Districts of the Philippines, and the Public Stock Corporations of Chile as the best known examples. The IHE see two possible reasons for this trend.

1. Developing countries may confuse corporatised entities with parastatals and direct public utilities.
2. This mode of water utility management is not 'self-exporting' as neither operators nor owners of Public Water PLCs have an interest in marketing the model overseas. This arises from the constraint of company by-laws which often restrict operators from expanding their activities beyond the service area, or beyond the core business of water and sanitation services. This condition arises because shareholders, representing the

interests of local customer constituencies, tend to be unenthusiastic about risky overseas adventures.

3.9.2 Benefits of corporatised water service utilities

Based on their accumulated experience, the IHE sees the following benefits arising from the mode of corporatised water service utilities:

- The use of company law to insulate water utilities from unwarranted political interference is generally successful in that Managing Directors of corporatised water service utilities have substantially more autonomy than their colleagues in parastatals and direct public utilities;
- The cost recovery and operational performance of corporatised water service utilities is significantly better than that of their public counterparts. For example, Dutch Public Water PLCs are on a par with delegated and direct private utilities in the United Kingdom and France in terms of water prices, labour productivity and leakage control. Likewise, the Philippines variant of the corporatised water service utility performs better on various counts than the model Asian water utility; and
- The fact that the corporatised utility's owners show no interest in profit maximisation — although they do insist on full cost recovery — curtails the monopoly exploitation problems inherent in the French and British models (IHE, 2001:13).

3.9.3 Drawbacks of corporatised water service utilities

On the negative side, IHE notes that:

- The managerial autonomy enjoyed by corporatised water service utilities can lead to over-engineering or gold-plating, especially in utilities where staff is strongly engineering-oriented. This is not a major problem since the result is merely better quality (and more expensive) water services for utility customers. The problem can be addressed through price regulation, as in the case of Chile, or by appointing independent accounting and sanitary engineering professionals to the Board of Directors, as is increasingly happening in the Netherlands;
- Utility management may be captured by political interests, presumably leading to unsound, inequitable or short-term decision-making;
- Corporatised water service utilities may have limited access to investment capital, presumably because shareholders tend to contribute low levels of equity, thus leading to a greater reliance on debt and poor credit ratings; and
- Shareholders may have limited expertise, and thus limited ability to contribute to decision-making.

3.10 Summary of international case studies

We have reviewed seven countries and eight utilities. All utilities meet the criteria of being 'corporate' entities, although the majority are owned/controlled by national or state governments, rather than municipalities.

Table 16 Overview of international case studies.

County	Income level	Utility	Owner/Controller
Uganda	Low	National Water and Sewerage Corporation (NWSC)	National government
Ghana	Low	Ghana Water Company Ltd (GWC)	National government
Botswana	Middle	Water Utilities Corporation (WUC)	National government
Chile	Middle	Santiago, EMOS	State government (?)
Eastern Europe	Middle	N/A	Transfer from national to municipal. Trend towards private partnerships

County	Income level	Utility	Owner/Controller
Australia	High	Melbourne, Yarra Valley Water	State government
Australia	High	Water Authority of Western Australia	State government
USA	High	N/A	Wide variety, public and private

The key learning points from the eight international case studies are summarised below.

Table 17 Summary of key learning points.

City/Utility/County	Key learning points
Uganda National Water and Sewerage Corporation (NWSC)	Corporatisation has assisted the NWSC to: ▪ Capture economies of scale, particularly scare management skills ▪ Facilitate transparency through ring-fencing (but not completely) ▪ Establish a clear contract between government and the utility (although not well). Failings of the corporate structure include: ▪ Political interference with Board and internal appointments ▪ The board has not acted in the best interests of consumers ▪ Lack of management incentives ▪ Moves towards lease/concession
Ghana Ghana Water Company Ltd (GWC)	Key features: ▪ Multi-sector regulation is possible and appears to be working. ▪ Difficulties with asset ownership. ▪ Difficulties with service planning ▪ Difficulties with completing organisational reform – stakeholder management and political backing.
Botswana Water Utilities Corporation (WUC)	Key features: ▪ Successful state-owned urban water enterprise, under a weak regulatory environment. ▪ High tariffs and operating expenditure. Key *external* success factors: ▪ the existence of a strong economy; ▪ a stable political environment; and ▪ the availability of good managers. Key *internal* success factors: ▪ a board which supports a business-like approach; and ▪ sound management practices.
Chile Santiago, EMOS	Key features: ▪ exceptional performance for a middle income country. Key success factors: ▪ Sound regulatory arrangements ▪ Management incentive to delay intended privatisation. ▪ Norms and traditions of professionalism and honesty in civil service. ▪ CEO's freedom to recruit managers. ▪ Strong emphasis on outsourcing.
Eastern Europe	Key features: ▪ Strong emphasis on local water service entities with part public/private ownership.

City/Utility/County	Key learning points
Australia Melbourne, Yarra Valley Water	Key features: ▪ Strong regulatory environment. ▪ Competition by Comparison – stimulates competition and informs customers about the service levels. Key success factors: ▪ Regulatory environment ▪ Application of effective management systems. ▪ Strong emphases on outsourcing, employee incentives and comprehensive management information.
Australia Water Authority of Western Australia	Key features: ▪ The state government (owners) is committed to re-structuring the organisation on commercial lines. ▪ Strong emphasis on outsourcing and good management information. ▪ The water utility is not directly responsible for implementing social objectives. These are achieved through subsidies from the state or municipality.
United States of America (No particular utility)	Key features: ▪ In 1998 at least 31% of utilities are independent municipal corporations with a wide variety of governance arrangements ▪ In 1998 some 71% of utilities had employed a private partnership of some sort, but generally under the control of the utility. ▪ Extensive use is made of 'organisational development' through new management techniques to improve performance ▪ Clear confidence in the benefits of organisational development techniques and outsourcing. ▪ Relative lack of interest in asset transfer and full privatisation options. ▪ The factors which influence performance are complex and, while ownership and legal form are relevant, they are clearly not the only factors nor necessarily the most important.

3.10.1 Summary of key case study findings

To summarise the key insights from the international case study reviews then:

1. Corporatised water service utilities exist world-wide. In fact the use of separate legal entities is not uncommon in low, medium and high income countries, although perhaps less prevalent in low income countries.
2. The corporatisation of water services does not, however, guarantee success in its own right (Uganda and Ghana prove this).
3. Utilities succeed or fail for a wide variety of reasons. Success requires a combination of factors, especially good governance, managerial independence – and a measure of luck.
4. The regulatory framework is important, but will not in itself ensure a positive outcome. For instance Botswana has a very weak regulatory environment while Melbourne has a very strong regulator yet both are successful utilities. Both attribute their success, in part, to sound management practices.
5. A trend amongst corporatised utilities is improve service delivery through increasing involvement of the private sector. These partnerships are more likely to entail service outsourcing and organisational development through the adoption of advanced management techniques then long term leases or outright asset transfers.

This then concludes the international case study review of corporatised water utilities. The next section of the report discusses in greater detail the key factors underlying the differences between a local government department as water service provider and a corporatised model.

4 Governing and Regulating Corporatised Utilities – International Perspectives

4.1 Introduction

This, the second component of the international review, continues to address the research question tacked in the preceding section,

> Q2. What is the international experience of corporatised municipal water service providers?

This section also begins to address the research question relating to a municipality's role following corporatisation:

> Q8. What municipal responsibilities remain following corporatisation?

Where possible this section attempts to identify the main differences between local government water departments and corporatised entities. The discussion draws on the case studies presented above and on other appropriate literature. The following issues are considered:

- The regulatory problem;
- Utility ownership; and
- Utility governance.

4.2 The regulatory problem

The fact that many municipalities own and operate water service providers is not an accident. These arrangements are the product of decades, if not centuries, or public policy decisions. This section briefly reviews those fundamental aspects of the water services industry that have given rise to this situation.

4.2.1 Competition vs. natural monopoly

Klein (1996) provides a useful review of the economic arguments underlying the history of water sector regulation.

The earliest water service providers, water vendors, were competitive private sector actors, and in fact remain so today in many parts of the world. As technology enabled the use of piped water systems the economics of the industry changed drastically though. Piped systems allow water to be delivered at far lower costs – around 10-20% of street vendor costs. However, with the reduction in costs come a loss of choice. It is generally not feasible to lay parallel and competing distribution networks.

4.2.2 The regulatory challenge – balancing consumer and producer interests

As in all monopoly industries prices tend to be set by a system of public regulation, rather than by competition or consumer bargaining. This then requires some form of agency to determine a fair price and to limit the abuse of monopoly powers.

In small water systems it is possible for consumers to form co-operatives to run the supply system 'themselves', thereby balancing the legitimate interests of water consumers and suppliers. As systems grow larger though individual consumers lose their ability to exercise

direct influence and they have to rely on other forms of representation – usually through elected municipal officials or independent regulatory agencies.

Once the balance of power shifts from the water supplier to the regulator a new dynamic is established. The regulator may prove to be friendly, tolerating excessive prices or sub-standard performance, or it may prove hostile, exploiting a water supplier once the water system is constructed. Investors do not have the option of walking away since the bulk of their investment is buried in the ground in the form of pipelines and water works. Private sector investors are therefore wary of water supply systems since the return on their investment is influenced by regulatory favour to a greater degree than their own performance.

4.2.3 Government ownership

As a result of these economic realities, governments have, over time, tended to assume the dual role of investor/operator and regulator. However, as many countries have discovered, government ownership per se, at whatever level of government, does not make it easier to limit monopoly power. Monopoly suppliers of all types are tempted to charge excessive prices, or ask for excessive subsidies, or provide low quality service, or any combination of these factors. Also, governments may not allow their water companies to charge cost-recovery tariffs and perform on a commercial basis – leading to supplier failure.

Klein concludes that the key to dealing with the fundamental problem of protecting consumer and supplier interests alike, lies chiefly in the choice of regulatory mechanism for the water supply companies. This involves three key choices:

- The choice of market structure;
- The choice of regulatory rules; and
- The choice of regulatory institutions.

4.2.4 The choice of market structure

The nature of piped water systems has, to date, precluded the establishment of competitive markets, such as in electricity or natural gas. Some reasons for this are that firstly, the cost of water pipelines forms the bulk of the total system costs – in contrast to electricity where generation is the bulk of the capital investment. Secondly, quality is extremely important in water and sanitation systems and is difficult to observe. Governments therefore sacrifice the benefits of competition in return for the assurance of safe supplies and environments.

The opportunities for competition are therefore limited, and tend to occur through comparisons of performance on price and quality, or through one-off bidding for the rights to deliver specific water services.

Examples from within the USA case by Pontek & Wehmeyer (1997) and Gullet & Bean (1997) show how corporatised entities have successfully improved their performance by having to bid against the private sector to retain responsibility for portions of their operations. In Chile the ‘threat’ of privatisation has also promoted improved performance.

4.2.5 Degree of integration

In the absence of true competition government faces a number of choices in structuring the industry. These choices have implications for the regulatory system and occur on at least three dimensions:

Vertical integration: implying the integration of bulk and distribution services.

Horizontal integration: typically meaning the integration of water supply and sanitation services.

Geographic integration: relating to the size of a utility's geographic service area, and particularly whether to include one or more urban centres and other settlements.

4.2.6 Vertical and horizontal integration

Halcrow's (2000) review international experience with horizontal and vertical integration and argue that there are generally benefits associated with integration in both cases. These relate to economies of scale, ability to plan for the whole water cycle, and ability to link tariffs.

4.2.7 Geographic integration

Geographic integration is a particularly important issue in South Africa at present, where decisions have to be taken on the extent to which service providers can be effective over large geographic areas, including rural areas. There is limited international literature on this topic but there are some important pointers.

Brazil provides an example of large, state-owned water companies serving wide areas containing many municipalities. These organisations have not been particularly successful, however, and the trend is towards returning control of water services to municipalities (PDG, 1994b).

In *Uganda* and *Ghana* corporatised service providers serving widely spread urban areas have not been particularly successful.

The USA provides some experience with system size. Beaudet suggests that in a country with a very large number of systems of different sizes and with different ownership arrangements the trend will be for small to medium sized systems to privatise (2000). This can be related to the limitations that smaller service providers have in attracting experienced managers.

International experience strongly suggests that small rural water supply and sanitation systems are best run by community based organisations, since this promotes demand-responsive approaches (World Bank, 1998). A key success factor though is that adequate support is provided to these organisations.

The *Western Australia* case study indicates that regional water service providers can be successful, although this situation involves a largely urban population.

This issue of the appropriate geographic system size is complex and there are no hard and fast rules. Nonetheless, the evidence suggests that service providers covering very large areas in low to middle income countries do not work well. Much depends on the consumer base and the internal management arrangements. Particular difficulties seem to arise in areas within an urban/rural mix to be served. It appears that urban management approaches cannot be applied to rural areas.

4.2.8 Implications for South African market structure

Klein appears to favour the division of the industry in order to allow different companies to run different components of the system – in the belief that regulators are likely to get better information about the costs and performance of the various components as a result. Better information facilitates comparison with similar operations in other systems, such as treatment plants, and perhaps the promotion of rivalry by comparison. Also, should a supplier fail to perform it should be easier to determine this and replace the supplier when they are only responsible for a small component of the system.

But the reality of the South African water industry is that the regulatory system is very undeveloped, and public regulators have shown little inclination to date to replace under-performing public suppliers with alternative suppliers. Intervention only tends to happen in extreme cases. Further fragmentation of the water industry for the purposes of regulatory comparison would certainly run against the trend within local government – which is presently moving towards amalgamation in order to achieve economies of scale and critical administrative mass. Nonetheless, it is possible that the larger metros may benefit from some subdivision of the industry, where the capacity to monitor and regulate may either exist or be developed.

4.2.9 The choice of regulatory rules

Ideally regulators should limit their powers of oversight to the issues of price and quality, delegating investment and operating decisions to the water companies since they are in a more informed position to take these decisions than the regulator.

Quality is an extremely important factor from the point of view of consumers. Fortunately it is usually possible to measure and monitor the quality of water company outputs. However this is not always the case, such as in the readiness of a water system for fire-fighting. In such cases the regulator may need to specify operational rules.

The regulation of water prices is a huge area of study and choice, and it is not necessary to go into this topic in detail here. Suffice to say that regulators face a bewilderingly complex array of options for rule making on prices, a long list of often contradictory principles, and the certainty that they can never satisfy everyone simultaneously.

In South Africa's case the regulatory rules are still at an early stage of development. Although the Department of Water Affairs and Forestry has published draft water pricing regulations these only address a few of the pricing issues facing regulators.

4.2.10 The choice of regulatory institution

Klein suggests that in selecting a regulatory institution government's core objectives should be to *manage discretion* and *reveal information*. In order to arrive at sensible decisions balancing the interests of producers and consumers, regulators need to obtain the necessary information, and also resist improper influence from companies, consumer interests, government authorities and the like.

Considering the first objective – *managing discretion* – governments face a number of choices and must determine:

- ***Whether to combine the regulation of price and quality in one agency or separate these functions***. A combined agency is more likely to accept trade-offs than separate agencies. In South Africa's case these functions are generally separated, with the regulation of quality being largely the responsibility of environmental agencies and the regulation of price being the combined responsibility of the Department of Water Affairs & Forestry, the Department of Provincial and Local Government, and the individual municipalities.
- ***The geographic boundaries*** of the regulator's responsibility. In South Africa's case these are either the national boundaries in the case of national regulators or the local boundaries of individual municipalities.
- ***The degree of separation*** between regulators and the authorities responsible for issuing licences and contracts. In some countries regulators are protected from conflicts of interest

by separating these responsibilities, particularly if publicly owned water companies are competing for licences. In South Africa's case there is no such separation and 'independent' water regulators have not been created.

The degree of insulation from the executive branch of government. Where separate, independent regulators exist it may be possible to insulate them from short-term political expediency to minimise tariff increases by making the regulator accountable to a non-executive branch of government, such as the parliament or the local council. In South Africa's case this issue does not arise since we do not have independent regulators.

The powers of the regulator. A balance needs to be struck between the regulator having insufficient power to be effective – and therefore possibly becoming reliant on the executive branch of government, or the regulator having too much power – and therefore possibly becoming unaccountable. Again South Africa does not face this issue since we do not have independent regulators.

The appointment of regulators. Independent regulators may be appointed or elected. Klein suggests that the evidence is in favour of appointed experts, since elected regulators tend to take inadequate account of company interests.

The funding of regulatory agencies. Regulators, or regulatory activities, may be funded out of general tax revenues or through special levies on the regulated industries. In South Africa both practices are followed, with water sector regulators being funded from general tax and rates, whilst the national electricity regulator is funded from a specific levy on electricity sales.

Appeals against regulatory decisions. All regulatory systems allow for appeals, either to the courts, to special commissions (e.g. Competitions Board) or to politicians (Ministers). South African law allows for a variety of appeal mechanisms.

Sectoral coverage. Regulators can cover one or more industries. The closer the regulatory agency is tied to a single regulated company the greater the danger of 'regulatory capture'. Many countries utilise cross sectoral regulators (Ghana, Australia and the USA from our case studies) and South Africa is beginning to follow this trend with the merger of the telecommunication and broadcasting industry regulators, and the future expansion of the electricity regulator to cover the gas industry. Municipalities already regulate a broad range of issues, such as public health, land use and traffic.

Turning to the second objective when structuring a regulatory institution – *revealing information* – government faces the intractable problem that, no matter how well designed or resourced the regulator, they remain dependant on information provided by the regulated companies, particularly if they are regulating a single company. Market structure can thus plays a significant role in revealing information. The presence of multiple players enables the regulator to compare and contrast. This was the primary reason behind the Victoria State Government's decision to split the Melbourne water system into three.

Another option open to regulators is the use of interest groups and rivals to generate information. For instance a regulator may force water companies to publish information on equipment costs, in the hope that competing suppliers will detect over-priced supply contracts.

4.2.11 Implications for South African municipalities

South African municipalities considering the corporatisation of their water services are affected by each of these regulatory choices, although many of the choices have already been imposed on them by national decisions. Nonetheless, the regulation of price and quality

remains a very important and relevant factor, no matter whether water services are supplied by public or private companies.

Perhaps the greatest problem facing South African municipalities in their role as price regulators is to access information on which to base decisions. A common international response to this problem is to split up the industry structure in order to facilitate competition by comparison. This may not be a suitable local response, however, given the significant geographical disparities in service levels within South Africa as a result of apartheid practices, and the lack of management capacity.

4.3 Utility ownership

This section of the report reviews the issue of ownership in more detail, and the extent to which differing ownership structures appear to impact on organisational effectiveness.

The commonly applied ownership models include:

- Ownership by national or provincial government under a statute specific to the body concerned (the parastatal model).
- Ownership by national or provincial government under company legislation.
- Full ownership by the municipality under company legislation.
- Mixed ownership with public and private sector bodies each owning shares.

Given the focus of this study the option of full private sector ownership has not been considered in detail, although there is a vast amount of literature available on the relative merits of this option – typically supportive of private sector ownership. By contrast the literature on the relative merits of other forms of public sector ownership is rather sparse. Nonetheless, one report in particular provides an informative comparison of case studies around the world (Pasteur, 1992).

Pasteur examined and compared 11 organisations providing water and sanitation services, with eight different ownership types – including the four identified above together with a number of sub-options. Pasteur concludes as follows:

> The best performers were a semi-autonomous municipal department (DMAE in Porto Alegre in Brazil) and two state government parastatals (Penang Water Authority in Malaysia and COAPES serving Hermosillo in Mexico), the Penang example of the latter having in earlier years been a municipal department.
>
> DMAE [Brazil] is associated with a statutory requirement to reserve 25% of revenues for investment, an international loan requiring financial self-sufficiency, considerable autonomy in planning and programming, and accountability to a consultative council from the community as well as to a municipal council and mayor. COAPES [Mexico] is associated with devolution to the city level, good pay and professional staff and state responsibility for capital funding. The Penang Island case [Malaysia] is associated with strong managerial and professional leadership, balanced relationships between policy board and management, clear terms of reference in a mission statement, well developed systems of accountability and control, a motivated and disciplined work force and, finally, a firm demand for the product and willingness to pay for it.

Interestingly one of Pasteur's top performers, DMAE from Brazil, is a municipal department and not a separate legal entity. It would appear that a strong governance framework stemming from financier requirements has been the key factor behind its successful performance.

Experience within the USA case study confirms that even in a highly developed country a wide variety of ownership forms are prevalent. Whilst there is a marked trend towards greater private sector involvement the emphasis is clearly towards outsourcing of services rather than the transfer of ownership of assets.

Interestingly the low and middle income countries reviewed in this study demonstrate shifts towards greater degrees of private sector involvement than the upper income countries, such as Australia and the USA:

- The Ugandan policy review has recommended a major shift away from a corporatised entity towards private sector involvement in the form of a lease or concession;
- Ghana has taken a decision to pursue unspecified forms of 'Private Sector Participation';
- Despite the outstanding performance of EMOS, Chile has recently called for bids to privatise the utility;
- Eastern European countries appear to be following a twin-track process of decentralising water services to municipal companies, and involving private sector shareholders.

Perhaps because the trend towards greater private sector involvement in the delivery of water services is a comparatively recent phenomenon in less developed countries, the literature review failed to locate any definitive studies demonstrating that a shift in ownership will, in itself, lead to improved utility performance. Nonetheless, there is a very clear bias within the literature in favour of greater private sector involvement, if not ownership.

4.4 Utility governance

The term 'governance' refers to the relationship between owners, members (board members or councillors) and managers.

The key differences between the various options relate to:

- The separation of ownership and control.
- The election or appointment of members.
- The extent to which politicians can influence boards or councils.
- The degree of differentiation between the responsibilities of members and managers.
- The capacity of members.

4.4.1 Separation of ownership and control

Shirley and Walsh (2000) deal comprehensively with the relative merits of public vs. private ownership for organisations providing a wide range of infrastructure. They argue that there are significant differences between public and private ownership relating to:

Monitoring: The diffuse ownership of public bodies leads to inadequate monitoring which combined with the poor information available relative to private companies constrains the ability of government to monitor effectively.

Take-over: The threat of a company take-over stimulates private sector management performance whereas public sector managers do not face a similar threat. Nonetheless the authors do not believe that this is a significant factor.

Bankruptcy: The threat of bankruptcy is an important stimulus for improving management in privately owned companies, whereas publicly owned companies are generally not subject to bankruptcy.

Contracts: Contracts between owners and managers are a popular means of ensuring performance within publicly owned companies. However, the authors, in this and other work, have shown that performance contracts with mangers in publicly owned companies do not have a good track record.

Shirley and Walsh's critique of performance contracts is particularly relevant for South African municipalities contemplating the corporatisation of their water services – since it is generally assumed that this would be accompanied by some form of contractual relationship such as a 'service level agreement'. In an attempt to understand why some countries have experienced greater success in the reform of their State Owned Enterprises (SOEs) than others the World Bank has undertaken extensive research into the design and implementation of the relationship between government and firm managers (World Bank 1995*)*. These relationships always take the form of a contract, although it need not be a formal or written document. The research identified three forms of contracts:

Performance contracts: which define the relationship between government and *public* managers;

Management contracts: which define the relationship when government contracts out the management of a state owned enterprise to *private* managers; and

Regulatory contracts: which define the relationship between a government and a regulated monopoly (as discussed above). Such contracts include explicit agreements about pricing or performance and implicit expectations about, for example, the powers of regulators (World Bank, 1995:107).

The World Bank team undertook a ground-breaking empirical analysis of these three forms of contracts, covering some 750 contracts in 12 developing countries. The analysis was conducted in terms of the three incentive factors which govern such relationships, information, rewards and penalties, and commitment. *Information problems* arise because each party has different sets of information and can use the information at the expense of the other party. Since neither side of the contract can know everything it is necessary to alleviate the information problem by introducing *rewards and penalties* to induce the parties to reveal information and comply with contractual provisions. However, rewards and penalties are, in themselves, insufficient. Each party needs to be convinced of the *commitment* of the other party to deliver. Good contracts thus build in mechanisms to strengthen the three links of the chain that lead to improved enterprise performance.

4.4.2 Evaluation of performance contracts

The study found that performance contracts had little positive impact on most of the sample. the authors use the incentive factor framework to argue that this is due, firstly, to the substantial *information advantage* that state owned enterprise managers have. Government agents generally operate from a serious disadvantage, as lower paid, middle or low-level civil servants. Performance targets in fact often result in perverse behaviour. For instance India Oil could achieve its oil exploration target of 'number of meters drilled' regardless of whether it struck oil or not!

Secondly, *rewards and penalties* were generally weak. The research found that rewards were often limited, or based on soft targets which did not encourage efficiency, and penalties were rarely included in contracts. Worse still, governments often simply reneged on contracts – for instance by failing to provide the necessary capital for investments.

Thirdly, as a result of the problems with rewards and penalties, most performance contracts failed to address the *commitment* problem.

In general then, the report concluded that, based on a sample of 12 performance contracts, they could find little evidence that explicit performance contracts helped improve state owned enterprise performance (World Bank, 1995:132).

4.4.3 Evaluation of management contracts with private managers

The World Bank study investigated 20 management contracts in a range of countries and sectors, using profitability and productivity as performance indicators.

Unlike the performance contract sample, which were generally state owned enterprises in monopoly industries, the management contracts largely involved firms facing competition. This factor seems to have played an important role in increasing the availability of *information*. As a result, *rewards and penalties* could be more clearly identified. The level of *commitment* seems to have varied from case to case. All in all, the study concluded, management contracts can work to improve the performance of state owned enterprises.

Despite their promise, however, the study noted that management contracts are fairly rare in developing countries. They concluded that this is because:

- Management contracts work better in some sectors than others – they are most often applied to industries with fairly homogenous outputs, such as hotels, agriculture and water.
- Management contracts can have lower political costs than privatisation, but they also have lower political gains (World Bank 1995:148).

The bank therefore proposes the following guidelines for management contracts. Authorities should ensure that:

- The contract is competitively bid;
- Most of the contractor's returns depend on a success fee based on a composite measure of performance and the contractor has autonomy to improve performance;
- Both parties face risks, hence each demands that the other take actions to prove commitment; and finally
- Donors can help to encourage the use of management contracts where appropriate by financing the search for a contractor and the costs of negotiation (World Bank, 1995:149).

4.4.4 Evaluation of regulatory contracts with private owners

These contracts define the relationship between government and the owners of a private regulated monopoly. The study chose the telecommunications sector for the study, covering 7 countries. Performance indicators were expansion and productivity; returns to capital; and effect on consumers. The study found that regulatory contracts generally improved performance and that:

- Successful regulatory contracts addressed the information, rewards and penalties and commitment problems simultaneously;
- Some differences in results were due to country characteristics that can only change in the long run; and
- Regulatory contracts are tough to design, but not impossible. Even though compromises were necessary important gains were achieved (World Bank 1995:168)

4.4.5 Conclusion on ownership and control

The bottom line of the World Bank analysis is that contracting can lead to improved public company performance, but only if incentives are aligned so that government and firm management both strive to achieve greater efficiency (World Bank 1995:170).

Interestingly the study went on to examine why the pace and extent of state owned enterprise reform is so limited in developing countries. The study suggests that:

- Reform must be politically desirable – the benefits to the leadership and its constituencies must outweigh the costs;
- Reform must be politically feasible – the leadership must be able to enact reform and overcome opposition; and
- Reform must be credible – promises that the leadership makes to compensate losers and protect investors property rights must be believable (World Bank 1995:176).

Without the minimum requirements for any one of these three conditions being met, reform is unlikely to succeed.

4.4.6 Election vs. appointment of members

Westerhoff et al (1998) discuss the differences between elected and appointed boards, noting that the advantage of an appointed board is that it can include 'outstanding citizens' who have business experience. By contrast, elected boards have a greater tendency to be dominated by politicians who are less likely to have management experience. Westerhoff et al note the important role of managers in keeping the board informed of both good and bad news and in promoting positive relationships between management and board.

4.4.7 The extent to which politicians can influence boards or councils

Leach *et al* (1994) give an instructive overview of the political dimension in British local government. While they are not specific in drawing conclusions they note that in Britain the trend within local government has been towards the separation of *representative* and *organisational* roles of councillors. Councillors are expected to focus on policy and strategic direction, and not on management. The authors noted that this has often not been a popular transition for councillors who have been used to having a say on day-to-day management issues.

The study by Leach *et al* does not look at the corporatisation option specifically. However, it does show the importance of separating the issues of local politics from those of management. A corporatised entity can bring advantages in structuring this separation. However, as the Ugandan and Ghanaian case studies show, it is quite possible for government to influence the boards of corporatised entities to take decisions which are not consistent with good business practice or in consumers' long term interests.

4.4.8 The degree of differentiation between the responsibilities of members and managers

This differentiation of responsibilities is related to the issue of political intervention discussed above. Kerley (1994) gives an excellent overview of the British experience of relations between members and management. He notes that the role of members in interacting with management can be both positive and negative. Much depends on the way in which structures are set up and the individual's capacity to understand management issues.

4.4.9 The Dutch model

IHE present an excellent overview of the governance relationships within the Dutch model for corporatised water services utilities, known as Public Water Public Limited Companies (PLCs).

IHE note that the legal framework of the Public Water PLC consists of three complementary parts. The first part concerns legislation that regulates the drinking water sector in general and legislation that regulates government-ownership of shares in PLCs.. The second part of the legal framework concerns company law, which defines, in broad terms, the main characteristics of a PLC as well as the main rights and obligations of the various actors in a PLC. The third part of the legal framework concerns the articles of association that have to be adopted at the time the PLC is established. These articles of association specify in greater detail the obligations and rights of the various actors. National and supranational legislation with respect to the drinking water sector will generally have precedence over company law, which in turn has precedence over the articles of association of a PLC (IHE, 2001:18).

Dutch law identifies and attributes responsibilities to four main actors in PLCs. These four actors are the Managing Director or Management Board, the Board of Directors, the Shareholders and the Worker's Council. The first three actors are present in each PLC. The Worker's Council is usually only required in companies, which have at least 100 staff members (IHE, 2001:18).

The following table compares the distribution of governance powers within two large Dutch public water PLCs.

Table 18 Powers of the Managing Director, the Board of Directors and the Shareholders Meeting for WML and WBE (IHE, 2001:23).

Responsibility	WML	WBE
Bill and Collect for Services	MD	MD
Terminate Service Provision to Defaulters	MD	MD
Determine Tariff Structure	SM	SM
Set Water Tariffs and Connection Fees	SM	BoD
Enter Loan Agreements	MD (limited), BoD	MD (limited), BoD
Procure Goods and Services	MD (limited), BoD	MD (limited), BoD
Procurement of Assets	MD (limited), BoD	MD (limited), BoD
Hire and Fire Individual Staff Members	MD	MD
Promote and Demote Individual Staff Members	MD	MD
Determine Salary and Incentive Structure	BoD	BoD
Determine Structure of the Organisation	MD	MD
Define Internal Work Processes and Standards	MD	MD
Hire and Fire the Managing Director	BoD	BoD
Appoint and Dismiss Board Members	BoD	Municipalities
Appoint External Auditor	SM	SM
Approve Rolling Multi-year Business Plan	SM	SM
Approve Annual Plan	BoD	BoD
Approve Annual Report (budget/audit report)	SM	SM
Share Issue	SM	SM
Participate in Other Enterprises	SM	MD (limited), BoD
Dissolve Company	SM	SM
Amend By-laws	SM	SM

4.4.10 Capacity of members

While importance of the experience and skill of members has been raised by Kerley, no comprehensive study relating the capacity of members to the performance of an organisation could be found. However, the fact that members, whether they are councils or boards, have to take policy and strategy decisions implies that they need experience and skill in these areas. The success of council run and corporatised entities in high income countries is likely to be influenced substantially by the availability of people with the necessary capacity to deal with policy and strategy.

If a situation exists where there councillors have limited capacity there is a clear benefit to be gained in using a corporatised entity, as people with the necessary experience can be appointed to the board of such an entity.

4.5 Reflections on the governance and regulation of corporatised entities

4.5.1 Key insights

This limited review of the international literature relating to the governance and regulation of corporatised utilities has hopefully provided some sense of the wide diversity of views on the topic. Governance is certainly not an exact science. Given the diversity of view and options it is difficult to extract decisive lessons for the South African context. Nonetheless, the following are offered as useful insights:

- The South African regulatory system clearly still has to undergo considerable development, with national regulators likely to move from a mode of 'assisting' to a mode of 'regulating' over time;
- The current trend towards amalgamation within the market structure may at some point reverse as regulators seek to improve their capacity to monitor the industry;
- As regulators in their own right South African municipalities are expected to engage with complex economic and governance issues relating to the price and quality of water services – no matter whether these services are supplied by public or private companies. These functions are likely to tax even the most competent of municipalities;
- In common with all regulators South African municipalities will face the problem of accessing adequate information on which to base decisions. Present day municipal accounting practices are likely to prove a major hindrance in this regard.

Probably one of the more persuasive insights stemming from the international literature review comes from the World Bank study on the reform of State Owned Enterprises, namely that to be effective:

- reform must be politically desirable – the benefits to the leadership and its constituencies must outweigh the costs;
- reform must be politically feasible – the leadership must be able to enact reform and overcome opposition; and
- reform must be credible – promises that the leadership makes to compensate losers and protect investors property rights must be believable (World Bank 1995:176).

Finally, it is useful to reflect on the issue of economic development. The international review has demonstrated that the greater the degree of economic development within a country the greater the degree of organisational sophistication and the greater the likelihood that corporatised utilities will be successful. The underlying factors for organisational success are

not easy to identify, and are generally contingent on the history and culture of individual countries and local authorities.

4.5.2 Outstanding issues

Given time and resource constraints the international literature review has not been exhaustive. The authors would like to note the following topics as potential areas for further research:

Relationships with organised labour: Surprisingly the available literature did not provide many insights into the relationship between corporatised utilities and organised labour – in contrast with the South African situation where this has been a key issue.

Financial matters: One of the main motivators behind calls for the corporatisation of South African municipal water services is the desire of operational managers to escape the restrictions imposed by municipal finance systems. Surprisingly the international literature review did not yield much on the relationship between operational managers and treasurers. Another financial matter that could do with more exploration is the issue of access to capital. It is often held that corporatised utilities will have easier access to capital (or cheaper capital) once they are 'off the Council's books'. It would be interesting to see whether this is indeed the case.

Many of the issues raised in this section are touched on again in the section dealing with the process of corporatisation, in particular the sub-sections dealing with content of management contracts and key risks.

5 The South African Environment for Corporatisation

5.1 Introduction

This section attempts to answer, in part, most of the remaining research questions,

Q3. What factors in South Africa may help or hinder corporatisation?
Q4. What forms may corporatisation take?
Q6. What process should a municipality follow to determine whether or not to corporatise water services? What factors should be considered? Who should be involved? How long should it take? What might it cost?
Q7. Once a decision is taken, what steps have to be taken to corporatise municipal water services?
Q8. What municipal responsibilities remain following corporatisation?

From the outset it must be recognised that the South African environment for the corporatisation of municipal services is largely determined by national policies and legislation. The Greater Johannesburg Metropolitan Council (GJMC) succinctly describes this situation in its recently released *Johannesburg Water Utility Project: Information for Bidders. Volume 1, General Context*.

> A local authority is a creature of statute and its powers are limited to those expressly granted to it under enabling legislation, i.e. the Constitution of the Republic of South Africa, 1996, as well as National and Provincial legislation. The establishment of a Water and Sanitation Utility by the Council is thus required to take place within the legal framework provided for in the Constitution and the variety of statutes and proposed statutes dealing with issues affecting local government as well as regulatory issues in respect of the water sector (GJMC, 2000a:12).

The GJMC's review of this "legal framework" has revealed the enormously complex legal situation facing those South African municipalities considering the corporatisation of their water services. The outcome of this review is summarised in a four volume report. The research team has had access to the executive summary of this report – which alone comprises 84 pages (GJMC, 2000b). Before commencing a review of this report though it is worth noting its limitations:

Nature of the GJMC as a local authority: The GJMC legal review was commissioned for a particular organisational context. Subsequent to the review taking place the metropolitan local authority (the GJMC) and its subsidiary four metropolitan local councils (MLCs) have merged into a single Category A municipality (a metro) as a result of the local government elections of December 2000. Issues relating to the previous dispensation are therefore no longer valid. On a similar note, category B local authorities and category C local authorities (districts) will face legal issues not considered in the GJMC review.

Changing national legislative framework: Since the review was undertaken the national legal framework has changed, with various acts being passed, amended and repealed. Local government legislation continues to evolve at a particularly rapid pace.

Provincial and local context of the GJMC: The review considers provincial proclamations and local by-laws which are peculiar to the Johannesburg context. Other local authorities will face differing contexts in this regard.

That said, the GJMC legal review nonetheless constitutes a very substantial piece of work, and is certainly the most complete examination of the legal framework for corporatisation uncovered in the course of this project's research. This section of the report therefore draws extensively on the GJMC report[2]. Additional key resources include the applicable government white papers, the White Paper on Local Government and the White Paper on Municipal Service Partnerships.

5.2 The white paper on local government

The white paper on local government (1998) makes a strong argument for new approaches to service delivery, noting that under apartheid systematic under-investment in municipal infrastructure in black areas deprived millions of people of access to basic services, including water and sanitation services. The white paper requires future developmental local government to address this backlog and notes that "the central mandate of local government is to develop service delivery capacity to meet the basic needs of communities" (DCD 1998:99).

5.2.1 Principles for selecting between service delivery options

The white paper goes on to suggest that municipalities can select from a range of service delivery options to enhance service provision and that they should strategically assess and plan the most appropriate forms of service delivery for their areas. In selecting between options local authorities should be guided by the following principles:

Accessibility of services: Municipalities must ensure that all citizens - regardless of race, gender or sexual orientation - have access to at least a minimum level of services.

Affordability of services: Accessibility is closely linked to affordability. Even when service infrastructure is in place, services will remain beyond the reach of many unless they are financially affordable to the municipality. Municipalities can ensure affordability through:

- Setting tariffs which balance the economic viability of continued service provision and the ability of the poor to access services.
- Determining appropriate service levels. Cross-subsidisation (between high and low-income users and commercial and residential users) within and between services.

Quality of products and services: The quality of services is difficult to define, but includes attributes such as suitability for purpose, timeliness, convenience, safety, continuity and responsiveness to service-users. It also includes a professional and respectful relationship between service-providers and service-users.

Accountability for services: Whichever delivery mechanism is adopted, municipal Councils remain accountable for ensuring the provision of quality services which are affordable and accessible.

Integrated development and services: Municipalities should adopt an integrated approach to planning and ensuring the provision of municipal services. This means taking into account the economic and social impacts of service provision in relation to municipal policy objectives such as poverty eradication, spatial integration and job creation through public works.

Sustainability of services: Ongoing service provision depends on financial and organisation systems which support sustainability. Sustainability includes both financial viability and the environmentally sound and socially just use of resources.

[2] Given the extent of the legal issues impacting on corporatisation of water services it has not been possible to cover all issues in detail. Interested readers are referred to GJMC 2000b.

Value-for-money: Value in the public sector is both a matter of the cost of inputs, and of the quality and value of the outputs. The above principles require that the best possible use is made of public resources to ensure universal access to affordable and sustainable services.

Ensuring and promoting competitiveness of local commerce and industry: The job-generating and competitive nature of commerce and industry must not be adversely affected by higher rates and service charges on industry and commerce in order to subsidise domestic users. Greater transparency is required to ensure that investors are aware of the full costs of doing business in a local area.

Promoting democracy: Local government administration must also promote the democratic values and principles enshrined in the Constitution, including the principles provided by Section 195(1) (DCD 1998:100-102).

5.2.2 Approaches to service delivery

The white paper suggests that municipalities will need to seek an appropriate mix of service delivery options. Choices about delivery options should be guided by clear criteria such as coverage, cost, quality and the socio-economic objectives of the municipality.

The white paper defines a range of service delivery mechanisms which municipalities can consider, include the following options:

- Building on existing capacity.
- Corporatisation.
- Public-public partnerships.
- Partnerships with community-based organisations and non-governmental organisations.
- Contracting out.
- Leases and concessions (public-private partnerships).
- Transfers of ownership (privatisation).

Each of these options is described briefly. The option of corporatisation is described as follows:

> Corporatisation refers to the separation of service delivery units from the Council (in the same way that an external service provider is separate from the municipality). Service units which are corporatised may be "ringfenced" or have their budgets separated from the rest of the municipal budget. They will be managed as operationally autonomous units. Corporatisation allows Council to set policy and service standards and hold the unit to account against those standards. It also offers greater autonomy and flexibility to the management of the service unit to introduce commercial management practices to the delivery system.
>
> Corporatisation can take a number of forms, ranging from the establishment of public utilities similar to the Water Boards which exist in parts of the country, to joint-ventures between municipalities. Corporatisation may be particularly appropriate for municipalities with large areas of jurisdiction, such as Metropolitan Councils.
>
> Where some municipal functions are corporatised, reporting requirements and accountability mechanisms must be clearly defined by the municipal Council. This is to ensure that lessons from policy implementation is fed back into policy development (DCD 1998).

5.2.3 Choosing service delivery options

The white paper notes that,

> In assessing the appropriateness of different service delivery mechanisms, it is important to note that the choice is not between public and private provision. Rather, the real issue facing each municipality is to find an appropriate combination of options which most effectively achieves their policy objectives.
>
> The adoption of any option should be based on a critical review of existing service delivery mechanisms, the requirements for service delivery put forward in the municipal IDP, and a comparative assessment of the performance of other municipalities or other service providers. An overall plan for the way in which the municipality will provide services (the "institutional plan" which forms part of the municipal integrated development plan) should be developed. The municipal Council should consult with all affected stakeholders in the development of their institutional plan, particularly consumers of the relevant service and the workers involved in providing the service.
>
> National and provincial government will collaborate on the development of a major capacity-building initiative to assist municipalities in developing and implementing plans to improve service delivery systems. Municipalities will be able to access advice regarding different service delivery options, as well as their overall approach to transforming administrative systems. Plans to launch the Municipal Infrastructure Investment Unit (which will provide advice to municipalities on private sector investment in municipal infrastructure) are already at an advanced stage. Appropriate support for other (non-private-sector-led) approaches to transforming delivery systems will also be established (DCD 1998).

The white paper goes on to focus on the issue of *capacity*, noting the need for an extensive training system to build the capacity of local government to meet its development challenges.

5.3 White paper on municipal service partnerships

Despite the recommendations spelt out in the 1998 White Paper on Local Government progress in establishing innovative municipal service partnerships has been slow. Government has therefore published the White Paper on Municipal Service Partnerships to clarify the policy framework for MSPs and as a means of leveraging "the resources of public institutions, CBOs, NGOs, and the private sector towards meeting the country's overall development objectives" (DPLG, 2000a).

5.3.1 MSP options

The white paper describes five typical MSP arrangements:

> **Service contract**
> The service provider receives a fee from the council to manage a particular aspect of a municipal service. Service contracts are usually short-term (one to three years). Examples include repair and maintenance or billing and collection functions. Evidence suggests that this type of arrangement is a starting point for involving CBOs and NGOs in municipal service provision with the other arrangements being considered as capacity and experience are developed over time.
>
> **Management contract**
> The service provider is responsible for the overall management of all aspects of a municipal service, but without the responsibility to finance the operating, maintenance, repair, or capital costs of the service. Management contracts are typically for three to five years. Management contracts typically specify the payment of a fixed fee plus a variable component ñ the latter being payable when the contractor meets or exceeds specified

performance targets. The service provider normally does not assume the risk for collecting tariffs from residents; however, high collection rates could be a trigger for incentive payments to the service provider. An example may be contracting the management of a water utility.

Lease
The service provider is responsible for the overall management of a municipal service, and the council's operating assets are leased to the contractor. The service provider is responsible for operating, repairing, and maintaining those assets. In some cases, the service provider may be responsible for collecting tariffs from resident and assume the related collection risk. The service provider pays the council rent for the facilities, which may include a component that varies with revenues. Generally, the service provider is not responsible for new capital investments or for replacement of the leased assets. Leases are typically for eight to fifteen years. Examples include the lease of a municipal market, port or water system.

Build/Operate/Transfer (BOT)
The service provider undertakes to design, build, manage, operate, maintain, and repair, at its own expense, a facility to be used for the delivery of a municipal service. The council becomes the owner of the facility at the end of the contract. BOTs may be used to develop new facilities, or expand existing ones. In the latter case, the service provider assumes the responsibility for operating and maintaining the existing facility, but may or may not (depending on the contract) assume responsibility for any replacement or improvement of the facility. A BOT typically requires the council to pay the service provider a fee (which may include performance incentives) for the services provided, leaving responsibility for tariff collection with the council.

Concession
The service provider undertakes the management, operation, repair, maintenance, replacement, design, construction, and financing of a municipal service facility or system. The service provider often assumes responsibility for managing, operating, repairing, and maintenance of related existing facilities. The contractor collects and retains all service tariffs, assumes the collection risk, and pays the council a concession fee (sometimes including a component that varies with revenue). The municipality still remains the owner of any existing facilities operated by the concessionaire, and the ownership of any new facilities constructed by the concessionaire is transferred to the municipality at the end of the concession period (DPLG, 2000a:9).

The option of corporatisation is not considered as an MSP by the white paper. Nonetheless, it is useful to reflect on the policy framework outlined within the white paper since a municipality may decide to corporatise its water services as a step towards implementing an MSP, or in conjunction with an MSP option such as Johannesburg's management contract model.

5.3.2 MSP policy framework

The white paper notes that while Government is committed to facilitating the use of MSP arrangements this does not mean that MSPs are the preferred option for improving service delivery, but rather that MSPs should enjoy equal status among a range of possible service delivery options available to municipal councils.

Should a municipality decide to establish an MSP arrangement is has to decide whether to involve the private sector, a public institution, or a CBO/NGO as their service delivery

partner. This decision will depend on the needs of the municipality concerned and should be taken within the IDP framework.

The white paper notes that "at the opening of parliament in June 1999, the President set a platform for a concerted action program to promote a greater role for partnerships between the private sector and the government. This type of partnership will consolidate and strengthen the resources that can be deployed to satisfy the need for public services, and for the development of South Africa's economy. In the context of MSPs, where large-scale capital investments are required, the private sector generally has the greatest capacity to enhance service delivery."

Practical effect will be given to Government's commitment to its MSP Policy through the following strategies:

A program of legislative reform: commencing with the Local Government Municipal Systems Bill (described below). This Act is intended to provide a simpler and more robust platform for municipal councils to establish MSP arrangements.

Policy alignment: greater policy alignment between departments to facilitate a more conducive cross-sectoral environment for MSPs.

Capacity enhancement: The activities of the Municipal Infrastructure Investment Unit (MIIU) are expected to provide an ongoing program for enhancing the capacity of municipal councils to engage in an array of MSP arrangements.

Institutional arrangements: Unspecified institutional arrangements to support and monitor the MSP Policy.

5.3.3 MSP Legislative Framework

The white paper notes that,

> The current legal and regulatory environment relating to MSP activities is unclear in several respects. This creates risks for councils and service providers alike. These risks increase the projected cost of MSP arrangements, thereby reducing the present viability of many potentially useful MSP projects (DPLG, 2000a:17).

The paper goes on to provide an overview of the present legal and regulatory environment, identifying where actual and potential problems exist and indicating proposed legislative reforms.

In particular the white paper notes the high level of uncertainty as to exactly what authority a province would have when intervening in a municipal function and what responsibility a province would incur if it intervenes, for instance, by exercising executive authority on the municipality's behalf.

Additional issues noted in the white paper include:

Tariff setting and collection: The white paper notes that under the Local Government Transition Act, the authority of a council to delegate tariff setting methodologies and tariff collection is not clear (particularly LGTA Sections l0C (7)(b), l0D (3) and 10G(7)(a)(ii)). This could well constitute a legal obstacle to corporatisation too.

Council reporting: The white paper notes that councils are presently obligated to meet a variety of national and provincial reporting requirements. However, the purposes of such

reporting and consulting, and the consequences of a council's failure to comply, are unclear. The Water Services Act (1997) also requires extensive reporting by councils on various aspects of water and sanitation services and also on various aspects of MSPs in the water services sector. The unclear purpose and intent of many existing reporting requirements creates uncertainty for municipalities as to the legality of their MSP arrangements.

Providing guarantees and other forms of public financial support to MSPs: The white paper notes that it is often necessary and desirable for municipal councils to provide various guarantees and financial assurances to MSP service providers.

Multi-jurisdictional service areas: The white paper notes that there may be circumstances under which two or more municipalities wish to engage jointly with an MSP service provider. The potential benefits from forming multi-jurisdictional service areas include cost-efficiency in the procurement process, and economies of scale for the service provider. However, current legislation does not provide clear legislative authority for municipalities to form such multi-jurisdictional service areas. This creates risks for councils and service providers.

Procurement and contracting: The white paper notes that efficient, competitive, transparent and socially equitable procurement and contracting arrangements are essential to ensure that MSPs actually improve service delivery. There is also a need to ensure that the historically disadvantaged can participate fully and effectively in municipal procurement and contracting. However, existing procurement legislation and regulations are geared to conventional procurement activities such as civil works construction and the purchase of equipment and services. Because of the larger number of risk implications that need to be considered in an MSP arrangement, a correspondingly more sophisticated approach to procurement is required.

NGO/CBOs in MSP arrangements: The white paper notes that many NGOs and CBOs are not organised as formal legal entities (for example, as a trust or a Section 21 company). This may limit their capacity to act as an MSP service provider. The Minister for Welfare and Population Development is directed, in terms of the Non-profit Organisations Act (1997), to issue model documents for non-profit organisations, including model constitutions and codes of good practice. Municipal councils considering entering into an MSP with an NGO or CBO should require the NGO or CBO to adopt a formal constitution and a code of good practice consistent with those issued by the Minister. Also, municipal councils should require NGOs and CBOs that wish to engage in the delivery of municipal services to be registered in terms of the Non-profit Organisations Act.

The white paper also considers aspects of the legislative framework which lie outside DPLG's mandate, where they have implications for using MSP arrangements, including:

Consultation with labour: The white paper notes that the Labour Relations Act (LRA) requires employers to consult with employees on matters relating to the workplace and changes in work practices. It also binds employers to future national or provincial collective agreements that provide for consultation with labour on matters in addition to those described in the LRA, or for more extensive joint decision-making than is implied in the LRA. Because MSPs invariably involve work place restructuring, consultation with labour should be an integral part of the MSP process. However, the LRA does not specify the timing and the scope of the consultation process. The interpretation of such decisions would therefore be subject to Constitutional and common law requirements of "fairness" and "reasonableness". This creates uncertainty for stakeholders (and investors in particular) until such time as a body of case history has been established. The paper notes that DPLG

will consult with the relevant stakeholders on the possibility of amendments to the LRA, or to the applicable ministerial regulations with the aim of defining a required process for consultation with labour on changes in work place practices that result from MSP arrangements.

Employee benefits: The white paper notes that the present approaches to handling transferred membership and lump sum payments for municipal employees affected by an MSP are not optimal from the perspective of public policy, affected employees and municipal employers. The paper notes that DPLG will explore the possibility of developing a proposal to amend the relevant provisions of the Income Tax Act. Such an amendment would preserve the tax-free status of employee benefits accrued in municipal pension or provident funds in respect of employee service prior to 1 March 1998. This will be done in consultation with the relevant Government departments, pension fund representatives, representatives of municipalities, and municipal labour unions.

Choice of bargaining council: The white paper notes that the extent to which MSP service providers are likely to be bound by the South African Local Government Bargaining Council, or other forums, is also unclear. The paper notes that DPLG will continue its dialogue with the Sectoral Forum and the SALGBC regarding the choice of a bargaining forum between MSP service providers and the unions representing their employees.

Insolvency of MSP service providers: The white paper notes that the Companies Act tends to favour the liquidation of, rather than the reorganisation of, insolvent enterprises. There is a real risk for councils and residents if an MSP service provider encounters financial difficulties and the related municipal services are suspended. Pending the development and enactment of suitable legislation, it is recommended that municipal councils and MSP service providers consider providing contractual safeguards in the event of the insolvency of an MSP service provider. Proposed legislation will include provisions for such safeguards. For instance, an MSP contract could include "step-in" rights, under which a municipal council and the service provider's financiers agree in advance on a method for replacing the service provider in the event of insolvency.

The Water Services Act (1997): The white paper notes that Water supply and sanitation services are a large component of the responsibility of most municipal councils, and are also likely candidates for MSP arrangements. As with any legislation, the precise intent of many of the key provisions of the Water Services Act (1997) (WSA) need to be spelled out in the supporting Ministerial regulations. Potential MSP arrangements in the water and sanitation sector are faced with some uncertainties with respect to the interpretation of a number of key provisions of the WSA. DPLG will continue to work with the Department of Water Affairs and Forestry to facilitate the formulation of regulations. This process should enable municipal councils:

- to achieve appropriate flexibility in selecting MSP service providers
- suitably specify the duration of contracts and other contractual provisions
- to suitably provide for basic services
- to comply with a clear and manageable reporting burden that is consistent with sound cost-benefit criteria.

Debarment for corrupt practices: The white paper notes that many countries with well-developed markets for government contracting have legislation that provides for administrative procedures to bar dishonest contractors, temporarily or permanently, from providing goods or services (including MSP services) to any governmental body. Such legislation typically includes several components:

- A description of the acts or omissions by a service provider or its principals that may result in debarment, for instance failure to pay taxes, engaging in corrupt procurement practices, or conviction of a serious crime.

- A range of possible debarment actions, including temporary or permanent debarment from engaging in some specified or all government contracts, and the time period during which debarment may be imposed.
- The contractor's right to appeal a debarment decision to the courts.
- An institutional framework for conducting debarment proceedings.

5.3.4 MSP planning and procurement

The white paper goes on to describe policies to be adopted for the planning and procurement of MSPs, noting that the specific approach and methodology to be followed by municipal councils in planning and procuring MSP arrangements will be set out in future Ministerial regulations and advisory guidelines.

Integrated Development Plans: The white paper notes that a municipality's Integrated Development Plan (IDP) should set out the overall strategy for achieving its developmental objectives. The IDP should include the municipality's strategies for mobilising resources and capacity, and transforming its service delivery mechanisms. As part of its IDP process, a council should consider which services can best be provided directly by the council, and which services may be candidates for MSPs. Candidate MSP projects should therefore be an integral part of a municipality's IDP. The results of this process must then form part of the council's Municipal Infrastructure Investment Plan.

MSP feasibility studies: The white paper notes that a feasibility study is an examination of a potential MSP project's technical and financial viability, its environmental sustainability, and its probable risks and benefits for the municipal council, residents and other key stakeholders. A feasibility study will be more or less detailed and exhaustive, depending on the complexity of the proposed MSP. Councils may wish to prepare more detailed and exhaustive feasibility studies for less-complex MSPs, if, for example, the MSP is one of the first being undertaken by the council, or one of the first in a particular sector in the municipality, or if it is politically controversial. The paper notes that the MIIU has produced a useful guide for municipal councils in developing a feasibility study and that municipal councils may also wish to seek assistance from the MIIU for the initial structuring of potential MSP projects.

Definition and role of the procurement stage: The white paper notes that procurement is the stage in the MSP cycle when the municipal council takes its proposed MSP "to the market". A sound procurement process will be one that achieves "value for money" for the council and its residents and promotes important societal goals such as empowerment. The paper goes on to outline various policies to be adopted for municipal planning and procurement of MSPs and proposes three general classes of competitive procurement activity as outlined in the following table.

Table 19 Competitive procurement methods and thresholds (DPLG, 2000a:23).

Competitive Procurement Process	Typical Duration of Project	Approximate Monetary Value
Formal Competitive Tendering	10 years (leases) to 20 or 25 years BOTs and Concessions	High. For example, greater than R20 million
Competitive Negotiation	1 to 9 years	Medium. For example, from R100,000 up to R20 million
Competitive Solicitation	one year or less	Small. For example, less than R100,000

Each of these options is described in more detail below:

Formal competitive procurement methods and thresholds: The white paper notes that leases, BOTs and concessions are the most complex, demanding, and risky types of MSPs for the council, consumers, service providers, and other stakeholders. Accordingly, these types of MSPs will generally be subject to formal competitive tendering. This is the most thorough and comprehensive of the proposed procurement arrangements.

Competitive negotiation: The white paper notes that a simpler tendering procedure is adequate for MSPs that are less complex, less demanding, and less risky and of a lower monetary amount. When a less formalised process is used than full competitive tendering, councils need to actively monitor the process to ensure that probity is maintained. Moreover, a council is always free to choose to use the more demanding formal competitive tendering procedure (or to incorporate elements of it into a competitive negotiation procedure) for these MSPs.

Competitive solicitation: The white paper notes that competitive solicitation will apply only to MSPs of the shortest duration and the lowest monetary value.

These options provide a useful indication of the level of complexity and effort that may be required to establish similar corporatised entities. Water services are complex and capital intensive, with significant associated risks. Only in small local authorities will annual water service budgets fall under the proposed R20 million benchmark.

The white paper goes on to comment on the following important aspects of decision-making:

Probity: The white paper notes that procurement processes create opportunities and temptations for a lack of probity. Corrupt practices are totally unacceptable since they undermine democratic processes, and sacrifice the public interest for the benefit of personal interests. Corporatisation process may also create such opportunities.

Transparency: The white paper notes that bidders, community residents, and other stakeholders must be informed regularly about the progress of MSP procurement activities. Transparency helps ensure that the municipal council, municipal officials, and bidders follow the procedures mandated by law and by the council.

Amendment and re-negotiation of MSP contracts: The white paper notes that many MSP contracts involve complex arrangements over a long period of time. During the contract period a valid need may arise to amend or even re-negotiate parts of the contract. Against this, there is the possibility that one or both parties may also seek to amend or renegotiate an MSP contract merely for reasons of convenience. In the latter instance, the resulting contract may be so substantially altered that it no longer resembles the contract contemplated by the competitive procurement process. The whole rationale for competitive bidding is therefore undermined. Moreover, this process may have damaged the interests of the other bidders, consumers, ratepayers and voters. Amendments to MSP contracts should therefore be limited to those circumstances in which the amendment would likely have been required no matter which bidder had won the contract. In addition, the council and/or the contract should establish a transparent and accountable amendment process to ensure that stakeholders can be informed of the reasons for, and scope of, the proposed amendment. Stakeholders can then make representations to the council with respect to those matters before the council decides to amend or renegotiate the MSP contract. Similar concerns may exist in relation to the interests of managers within independent corporatised utilities.

5.3.5 Institutional roles and responsibilities

Finally, the white paper outlines the roles and responsibilities of the various actors involved in the establishment of MSPs:

Municipal Council institutional arrangements: The white paper notes that Councils have the primary responsibility for electing to utilise MSPs and for ensuring that the MSP service provider performs in accordance with the contract. Before engaging in an MSP arrangement, councils must satisfy themselves that they have:

- the capacity to do so
- carried out adequate stakeholder consultation
- identified MSP projects that are sensible and consistent with the IDP
- procured MSP service providers using competitive and transparent procedures
- ensured that MSP service providers fulfil their contractual obligations

The paper notes that Councils have the responsibility to determine their institutional and management framework for carrying out MSPs. However, in doing so, councils must provide for a clear designation of responsibilities for the management and implementation of each stage of the MSP project life cycle, including:

- project planning and identification
- procurement
- contract preparation and negotiation
- performance monitoring and compliance
- overall management of the MSP project

Councils also have the responsibility to establish effective planning and reporting systems that:

- describe how service delivery will be implemented within their IDP framework
- monitor the implementation of the IDP
- monitor service delivery performance

Municipal Services Public Protector: The white paper notes that municipal councillors are elected to represent the interests of their constituents and are accountable to them through the democratic process of local elections. However, the White Paper on Local Government advocates augmenting the process of representative democracy with a more accessible and day-to-day system of participatory democracy. Councillors and officials should therefore advocate and practice the *batho pele* principles.

The paper notes that residents require timely and effective ways to express their opinions regarding service delivery and to obtain redress. This applies to services delivered directly by the council and those delivered through MSPs. Such mechanisms promote resident empowerment, help curb possible abuses of monopoly positions by service providers and give effect to participatory democracy. Municipal councils, in consultation with their residents, should therefore consider creating the position of a municipal services public protector. The functions of this position should include:

- actively soliciting resident and consumer opinion on municipal service provision
- collecting, analysing, and evaluating resident and consumer complaints
- meeting with the complainants and advising them regarding the validity of their complaints and potential solutions
- advocating valid complaints and proposed solutions to the council or officials
- advising the complainants of the council's decision and proposed remedial actions

- monitoring the council's remedial actions and informing residents and consumers

The position should have robust terms of reference that insulate the incumbent from council interference to a great extent. Such terms of reference should include the following:

- A term of office that is the same as the council's term of office but begins its term in a different year so that there is overlap between the incumbent and a new council
- A guarantee of no reduction in salary during the incumbent's term of office
- Dismissal for serious causes e.g. gross incompetence, or conviction of a felony

The paper notes that a possible additional role for a municipal services public protector would be to advise and assist residents to pursue their rights if the council fails to address their complaints. This might involve assistance in a variety of forums, including the courts, in arbitration or before a sector regulator, such as NER. However, to fulfil this role the municipal services public protector should be appointed independently from the council.

Sufficient budgetary resources need to be made available to permit the execution of the municipal services public protector's functions. These may come from general municipal revenues or from earmarked surcharges on tariffs for municipal services or municipal rates.

The municipal services public protector is intended to complement and support the functioning of the council and judicial and regulatory institutions, not to be a substitute for those institutions. To preserve the processes of democratic governance, the municipal services public protector would therefore not be empowered to overturn a decision of the council. In stead, councils would be obliged to consider all complaints and proposed remedies put to it by the municipal services public protector and to decide on appropriate and suitable actions that would remedy the causes of the complaint.

The Municipal Infrastructure Investment Unit: The white paper notes that the MIIU is providing support to municipal councils in the areas of preparation, obtaining suitable expertise for municipalities in tendering and structuring financial deals, and contract negotiation. The large body of information and expertise being developed by the MIIU needs to be made more accessible, both to the public and to policy making and/or regulatory authorities such as DPLG, the provinces, and SALGA. Information provided by municipal councils and subsequent analyses of this data by the MIIU will:

- provide a source of MSP information that will be accessible to all councils and other interested parties, such as national sector regulators and MSP service providers
- target municipal MSP capacity-building activities in accordance with identified needs
- provide feedback for the ongoing refinement and development by DPLG, and potentially other sector regulators, of national MSP policy
- provide feedback for the ongoing development by DPLG of advisory MSP guidelines
- assist donor agencies interested in supporting capacity enhancement activities to better understand the needs of municipal councils

Technical Assistance Co-ordination: The white paper notes that without an effective network technical support for MSP contract management and compliance, those municipalities that lack experience in performance monitoring run the risk of being unable to sustain their MSPs. Until a substantial volume of ongoing and successful MSPs has been established, municipal councils will need a network of technical support mechanisms, including:

- formalised training

- on-the-job training
- experienced technical advice
- information dissemination and experience sharing

The paper notes that DPLG will continue to take the lead role in co-ordinating technical assistance activities and liasing with donor organisations. The role of implementing these technical assistance activities should however be increasingly assumed by institutions of higher learning, especially universities, the South African Local Government Association and the Institute of Local Government Managers.

Information dissemination: The white paper notes that SALGA and/or ILGM should also increasingly assume the responsibility for information dissemination. Additional funding will be required for the on-going management of conferences, workshops, meetings, newsletters, web pages and so on. Donors should be consulted about supporting a portion of the costs for the establishment and initial operation of this portion of the MSP contract compliance support network.

Policy monitoring and evaluation: The white paper notes that the Constitution requires that the national and provincial spheres monitor and evaluate the performance of the local sphere in order to:

- Review the implementation of policies and legislation
- Review, refine and update policies and legislation
- Discharge other Constitutionally mandated monitoring and oversight requirements (for example, oversight of municipalities by the National Assembly under Section 55(2) (b) (ii) of the Constitution)
- Support the monitoring and oversight roles of national and provincial government with respect to the delivery of municipal services and maintenance of high standards of governance by municipal councils (Sections 152 and 155(7) of the Constitution)

The paper notes, however, that the above means that the national or provincial spheres cannot pre-empt or second-guess the decisions of councils, where such decisions conform to relevant policy and legislation. Only where a council fails to conform to these requirements should the other spheres intervene.

The paper also notes that an appropriate system for local governments to communicate their performance (via reporting and other means) needs to be established. This system should be focused on ensuring that the requirements of the MSP Policy and legislative framework are being discharged satisfactorily, but at the same time, should not impose an undue reporting burden on municipalities.

5.4 The powers of local government

This section of the report reviews the powers of local government. Unless a municipality is specifically empowered by law to perform a function its actions will be ulta vires. The constitution is the most important law determining the powers of local government.

5.4.1 The Constitution of the Republic of South Africa

The constitution makes the following relevant provisions:

- The right of all to a healthy environment and to have the environment protected against pollution and degradation.

- The right of all to have access to, inter alia, water
- The circumstances in which these rights can be limited by a law of general application (e.g. the Water Services Act, 1997).
- The obligations on organs of state to collaborate and endeavour to resolve their disputes without recourse to law.
- The provisions of Chapter 7 which set out how municipalities are to be structured and what their powers are. (The Municipal Structures Act, the Municipal Systems Act and the Municipal Financial Management Act give effect to Chapter 7).
- Section 155 sets out three Categories of municipality which are to be established and provides for different types of municipality within the three categories (paragraph 13).
- Section 156, which deals with the powers of municipalities. Part B of Schedule 4 of the constitution provides that municipalities will be responsible for "water and sanitation services limited to potable water supply systems and domestic waste-water and sewerage disposal systems".
- The possibility that the company will be subject to audit by the Auditor-General.
- The obligation on municipalities to prepare annual budgets, the form of which is to be prescribed by national legislation.
- Section 229, which deals with the municipal fiscal powers and functions, including the powers of municipalities to impose rates, surcharges on fees, and other taxes and duties.
- Section 230, which deals with the powers of a municipality to raise loans for capital or current expenditure (GJMC 2000b:7-8).

5.4.2 Local Government Transition Act, 1993

The LGTA deals with:

- The functions of local authorities. In the case of two-tier local authorities, such as the GJMC and its associated MLCs, the various responsibilities of each are spelt out.
- The powers of an MLC to levy property rates, as opposed to a metro which does not.
- The powers of a municipality to levy and recover levies, fees, tariffs and taxes.
- The provision for ordinances, by-laws, regulations, statutory notices, resolutions and delegations of powers from defunct local authorities.
- The ownership of assets (GJMC 2000b:9).

The LGTA will lapse with the passing, and implementation, of the set of new local government legislation.

5.4.3 The Gauteng Rationalisation of Local Government Affairs Act, 1998

This provincial Act makes reference to the powers given to a municipal council to contract with public or privates providers of goods or services, subject to the provisions of the Water Services Act of 1997 and other national legislation (GJMC 2000b:10).

5.4.4 Local Government: Municipal Structures Act, 1998

This Act gives effect to those provisions of the constitution relating to the categories and types of municipality to be provided for in various areas. The relevant MECs will have established new municipalities in each province following the local government elections of December 2000.

The Act provides that the powers and functions of municipalities will be those covered by sections 156 and 229 of the constitution (GJMC 2000b:10).

5.4.5 Local Government: Municipal Structures Amendment Act, 2000

The Local Government: Municipal Structures Act, 1998 has subsequently been amended by the Local Government: Municipal Structures Amendment Act, 2000.

Of particular note is the following amendment, where **[bracketed text]** is to be deleted and underlined text inserted.

> **Amendment of section 84 of Act 117 of 1998**
> 6. Section 84 of the principal Act is hereby amended—
> *(a)* by the substitution for subsection (1) of the following subsection: ‘‘(1) A district municipality has the following functions and powers:
> *(a)* Integrated development planning for the district municipality as a whole, including a framework for integrated development plans **[for the local municipalities within]** of all municipalities in the area of the district municipality **[, taking into account the integrated development plans of those local municipalities]**.
> *(b)* **[Bulk supply of water that affects a significant proportion of municipalities in the district]** Potable water supply systems.
> …
> *(d)* **[Bulk sewage purification works and main sewage disposal that affects a significant proportion of municipalities in the district]** Domestic waste-water and sewage disposal systems.
> …
> *(j)* Fire fighting services serving the area of the district municipality as a whole, which includes—
> (i) planning, co-ordination and regulation of fire services;
> (ii) specialised fire fighting services such as mountain, veld and chemical fire services;
> (iii) co-ordination of the standardisation of infrastructure, vehicles, equipment and procedures;
> (iv) training of fire officers.
>
> (Local Government: Municipal Structures Amendment Act, 2000b:6)

This amendment effectively transfers all water service responsibilities from category B municipalities to category C (district) municipalities. This legal position is somewhat at odds with the reality on the ground, where most (non-metro and non-water board) water services are owned and operated by the predecessors of category B local authorities. Not surprisingly there has been some opposition to this amendment. At the time of writing it is not clear how the situation will be resolved. It is quite possible that this legislatively-driven institutional change may provide a huge impetus for district-wide corporatised water utilities.

5.4.6 Local Government: Municipal Systems Act, 2000

The Systems Act is of critical importance to the issue of corporatisation since it deals with municipal service providers, their selection, establishment, control and related matters.

At the time that the GJMC legal review was undertaken the Systems Bill was still under review. Various amendments were made to the GJMC’s version of the Bill prior to acceptance by parliament. The following comments are therefor gleaned from a combined reading of the GJMC report and the final Bill submitted to parliament (the text of which is synonymous with the Act).

Chapter 2 of the Act deals with the *legal nature and rights and duties of municipalities*. In particular section 4 gives municipalities the right to charge fees and impose surcharges.

Chapter 3 of the Act deals with *municipal powers and functions* and establishes the basis for municipal powers.

Chapter 4 of the Act deals with *community participation* and requires municipalities to develop a culture of public participation in municipal affairs, such as in the choice of service providers and the development, implementation and review of a tariffs policy and a credit control policy (See the chapter dealing with *Process considerations* for a more detailed review of the Act's implications for a municipal decision process on the corporatisation of water services).

Chapter 5 of the Act deals with *integrated development planning* and imposes and obligation on municipalities to adopt, by by-law, an integrated development plan (IDP). Operational strategies must ensure that the municipality has the capacity and resources to realise and sustain its development objectives. The IDP must include a financial plan with a three year budget projection, reflecting how capital and operating expenditure is to be provided. An adopted IDP is binding on all persons, unless inconsistent with national or provincial plans (GJMC 2000b).

Chapter 6 of the Act deals with *performance management* and requires municipalities to establish a municipal performance management system. In particular this involves,

- The requirement that each municipality should establish which of its structures and components, including service providers, should be key role players in the system.
- The establishment of performance indicators and targets for improved performance with regard to developmental objectives.
- The assessment of performance and consideration of reasons for under-performance.
- The publication of annual reports reflecting on performance during the financial year covered by the report, including the performance of service providers.
- The establishment of Ministerial regulations regarding performance management systems (GJMC 2000b).

Chapter 7 of the Act deals with *local public administration and human resources*, including the important role of the municipal CEO.

Chapter 8 of the Act deals with *municipal services* and is of crucial importance to the issue of corporatisation[3]. Its main provisions include:

- That a municipality must give effect to the provisions of the constitution by giving priority to the basic needs of the community and ensuring that all residents and communities have access to at least the minimum basic municipal services.
- That a municipal council must, through the enactment of by-laws, adopt and implement a tariff policy on the levying of fees for services which complies with the Act and other sectoral legislation (e.g. the Water Services Act). Various pricing principles are set out in the bill.
- That a municipal service may be provided by a municipality itself through its internal administrative organs, or by way of a service delivery agreement concluded with a service

[3] For a more detailed review of the decision process contemplated in the municipal systems act see the chapter on 'Process considerations' below.

provider (or a combination of service providers) including a municipal entity; another municipality; an organ of state (including a water committee established in terms of the Water Services Act, 1997, a licensed service provider registered or recognised in terms of national legislation; and a traditional authority); a community based organisation (or other non-governmental organisation legally competent to enter into such an agreement); or any other institution, entity or person legal competent to operate a business activity. Relevant definitions include

> **"ownership control"**, in relation to a company, co-operative, trust, fund or any other corporate entity established in terms of any applicable national or provincial legislation, means the ability to exercise any of the following powers to govern the financial and operating policies of the entity in order to obtain benefits from its activities:
> (a) To appoint or remove at least the majority of the board of directors or equivalent governing body;
> (b) To appoint or remove that entity's chief executive officer;
> (c) To cast at least the majority of the votes at meetings of the board of directors or equivalent governing body; or
> (d) To control at least the majority of the voting rights at a general meeting in the case of a company, co-operative or other body having members.
>
> **"municipal entity"** means –
> (a) a company, co-operative, trust, fund or any other corporate entity established in terms of any applicable national or provincial legislation and which operates under the ownership control of one or more municipalities, and includes, in the case of a company under such ownership control, and subsidiary of that company; or
> (b) a service utility
>
> **"service authority"** means the power of a municipality to regulate the provision of a municipal service by a service provider;
>
> **"service delivery agreement"** means an agreement between a municipality and an institution or person mentioned in section 76(b) in terms of which a municipal service is provided by that institution or person, either for its own account or on behalf of the municipality;
>
> **"service provider"** means a person or institution or any combination of persons and institutions which provide a municipal service;
>
> **"service utility"** means a municipal entity established in terms of section 82(1)(c); (DPLG, 2000c:9-10).

- Section 77 prescribes when a municipality must review and decide upon appropriate mechanisms for the provision of services,

> **77.** A municipality must review and decide on the appropriate mechanism to provide a municipal service when—
> *(a)* preparing or reviewing its integrated development plan;
> *(b)* a new municipal service is to be provided;
> *(c)* an existing municipal service is to be significantly upgraded, extended or improved;
> *(d)* a performance evaluation in terms of Chapter 6 requires a review of the delivery mechanism;
> *(e)* the municipality is restructured or reorganised in terms of the Municipal Structures Act;

(f) requested by the local community through mechanisms, processes and procedures established in terms of Chapter 4; or
(g) instructed to do so by the provincial executive acting in terms of section 139(1)*(a)* of the Constitution. (DPLG, 2000c:35)

- Section 78 prescribes the criteria and process to be applied when so deciding.

78. (1) When a municipality has in terms of section 77 to decide on a mechanism to provide a municipal service in the municipality or a part of the municipality, or to review any existing mechanism—
(a) it must first assess—
(i) the direct and indirect costs and benefits associated with the project if the service is provided by the municipality through an internal mechanism, including the expected effect on the environment and on human health, well-being and safety;
(ii) 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 mentioned in section 76*(a)*;
(iii) the extent to which the re-organisation of its administration and the development of the human resource capacity within that administration, as provided for in sections 51 and 68, respectively, could be utilised to provide a service through an internal mechanism mentioned in section 76*(a)*;
(iv) the likely impact on development, job creation and employment patterns in the municipality; and
(v) the views of organised labour; and
(b) it may take into account any developing trends in the sustainable provision of municipal services generally.
(2) After having applied subsection (1), a municipality may—
(a) decide on an appropriate internal mechanism to provide the service; or
(b) before it takes a decision on an appropriate mechanism, explore the possibility of providing the service through an external mechanism mentioned in section 76*(b)*.
(3) If a municipality decides in terms of subsection (2)*(b)* to explore the possibility of providing the service through an external mechanism it must—
(a) give notice to the local community of its intention to explore the provision of the service through an external mechanism; and
(b) assess the different service delivery options in terms of section 76*(b)*, taking into account—
(i) the direct and indirect costs and benefits associated with the project, including the expected effect of any service delivery mechanism on the environment and on human health, well-being and safety;
(ii) the capacity and potential future capacity of prospective service providers to furnish the skills, expertise and resources necessary for the provision of the service;
(iii) the views of the local community;
(iv) the likely impact on development and employment patterns in the municipality; and
(v) the views of organised labour.
(4) After having applied subsection (3), a municipality must decide on an appropriate internal or external mechanism, taking into account the requirements of section 73(2) in achieving the best outcome.
(5) When applying this section a municipality must comply with—
(a) any applicable legislation relating to the appointment of a service provider other than the municipality; and
(b) any additional requirements that may be prescribed by regulation (DPLG, 2000c:35)

- If a municipality decides to provide services through internal mechanisms the Act requires it to:

> **79**. If a municipality decides to provide a municipal service through an internal mechanism mentioned in section 76*(a)*, it must—
> *(a)* allocate sufficient human, financial and other resources necessary for the proper provision of the service; and
> *(b)* transform the provision of that service in accordance with the requirements of this Act (DPLG, 2000c:36).

- If a municipality decides to provide services through service delivery agreements with external mechanisms then section 80 compels the municipality to establish a mechanism and programme for community consultation and information dissemination regarding the service delivery agreement. The contents of the service delivery agreement must be communicated to the local community through the media.

> **80**. (1) If a municipality decides to provide a service through a service delivery agreement in terms of section 76*(b)* with—
> *(a)* a municipal entity, another municipality or a national or provincial organ of state, it may negotiate and enter into such an agreement with the relevant municipal entity, municipality or organ of state without applying Part 3 of this Chapter; or
> *(b)* any institution or entity, or any person, juristic or natural, not mentioned in paragraph *(a)*, it must apply Part 3 of this Chapter before entering into such an agreement with any such institution, entity or person.
> (2) Before a municipality enters into a service delivery agreement for a basic municipal service it must establish a mechanism and programme for community consultation and information dissemination regarding the service delivery agreement. The contents of a service delivery agreement must be communicated to the local community through the media (DPLG, 2000c:36).

- Section 81 covers the responsibilities of municipalities when providing services through service delivery agreements with external mechanisms. This section is of crucial importance in defining the responsibilities of the municipality and is reproduced in full below

> **81.** (1) If a municipal service is provided through a service delivery agreement in terms of section 76*(b)*, the municipality remains responsible for ensuring that that service is provided to the local community in terms of the provisions of this Act, and accordingly must—
> *(a)* regulate the provision of the service, in accordance with section 41;
> *(b)* monitor and assess the implementation of the agreement, including the performance of the service provider in accordance with section 41;
> *(c)* perform its functions and exercise its powers in terms of Chapters 5 and 6 if the municipal service in question falls within a development priority or objective in terms of the municipality's integrated development plan;
> *(d)* within a tariff policy determined by the municipal council in terms of section 74, control the setting and adjustment of tariffs by the service provider for the municipal service in question; and
> *(e)* generally exercise its service authority so as to ensure uninterrupted delivery of the service in the best interest of the local community.
> (2) A municipality, through a service delivery agreement—
> *(a)* may assign to a service provider responsibility for—

(i) developing and implementing detailed service delivery plans within the framework of the municipality's integrated development plan;
(ii) the operational planning, management and provision of the municipal service;
(iii) undertaking social and economic development that is directly related to the provision of the service;
(iv) customer management;
(v) managing its own accounting, financial management, budgeting, investment and borrowing activities within a framework of transparency, accountability, reporting and financial control determined by the municipality, subject to applicable municipal finance management legislation;
(vi) the collection of service fees for its own account from users of services in accordance with the municipal council's tariff policy in accordance with the credit control measures established in terms of Chapter 9;

(b) may pass on to the service provider, through a transparent system that must be subject to performance monitoring and audit, funds for the subsidisation of services to the poor;
(c) may in accordance with applicable labour legislation, transfer or second any of its staff members to the service provider, with the concurrence of the staff member concerned;
(d) must ensure continuity of the service if the service provider is placed under judicial management, becomes insolvent, is liquidated or is for any reason unable to continue performing its functions in terms of the service delivery agreement; and
(e) must, where applicable, take over the municipal service, including all assets, when the service delivery agreement expires or is terminated.

(3) The municipal council has the right to set, review or adjust the tariffs within its tariff policy. The service delivery agreement may provide for the adjustment of tariffs by the service provider within the limitations set by the municipal council.
(4) A service delivery agreement may be amended by agreement between the parties, except where an agreement has been concluded following a competitive bidding process, in which case an amendment can only be made after the local community has been given—
(a) reasonable notice of the intention to amend the agreement and the reasons for the proposed amendment; and
(b) sufficient opportunity to make representations to the municipality.
(5) No councillor or staff member of a municipality may share in any profits or improperly receive any benefits from a service provider providing a municipal service in terms of a service delivery agreement (DPLG, 2000c:36-37).

- Section 82 deals with municipal entities and is also of crucial importance to the issue of corporatisation.

82. (1) If a municipality intends to provide a municipal service in the municipality through a service delivery agreement with a municipal entity, it may—
(a) alone or together with another municipality, establish in terms of applicable national or provincial legislation a company, co-operative, trust, fund or other corporate entity to provide that municipal service as a municipal entity under the ownership control of that municipality or those municipalities;
(b) alone or together with another municipality, acquire ownership control in any existing company, co-operative, trust, fund or other corporate entity which as its main business intends to provide that municipal service in terms of a service delivery agreement with the municipality; or
(c) establish in terms of subsection (2) a service utility to provide that municipal service.
(2) (a) A municipality establishes a service utility in terms of subsection (1)(c) by passing a by-law establishing and regulating the functioning and control of the service utility.

(b) A service utility is a separate juristic person.
(c) The municipality which established the service utility must exercise ownership control over it in terms of its by-laws (DPLG, 2000c:37-38).

- Sections 83 and 84 deal with service delivery agreements involving competitive bidding.
- Sections 85-93 deal with municipal service districts, including: the establishment of internal municipal services districts; the establishment of a policy framework for internal municipal service districts; the establishment of multi-jurisdictional municipal service districts; cases where the Minister requests the establishment of multi-jurisdictional service districts; the contents of agreements establishing multi-jurisdictional service districts; the legal status of government bodies for multi-jurisdictional service districts; the powers and duties of these governing bodies; the control of these governing bodies; and the termination of multi-jurisdictional service districts.
- Section 94 provides for the Minister to make regulations on various service related matters, as follows:

94. (1) The Minister may for the purposes of this Chapter make regulations or issue guidelines in accordance with section 120 to provide for or regulate the following matters:
(a) The preparation, adoption and implementation of a municipal tariff policy;
(b) the subsidisation of tariffs for poor households through—
  (i) cross-subsidisation within and between services;
  (ii) equitable share allocations to municipalities; and
  (iii) national and provincial grants to municipalities;
(c) limits on tariff increases;
(d) criteria to be taken into account by municipalities when imposing surcharges on tariffs for services and determining the duration thereof;
(e) incentives and penalties to encourage—
  (i) the economical, efficient and effective use of resources when providing services;
  (ii) the recycling of waste; and
  (iii) other environmental objectives;
(f) criteria to be taken into account by municipalities when assessing options for the provision of a municipal service;
(g) measures against malpractices in selecting and appointing service providers, including measures against the stripping of municipal assets;
(h) mechanisms and procedures for the co-ordination and integration of sectoral requirements in terms of legislation with the provisions of this Chapter, and the manner in which municipalities must comply with these;
(i) standard draft service delivery agreements;
(j) performance guarantees by service providers; and
(k) any other matter that may facilitate—
  (i) the effective and efficient provision of municipal services; or
  (ii) the application of this Chapter.
(2) The Minister may make regulations and issue guidelines contemplated in paragraphs (a), (b), (c), (d) and (e) of subsection (1) only after consultation with the Minister of Finance.
(3) When making regulations or issuing guidelines in terms of section 120 to provide for or to regulate the matters mentioned in subsection (1) of this section, the Minister must—
(a) take into account the capacity of municipalities to comply with those matters; and
(b) differentiate between different kinds of municipalities according to their respective capacities.

(4) The Minister, by notice in the Gazette, may phase in the application of the provisions of this Chapter which place a financial or administrative burden on municipalities.
(5) A notice in terms of subsection (4) may—
(a) determine different dates on which different provisions of this Chapter becomes applicable to municipalities;
(b) apply to all municipalities generally;
(c) differentiate between different kinds of municipalities which may, for the purpose of the phasing in of the relevant provisions, be defined in the notice in relation to categories or types of municipalities or in any other way; or
(d) apply to a specific kind of municipality only, as defined in the notice (DPLG, 2000c:41-42).

Chapter 9 of the Act deals with *credit control and debt collection.* Its main provisions include:

- requirements for municipalities to establish and implement sound customer care and management systems;
- requirements for municipalities to establish and implement credit control and debt collection policies and to consider various issues within these policies, such as customer classes and customer affordability;
- provisions for Ministerial regulations and guidelines.

Chapter 10 of the Act deals with *provincial and national monitoring and standard setting*. Relevant provisions include:

- provincial monitoring of local authorities;
- actions to be taken by the MEC in the event of non-performance or maladministration;

Chapters 11 and 12 deal with *legal* and *miscellaneous* matters and provide for, amongst other matters, the phasing in of the Act.

In summary then, the Act provides a comprehensive legal framework for decision-making around the corporatisation of water services, the implementation of such decisions, and the ongoing responsibilities of municipalities who own and control corporatised entities. The Act also allows the Minister considerable scope for influencing the conduct of municipalities through the establishment of various regulations and guidelines. The possibility exists for conflicts between these regulations and regulations issued by the Minister of Water Affairs and Forestry in terms of the Water Services Act.

5.4.7 Draft Local Government: Municipal Finance Management Bill

The Municipal Finance Management Bill was still in the early drafting stages at the time that the GJMC legal review was carried out. Important provisions highlighted in the review include:

- far-reaching powers conferred on the National Treasury to promote and enforce transparency and effective management in the financial affairs of municipalities and municipal entities, including a framework for a procurement and provisioning system;
- provision for a Treasury-defined framework within which municipalities and municipal entities must conduct their cash management and investments;
- a requirement that every municipality establish a Revenue Fund and that consolidated financial statements for each financial year be prepared by the Municipal Manager in respect of the municipality and the entities under its ownership control;

- the requirement for Treasury consent prior to the establishment by a municipality of a municipal entity.

The draft bill deals in detail with the financial affairs of municipal entities.

5.4.8 The power to form a company

At the time that the GJMC legal review was undertaken the only power which a local authority had to form a company was in terms of section 17D of the promotion of Local Government Affairs Act, 1983. The passing of the Municipal Systems Act, 2000 (in particular Chapter 8 described above) has altered this position.

5.5 The water sector and other regulatory legislation

5.5.1 The Water Services Act, 1997

For convenience the key Section 19 of the Water Service Act is extracted below:

Contracts and joint ventures with water services providers

19. (1) A water services authority-

(a) may perform the functions of a water services provider itself; and

(b) may-

(i) enter into a written contract with a water services provider; or

(ii) form a joint venture with another water services institution, to provide water services.

(2) A water services authority may only enter into a contract with a private sector water services provider after it has considered all known public sector water services providers which are willing and able to perform the relevant functions.

(3) Before entering into or renewing-

(a) a contract with a water services provider; or

(b) a joint venture with another water services institution other than a public sector water services institution which will provide services within the joint venture at cost and without profit,

the water services authority must publicly disclose its intention to do so.

(4) Any water services provider entering into a contract or joint venture with a water services authority must, before entering into such a contract or joint venture, disclose and provide information on-

(a) any other interests it may have, which are ancillary to or associated with the relevant water services authority; and

(b) any rate of return on investment it will or may gain by entering into such a contract or joint venture.

(5) The Minister may, after consultation with the Minister for Provincial Affairs and Constitutional Development, prescribe-

(a) matters which must be regulated by a contract between a water services provider and a water services authority;

(b) compulsory provisions to be included in such a contract; and

(c) requirements for a joint venture between a water services authority and a water services institution, to ensure-

(i) that water services are provided on an efficient, equitable, cost-effective and sustainable basis;

(ii) that the terms of the contract are fair and equitable to the water services authority, the water services provider and the consumer; and

(iii) compliance with this Act.

(6) As soon as such a contract or join venture agreement has been concluded, the water services authority must supply a copy thereof to the relevant Province and to the Minister.

> (7) The Minister may provide model contracts to be used as a guide for contracts between water services authorities and water services providers.

The GJMC legal review covers the Water Services Act in some detail.

- In terms of the Act the municipality is regarded as the water services authority whilst the corporatised utility is regarded as a water services provider.
- Section 19(1)(b)(i) of the Act empowers the GJMC to contract with the Company to provide water servitudes.
- Section 19(2) of the Act provides that the GJMC may only contract with a private service provider after having considered all known public sector providers who are able and willing to perform the relevant functions. In the view of the GJMC's legal advisors the corporatised utility, being controlled by the GJMC through its shareholding and power to appoint directors, is not a "private sector" provider and hence Section 19(2) would not apply.
- The Minister can prescribe the matters to be regulated in a contract, including compulsory provisions to be included in it.
- Water services must be provided in terms of conditions set by the Company, which must accord with conditions for water services contained in by-laws made by the GJMC.
- The GJMC is obliged to pass by-laws which must provide for, inter alia, standards of service, the determination and structure of tariffs, the payment and collection of money for services, the circumstances in which supply can be limited or discontinued, and the conditions under which water may be provided.
- The Minister's powers to prescribe national standards relating, inter alia, to the provision of water services and requirement for persons who install and operate water service works.
- The Minister's powers to prescribe norms and standard for tariffs, including his power to place limitations on surplus or profit and on the use of income generated by the recovery of charges. No water service institution may use a tariff which is substantially different from prescribed norms and standards.
- Provisions relating to water services providers, including the stipulation that an authority like GJMC must approve the service provider and its approval must be for a limited period and subject to conditions it may impose. A water services authority must monitor the performance of the provider.
- Water for industrial use cannot be obtained from a source other than that provided by the water services provider without the permission of the water services authority.
- The Minister's power to intervene if a water services authority does no perform effectively.
- The Minister's powers to grant financial assistance to water services institutions, including loans and grants.
- The duty of a water services authority to prepare a water services development plan, including details of water services providers, the contract and proposed contracts with such providers and financial details pertaining to capital and operating costs.
- Reference is made to a "water services intermediary", who is a person obliged to supply water services to another in terms of a contract where the supply of such services is incidental to the main purpose of the contract (e.g. a contract of lease) and the power of a water services provider to intervene if the intermediary fails in its obligations.

- The powers and functions of water boards, which are organs of state, including their primary duty to supply water to water services institution, their power to set conditions of supply, including tariffs, and to limit or discontinue water services to their customers.

5.5.2 Draft Regulations: Water Services Act, 1997

The Minister is empowered by the Water Services Act to regulate the relationship between water service authorities and water service providers. DWAF has published a set of draft regulations and requester written comments by 15 September 2000. The final regulations have still to be published at the time of writing.

The draft regulations are accompanied by some useful explanatory comments. In these the Minister notes that:

> Government wishes to progress from a situation in which central government runs a significant proportion of services, to one in which this responsibility is placed under local government, with all municipalities ultimately assuming responsibility. The means by which local government achieves service delivery vary. This may range from providing the service itself; to a management contract for the operation of a single plant; to the large metropolitan area seeking to contract with a suitable company to build, operate and manage facilities under a concession-type agreement. Regulations need to ensure that all responsibilities are clearly allocated while being simultaneously comprehensive and reasonable (DWAF 2000b:1).

The document goes on to set out a regulatory framework, establishing the roles and responsibilities of different bodies with respect to the regulation of water services.

Table 20 Water service regulatory roles and responsibilities (DWAF, 2000b:2).

Role	Who	Responsibilities
Constitution of South Africa	Ministers of Water Affairs and Forestry, and Provincial and Local Government	▪ To set national norms and standards ▪ To fill the role of Water Service Authority if service at local level fails ▪ To provide support to local government in relation to water services ▪ To legislate with regard to municipal functions (including minimum procurement rules) ▪ To monitor performance
	Municipal government (local sphere)	▪ To be responsible for the provision of basic level of service to all South Africans
Regulator	Minister of Water Affairs and Forestry	▪ To set minimum levels of service ▪ To set minimum reporting requirements ▪ To set tariff policy ▪ To monitor performance ▪ To encourage regionalisation to achieve economies of scale
Water Services Authority (WSA)	Municipal government	▪ To achieve requirements set by regulators ▪ To balance the needs of stakeholders ▪ To enter into contracts with WSP(s) best able to achieve these requirements ▪ To monitor performance of the WSP in terms of the contract with the WSA ▪ To report to regulators
Water Services Provider (WSP)	Public, private or mixed entities, or municipal government itself	▪ To provide the services and perform the duties as required in the contract, the WSA and the Constitution

The document notes that in addition to the above roles and responsibilities, national departments, in particular the Departments of Water Affairs and Forestry, Provincial and Local Government, and Finance provide support to municipalities in the form of capacity building, financial assistance and operational support. Other departments such as Environment, Health, and Labour also regulate elements of this sector.

The document states that the objective of the regulations is to promote the best interests of customers and to ensure fair treatment of Water Service Providers (WSPs). The aim is to achieve a water supply and sanitation services sector that:

1. Is efficient and financially sustainable,
2. provides universal coverage with services that people want and are willing to pay for,
3. allows a range of different methods of service provision, levels of service, and a choice of service providers, and
4. treats public and private providers in a similar manner (DWAF, 2000b:1).

The Minister goes on to highlight key issues under each of these objectives, of which the following are relevant to the issue of corporatisation:

Treat public and private providers in a similar manner

1. The minimum standards set by the regulator are the responsibility of the WSA to achieve, irrespective of whether they contract with public, private or mixed service providers.
2. The benchmarking system will apply to all WSAs, and will capture the performance of the WSA, irrespective of the structure of the WSP(s) they contract with.
3. Under the Constitution and legal system, including the Act, the discretion of the Minister of Water Affairs and Forestry is fettered and ad hoc interventions are not permitted.
4. A lawful agreement entered into prior to promulgation of section 19(5) regulations will not be voided (DWAF, 2000a:3).

The document notes that aside from the challenges of implementation, developments in the water and sanitation sector and local government framework subsequent to 1994 have resulted in a range of issues where greater clarity in policy is required. This has arisen partly because the Water and Sanitation White Paper was published in 1994 before a new local government framework had been established. Since then there have been major developments in the sector. The framework for local government has been established and a streamlined new local government system is being put in place. Local government finance has been reformed and policies to address poverty have been implemented. Policies on public private partnerships have been developed and a regulatory framework for such partnerships has been produced. The restructuring of state enterprises is proceeding apace.

Given this new environment DWAF will be reviewing the policy framework governing water services in order to provide all stakeholders with a clear, secure and predictable environment within which to operate. Specific issues that may arise include:

1. The structure(s) and method(s) of operation through which these regulations are to be implemented.
2. The relationship between the provisions of the National Water Act and the Water Services Act, as well as the regulation of water use by industrial users.

3. The role of Water Boards in the achievement of regional scale in service provision and as a competitive public alternative to promote efficiency in the sector.
4. The regulation of Water Boards and the rules governing the establishment by them of joint ventures and other corporate entities.
5. The approach to the regulation of WSPs, particularly with respect to the regulation of tariffs and rates of return outlined in s.19 of the Act.
6. Possible amendments of s.10.2(b) and (c), and s.19.2 of the Water Services Act.
7. Technical issues such as the use of the words "license" or "permit" instead of the word "contract" to reduce the potential for litigation and whether "joint venture" should be referred to separately from other agreements in the Water Services Act, will also be considered (DWAF, 2000b:4).

The scope of these issues indicates that the water sector regulatory environment still has to undergo considerable development. Although not all of these issues relate directly to the topic of corporatisation of municipal water services, the extent of the envisaged changes creates significant uncertainty for municipalities.

Considering the draft regulations themselves, the GJMC legal review concluded that the WSA-WSP contract should provide for at least the following:

- The definition of the scope of services to be provided, including the contract area, the levels and standards of service, the provision of security by the provider for fulfilment of obligations, the structure of the tariffs to be charged, the periodic review of tariffs and the furnishing by the provider of an asset management plan.
- Public disclosure of the provider's records relating to the provision of services, an annual report prepared by the provider, and the issuing and publication by the provider of a set of consumer rules containing at least those matters set out in the regulations.
- The services providers is required to operate an open bookkeeping system, to which the water services authority shall have access as well as to all other information required for monitoring the contract, and the retention of all books of account, records and statements in accordance with generally accepted accounting principles.
- Contract monitoring, including the establishment of a monitoring office and provision for its functions and powers and the costs of establishing and operating it.
- Commencement, renewal and termination procedures, including the circumstances in which a water services authority may appoint a substitute provider.
- The right of the water services authority to terminate the contract and claim damages in the event of corruption on the part of the service provider, its employees, subcontractors or any body it controls (GJMC, 2000:23-24).

The nine page draft regulations thus provide a reasonably clear indication of the required scope of the contract that would have to be established between the municipality as the services authority and the corporatised entity as the services provider. Whist the regulations would generally appear sensible they are fairly onerous, and would probably be prohibitively complex and expensive to implement for very small municipalities.

5.5.3 The National Water Act

The GJMC legal review notes that the National Water Act provides for fundamental reform of waster law, placing water under the control of government. The envisaged *national water strategy* and *catchment management strategies* will, when determined, be binding on municipalities and their water service providers. Classification of water resources in terms of the Act and the determination of the water reserve may also affect the business of a

corporatised utility, particularly its power to supply commercial customers, due to quotas. Pollution measures may also affect utilities, particularly in the area of wastewater treatment.

For the purposes of the Act the GJMC legal review expected the envisaged Johannesburg utility to be regarded as a water user, but advised that in terms of its supply function it would be exempt from registration in terms of Regulation 10 of the regulations relating to the registration of water use. Some uncertainty existed as to this interpretation however. On the other hand it appeared certain that the utility would have to register as a water user in respect of its sanitation activities.

The Act also provides for regulations on water pricing, which will bind municipalities, and in turn water service providers.

Provisions relating to dams with a safety risk will also apply to corporatised utilities. Dams such as reservoirs and sewerage treatment plants exceeding the required minimum dimensions will have to be registered as dams with a safety risk.

Failure to comply with various sections of the Act constitutes a criminal offence and Directors and other officers of a corporatised utility may be personally liable. Courts may also award damages (GJMC, 2000b:26).

5.5.4 The Water Act

Most section of this Act have been repealed. Regulations made under the Act remain in force until repealed by other regulations made under the National Water Act. As the regulations under the Water Act are repealed, the Act will become a dead letter. At the time of the GJMC legal review it was anticipated that DWAF would finalise regulations under the new Act and repeal all regulations under the Water Act by the end of 2000. At the time of writing this report this has not been achieved.

5.5.5 The Environment Conservation Act

According to the GJMC legal review, section 20 of this Act applies prima facie to sludge disposal, since it is solid waste and may be dumped at disposal sites. Permits are apparently issued by DWAF.

New infrastructure, such as reservoirs and waste water treatment plants, may also require environmental impact assessments in terms of the Act (GJMC, 2000b).

5.5.6 National Environmental Management Act

The GJMC legal review found that the principles laid down in this Act apply to corporatised utilities as organs of state. Development s required to be socially, environmentally and economically sustainable. The Act seeks to co-ordinate and integrate environmental functions of various organs of state (GJMC, 2000b).

5.5.7 The Occupational Health and Safety Act

The GJMC legal review found that this Act would apply to a corporatised utility (GJMC, 2000b).

5.5.8 Planning controls

The GJMC legal review notes that planning legislation will affect a corporatised utility, insofar as it required to create new infrastructure, such as dams, reservoirs, treatment plants and other large infrastructural developments (GJMC, 2000b).

5.6 Property Issues

The GJMC legal review considered issues to do with immovable and moveable property.

5.6.1 Immovable property

The legal review considered rights of access to property for purposes related to municipal services, in terms of powers contained in:

- The Water Services Act
- The Municipal Systems Bill
- The Gauteng Rationalisation of Local Government Affairs Act, 1998 (which contains detailed procedures)
- The National Water Act, 1998
- The Local Government Ordinance Act, 1939 (which can be used to supplement other similar powers)

The review concludes that a corporatised utility will have no powers of expropriation. The reviewers suggest that a policy decision needs to be taken as to whether service providers should have powers of expropriation and, if so, that this should be included in the Municipal Systems Act.

The review goes on to consider the issue of servitudes and the transfer of servitudes and land to the corporatised utility. The point is made that transfer would have to be effected by the usual method of a Deed of Transfer, with the attendant costs. Given current land values and property transfer duties these could amount to a very significant sum. The reviewer therefore suggest that consideration be given to Council retaining these assets in order to avoid unnecessary expenditure[4].

5.6.2 Moveable property

The GJMC legal review suggests that moveable property should be transferred to the corporatised utility. It also suggests that the Systems Bill should be amended to enable a municipality to make donations and let property at a normal rent to a corporatised utility which it controls (GJMC, 2000b).

5.7 Revenue ownership issues

The GJMC legal review considered issues relating to the ownership of revenue, and the identification of the appropriate creditor.

5.7.1 Ownership issues

The review examined the relevant provisions of the Constitution, the LGTA, the LGO, the Water Services Act and the By-Laws to determine who may be entitled to own the revenue due for water and sanitation charges. As reported earlier in this report in the section describing the White Paper on Municipal Service Partnerships, this issue has been a major cause of uncertainty for private sector service providers. The legal review goes on to examine

[4] The review is not particularly conclusive on the legal issues associated with immovable property. Further research is required to clarify the situation.

the provisions of the draft Municipal Systems Bill and potential conflicts between the Bill and the existing legislation.

Unfortunately the legal review does not reach a firm conclusion on this critical issue. The recent passing of the Municipal Systems Act will, presumably, have clarified the matter.

5.7.2 Identification of appropriate creditor

The legal review considers how a corporatised utility might best establish legal standing to claim, and if necessary institute legal proceedings, to recover amounts owing for water and sanitation charges. Five possible options are postulated, and each is examined in turn. The review points out that this is a very complicated legal matter. Unfortunately, however, the detailed arguments are not presented in the executive summary and the full body of the text was not available to the research team at the time of writing. Nonetheless, it would appear that a number of the options considered may be feasible.

5.8 Municipal privileges

The GJMC legal review goes on to consider the question of municipal privileges in relation to each of the five options mentioned earlier in the section dealing with the identification of appropriate creditor. It is noted that at present the Council relies heavily on certain of these privileges for the recovery of such charges.

The review points out that one of the greatest privileges presently held by the Council in respect of water and sanitation charges is its embargo on the transfer of land when such charges are not paid – the clearance certificate right. These rights are found in Section 50(1) of the LGO and Section 118 of the Municipal Systems Bill. These rights have been subject to a fair amount of judicial interpretation and are the rights of the Council. These rights would be incapable of cession to the utility and, but for large administrative difficulties, incapable of exercise by the utility and the Council jointly. The review draws attention to the provisions of the Insolvency Act which appear to confirm the interpretation that clearance certificate rights would be lost in the event of the Council not remaining the creditor or if the were not re-established in terms of some other legislation.

The review notes that claims for water and sanitation fees presently rank lower in priority than those of a first bond holder in terms of Section 50(3) of the LGO and Section 118(3) of the Municipal Systems Bill. These rights are linked to those associated with clearance certificates and follow clearance certificate rights.

At present the Council enjoys a legislated right to terminate water supplies in terms of section 87 of the LGO and its Water By-Laws. Without this legislative protection the termination of water supplies, without a prior court order having been obtained, would be unlawful. However, Section 21(1) of the Water Services Act appears wide enough to enable a corporatised utility to have these rights and an amendment to the By-Laws could thus grant this privilege to a utility. This privilege, if granted to a utility, would be subject to the administrative difficulty associated with Section 4(3)(c) of the Water Services Act. The review also points out that should the utility take cession of the Council's claims, without amendment to the By-Laws, this privilege would be lost.

The review also points out that there is currently authority for the proposition that sewerage charges may only be prescribed after 30 years. This contention is apparently based on the finding that sewerage charges are of the nature of a tax. The tax is a burden that is

legislatively imposed upon the general public by an organ of the state. Accordingly, only the Council, the cessionary of its claims, or an organ of the state could claim this privilege.

The review notes that the Council presently enjoys a Common Law right that it cannot be prevented, through its negligent misrepresentations, from claiming amounts due to it. This again is a privilege that accrues to the Council as the trustee of public monies. It would only accrue to the Council, the cessionary of its claims, or an entity established as the trust to public funds.

As access to a premises for the purposes of carrying out water services may amount to trespassing, legislative assistance is required in this regard. Chapter 5 of the Rationalisation of Local Government Affairs Act (Gauteng), Section 80 of the Water Services Act and Section 99 of the Municipal Systems Bill effectively grant such rights to the Council or the utility. There are accordingly no difficulties in this regard.

Several presumptions in the By-Laws and the LGO assist the Council in proving amounts owing to it. These legislative presumptions would have to be re-enacted in favour of the utility in the event of the Council not remaining the creditor. In the vent of the utility being a private company, such legislative presumptions may fall foul of the constitutional right of equality. These privileges would then only remain if the utility was a collection agent or legislatively constituted.

The review notes that Common Law presumptions in favour of the validity of official acts and the admissibility of evidence in public documents would be lost to any creditor that was not a public body.

Finally, the review notes that in terms of Rule 62 of the Magistrates' Court Rules and Section 13 of the Companies Act a private company, in attempting to collect amounts due would be obliged to provide security for the costs of such suit (GJMC, 2000b).

5.9 Procurement issues

The GJMC legal review deals with procurement provisions which affect both municipal councils and the proposed corporatised utility, considering the following legislation:

- The Constitution – concluding that in the case of Johannesburg the GJMC, the MLCs and the envisaged company are organs of state.
- Section 217 of the Constitution – which requires that an organ of state,, when it contacts for goods or services, must do so in accordance with a system which is fair, equitable, transparent, competitive, and cost effective. Such as system may include tender procedures, quotations or other methods.
- Various enactments relating to municipal procurement procedures – between which there appears to lie considerable scope for confusion and uncertainty. The review includes three legal opinions on the matter.
- The Preferential Procurement Policy Framework (Act 5 of 2000) – which establishes a policy of providing for categories of preference and the protection of previously disadvantaged persons and which is binding upon all organs of state.
- The proposed Local Government: Municipal Finance Management Act – the draft bill of which was not yet published at the time of the review. Nonetheless the review notes that the Act will probably provides for procurement provisions.

- The relevant provisions of the Local Government: Municipal Systems Bill – insofar as they require a municipality which intends to provide a service by way of a service delivery agreement with a private sector body to follow a selection and pre-qualification process.

The review concludes by drawing attention to the possible invalidity of provisions which appear to permit a municipality to conclude a service delivery agreement with certain bodies, including Service Utilities and Municipal Enterprises established by it, without complying with Section 217 of the Constitution, which requires a municipality to award contacts for services in accordance with a system which is fair, equitable, transparent, competitive and cost effective.

5.10 Companies legislation and the Competition Act

5.10.1 The Companies Act

The GJMC review concludes that the envisaged Johannesburg water utility should be established as a private company and that its capitalisation should be determined in consultation with the project's financial advisors.

The company memorandum and articles of association should therefore be registered with the Registrar of Companies, and a certificate to commence business obtained before the company commences business. The company's board of directors should have security of tenure and a large measure of independence from the shareholders. The directors should be liable to be removed only for misconduct.

The review notes that directors may become personally liable for the debts of the company if the company was trading recklessly or with intent to defraud creditors. Also, directors may become personally liable for criminal offences committed by the company under Section 332 of the Criminal Procedure Act. A director may be liable for damages suffered by the company as a result of the negligence, default, breach of duty or breach of trust of that director. Directors are required to declare conflicts of interest. It is essential that the company's statutory obligations and the activities of its directors be controlled by a competent company secretary (GJMC, 2000b).

5.10.2 The Competition Act

The GJMC review found that the Competition Act would not apply since the utility is to be controlled by legislation, By-Laws and legislative tariffs (GJMC, 2000b).

5.11 Labour relations and other employment issues

5.11.1 Transfer of a business under the Labour Relations Act

The GJMC legal review found that in terms of Section 197 of the Labour relations Act, 1995 when the whole or any part of a business is transferred as a going concern all the rights and obligations that existed between the old employer and each employee are automatically transferred to the new employer.

The review was of the opinion that:

- The supply of water services constitutes a *part of the business or undertaking* of the old employer;
- The creation of the corporatised water utility involves the *transfer* of the supply of water services from each old employer to the water utility;

- The provision of these services would be transferred as a *going concern* as there would be no interruption in the supply of these services.

The review therefore concluded that all rights and obligations between the old employer and each employee at the time of transfer continue in force as if they were rights and obligations between the new employer (the corporatised utility) and each employee. An agreement by either the old or new employer may be concluded to vary the rights and obligations that are to be transferred. If the employees who are to be transferred to the Utility have difference terms and conditions of employment they will be transferred with their existing terms and conditions unless an agreement rationalising terms and conditions is concluded.

An employee who refuses to be transferred would normally not be entitled to receive retrenchment benefits. The review notes, however, that rights that accrue to employees in terms of their terms and conditions may allow them to opt out of a transfer situation and that until a full examination of the relevant documentation is undertaken no conclusion could be reached.

The review also examines the legislation governing the transfer of staff from one municipality to another, and from a municipality to a utility. The legislation governing the transfer of staff from one municipality to another states that staff must not experience a decrease in terms and conditions with the transfer. This means that parity can only be achieved by extending the most favourable terms and conditions for a particular grade to all relevant staff members. The transfer of staff from a municipality to a utility must, be in accordance with applicable labour legislation and, according to a section of the draft Local Government: municipal Systems Bill at the time, with the concurrence of staff concerned.

The review notes that unless a corporatised utility is fortunate enough to take over staff with *uniform* terms and conditions, one of the key tasks facing the utility will be to achieve parity in terms and conditions of employment.

The review notes that terms and conditions of employment stem from three sources:
1. Legislation;
2. Collective agreements; and
3. Standard terms of employment and contracts of employment.

The main piece of legislation dealing with terms and conditions is the Basic Conditions of Employment Act, 1997 (BCEA) which creates a floor of minimum terms and conditions for almost all workers. The BCEA allows for variation of a basic condition by either a collective agreement, a bargaining council agreement, or an individual agreement with the greatest scope to vary terms and conditions being afforded to bargaining council agreements. Collective agreements have less scope to vary basic conditions and individual agreement have limited scope for variation. There are, however, certain core rights that may not be varied by any of the above means.

Collective agreements determining terms and conditions may be concluded at a national or at a local council level. The relevant national level structure is the South African Local Government Bargaining Council (SALGBC). At the time of the review the SALGBC had not been registered as a bargaining council. Its status is determined by an Establishment Agreement signed by the South African Local Government Association (SALGA) and two

registered trade unions, namely the Independent Municipal and Allied Trade Union (IMATU) and the South African Municipal Workers Union (SAMWU).

According to the review the effect of the SALGBC not being registered is that:

- agreements concluded in the bargaining council may not be extended to non-parties such as a corporatised utility; and
- there is less scope for the SALGBC to vary the minimum terms and conditions set out in the BCEA than if it had been a registered bargaining council.

The review notes that the constitution of the SALGBC is broad enough to allow for membership by a corporatised utility engaged in the provision of municipal services. Also that the SALGBC is empowered to conclude agreements on wages, conditions of employment and all other matters of mutual interest.

The review notes that in establishing uniform terms and conditions a distinction must be made between *work practices* and *terms and conditions*. The distinction is significant for two reasons, namely:

- an employer cannot change the terms and conditions of employment without the employee's consent. No consent is required to change work practices;
- terms and conditions of employment are 'rights and obligations' that will be transferred from the old employer to the corporatised utility in terms of Section 197(2)(a) of the Labour Relations Act. There is no equivalent transfer of work practices.

The review goes on to consider how the proposed Johannesburg water utility may proceed to secure changed conditions if agreement is not reached in negotiations. It appears that there are four ways by which an employer may attempt to coerce "*consent*". These are:

1. to lock-out employees until they accept the changes to their conditions of employment;
2. to terminate services on the basis of the employer's operational requirements;
3. to change conditions of employment unilaterally; and
4. to refer the dispute to arbitration in respect of employees employed in an essential service.

In addition, if the parties agree, any deadlock may be broken by submission to voluntary arbitration rather than an exercise in power. The review notes that the third and fourth options are the most controversial and complex, and deals with these in some detail (unfortunately not covered in the executive summary though).

The review does note that an employer may dismiss employees for operational requirements following an inability to agree on conditions of employment, if there is an operational necessity for the employer to revise conditions of employment. In this case the employer will have to establish that:

1. the change is an operational necessity and the continuation of existing conditions will seriously affect the viability of the business;
2. it is engaged in consultation that meet the requirements of Section 189 of the Labour Relations Act;
3. the employees were not dismissed in order to pressure them to accept the revised conditions of employment or because they had engaged in a protracted strike.

The other option that an employer can utilise to coerce consent on proposed changes to terms and conditions is to implement the changes unilaterally. Employees may challenge a unilateral change to terms and conditions by:

1. instituting a common law action for breach of contract;
2. relying on Section 64(4) of the Labour Relations Act (the status quo provision) to restore earlier conditions;
3. arguing that any unilateral change amounts to unfair dismissal.

The review notes that strictly speaking no contract of any kind can be unilaterally varied as a contract is a product of consent and can therefore only be varied by consent. However, at common law an employer can lawfully terminate a contract of employment by giving notice to the employee in terms of the contract and offering to re-employ the employee on the desired revised terms. If this course of action were adopted, no common law breach of contact would arise.

In relation to the status quo remedy mentioned above (Section 64(4) of the Labour Relations Act) the review notes that this clause is designed to freeze the capacity of an employer to exercise power (in the form of unilateral alterations to employment contracts) until such time as statutory conciliation has run its course and the employees have acquired the right to protect their interest through protracted strike action. The remedy only operates for a limited period, which is not more than thirty days.

The effect of this section is that it prevents an employer from acting precipitately in unilaterally implementing changes to terms and conditions of employment. A change will only be implemented once a dispute on the issue has been duly processed by a bargaining council and employees will then be able to strike in response to the change.

The review concludes by noting that in terms of common law a unilateral change to an employment contract strictly speaking amounts to a dismissal (if the change is a material one) coupled with simultaneous re-employment on revised terms and conditions. The question is whether a unilateral change to employment terms amounts to a dismissal for the purposes of the Labour Relations Act. According to the review the courts have generally not regarded a unilateral change as being the equivalent of a dismissal as the employment relationship is not terminated. A unilateral change is more seen as an exercise of employer power. Even if a unilateral change did constitute a dismissal it may not be an unfair dismissal if consultations at least as rigorous as those required y section 189 of the labour Relations Act (which regulates operational requirement dismissals) are carried out. It is also arguable that the offer of re-employment should block a claim for severance pay flowing from putative retrenchment (GJMC, 2000b).

5.11.2 The law regulating employees in the provision of municipal services

The GJMC legal review considered the law regulating employees in the provision of municipal services and the implications of the law for the envisaged corporatised utility. The following Acts, proposed Bills and policy documents were found to apply:

- the Labour Relations Act,1995
- the Basic Conditions of Employment act, 1997
- the Employment Equity Act, 1998

- the Skills Development Act, 1998
- the Unemployment Insurance act, 1996
- the Occupational Health and Safety Act, 1993
- the Compensation for Occupational Injuries and Diseases Act, 1993;
- the Local Government: Municipal Systems Bill; and
- the Framework for Restructuring of Municipal Service Provision (an agreement between government and labour) (GJMC, 2000b).

The review does not, however, go into any detail as to the implications of these acts, bills and policy documents for the corporatised utility.

5.12 South African Municipal Workers Union perspective

This section of the report is based largely on an interview with the South African Municipal Workers Union (Samwu), an affiliate of the Congress of South African Trade Unions (Cosatu) the largest trade union federation in South Africa. Samwu organises largely blue collar workers and is the largest union in the municipal sector[5]. It has a history of vociferous opposition to the privatisation of municipal services. The following questions were used as the basis for the interview:

1. What is your perception about the term corporatisation?
2. What is your position as a union on corporatisation of water and sanitation services in South Africa?
3. As a union, what is your position on corporatisation as distinct from privatisation?
4. What do you see as the potential benefits to LAs of corporatisation?
5. Do you see a trend towards corporatisation as a method of municipal service provision in South Africa? If so what do you see driving the trend?
6. If in the future local authorities in South Africa find themselves with no choice but to corporatise, what course of implementation would you as unions advocate for? In other words of the different, forms of corporatisation, which one do you think is most suitable for South Africa and why?
7. Could you point to any international examples of corporatisation that that may offer useful lessons for South Africa?
8. How would you respond to the tentative conclusions reached in the draft research report?
9. Any further comments?

5.12.1 Defining corporatisation

Samwu acknowledges that the term appears to have multiple meanings. In general though, the union perceives the process of corporatisation as having a market orientation, and as such as merely one variant of privatization. Corporatisation is thus viewed negatively.

5.12.2 The link between corporatisation and marketisation

Samwu perceive corporatisation as a process of introducing private sector thinking into the delivery of a public good, in that the emphasis shifts towards measures such as 'return on investment' and against cross subsidies. In effect a public service is commeditised and marketised.

[5] The interview was conducted on 3 May, 2001 with the union's General Secretary, Mr. Ronny Rodgers and the National Water Co-ordinator, Mr. Lance Veotte.

At the same time the union noted that it did not have a problem with financially 'ring fencing;' a service as a means of promoting improved management.

5.12.3 Corporatisation in South Africa

Samwu does not believe that corporatisation is an appropriate choice for South African municipalities at this stage. The union fears that corporatisation may entrench apartheid disparities, in that autonomous corporatised entities may resist pressure from democratically elected Councils to correct historical service inequities. They see a conflict between addressing the huge backlog in water services provision and the introduction of commercial incentives through corporatisation.

Furthermore, the union argues that corporatisation is not an appropriate response since it may lead to further job losses in the context of an already high level of unemployment.

From a legal perspective Samwu believes that municipalities are compelled to deliver services themselves, in that the Municipal Services Act requires municipalities to deliver services, rather than outsourcing their responsibilities.

Lastly, Samwu is concerned that corporatisation may lead to the fragmentation of services, that municipalities should not break services up into components since this will hinder their ability to provide these services in a co-ordinated manner.

5.12.4 The potential benefits of corporatisation

Samwu acknowledges that corporatisation may be of benefit in cases where municipalities are able to generate capital funding, in that it is believed that corporatised entities may have greater access to sources of capital than municipalities.

Nonetheless the union questions whether corporatised entities would indeed invest in service improvements which do not show a financial return – whereas a municipality would make such an investment since it is not profit motivated.

5.12.5 The trend toward municipal corporatisation in South Africa

The union believes that corporatisation is being promoted in South Africa as a product of the government's macro economic policy, and cites the Egoli 2002 programme as a prime example. The pressure on municipalities to deliver services, coupled with the reduction in fiscal transfers from central to local government, is seen to be forcing municipalities into partnerships with multinationals. The union see the intention of national government as turning local authorities into regulators, rather than service deliverers. Samwu is clearly against this trend, and intends to oppose it wherever possible.

5.12.6 Corporatisation form that is best for South Africa

In the event of a municipality corporatising its water services the union feels that the following measures should be put into place:

- there should be high levels of regulation;
- government must guarantee services for communities that cannot afford them;
- quality must be emphasised by setting minimum standards;
- there should be regular reviews;
- the period for corporatisation must be defined;
- by-laws should be used and a memorandum of understanding should be drawn up;

- environmental issues must be considered, together with penalties for non-compliance; and
- workers rights must be protected.

Samwu remains suspicious of a broader agenda to "smash" the power of the unions.

5.12.7 Lessons from international cases

Samwu raises criticisms about a number of international cases, including Ghana and Buenos Aires, where the local authority came into conflict with the water service provider. However the Buenos Aires case involved a long term private concession, rather than a corporatised entity in terms of this project's definition.

5.12.8 Views on tentative conclusions

Commenting on the tentative conclusions reached in this project's first draft research report, Samwu felt that there was little justification for the view that corporatisation may be a sensible option for some municipalities. The interviewees agreed that the current legal, policy and political environment was not favourable for corporatisation.

The union's major objections though were that insufficient attention had been given to analysing whether the current system of municipal service provision should not be retained and improved as a viable option. In general the union was of the view that those municipalities who had decided to corporatise water services (Johannesburg and more recently Cape Town) had done so with insufficient consultation with concerned stakeholders. This, in the union's view, contradicted the letter and the spirit of the legislation which municipalities were supposed to uphold.

5.13 Independent Municipal and Allied Trade Union perspective

This section of the report is based on an interview with the Independent Municipal and Allied Trade Union[6]. The same questions were used as in the Samwu interview.

5.13.1 Defining corporatisation

Imatu understand corporatisation to mean the establishment of a company, under company law, to deliver municipal services. As such the union views corporatisation as a form of privatisation.

5.13.2 Concerns around corporatisation of water services in South Africa

Imatu is against the corporatisation of water services within South Africa, on the grounds that such entities will be driven by profit motives, rather than service motives. Imatu believes that the Boards of corporatised entities are likely to look after the interests of the company before those of the people that they are supposed to be serving. The union is concerned that corporatisation will reduce the role of the Council, leaving municipalities with no role to play. The union is also concerned about the possibility of corruption.

The union queried the financial impacts of corporatisation, in that municipal services are not presently exposed to company tax and some elements of VAT. By contrast, the union understands that utilities corporatised under company law are required to pay company tax, and may have a greater VAT liability. Such transfers to the central fiscus undermine the ability of the utility to deliver local services.

[6] Interviews were conducted on 25 July 2001 with Mr Klasie Classen, General Secretary of Imatu, and on 26 July 2001 with Mr Clive Dunstan, President of Imatu.

The union also raised a concern about the impact of a company failure and a resulting liquidation. Who would then be responsible for service delivery?

Lastly, the union believes that public entities are less likely to lead to job losses and that workers are more likely to retain their benefits than in corporatised entities, particularly those with private sector involvement.

5.13.3 The potential benefits of corporatisation

Imatu see the only potential benefit of corporatisation as increased accessing capital, since separate companies will have 'their own books'. However, the union argues that this is only applicable to water and electricity services. Rather than corporatising services, the union believes that local government should focus on improving their internal management culture and running in a more 'businesslike' fashion. The union believes that the only beneficiaries of corporatisation will be national agencies such as the DBSA and the MIIU.

5.13.4 Driving forces behind corporatisation in South Africa

Imatu sees the policy push for corporatisation as stemming from central government's perspective that municipalities lack the capacity to deliver services. They believe that this push does not take sustainability into consideration. The union also argues that institutions created by government, such as the DBSA and the MIIU, are only lending to those entities that can repay loans. Non-trading services, such as clinics, are therefore excluded.

Imatu also perceives international drivers for corporatisation, such as American and French companies, who are attracted by a pro-investor climate and the prospect of asset sales.

Given these forces Imatu expects that corporatisation sill be a trend in South Africa, since it is 'an easy way out' for Councillors who believe that they are doing the country a favour by bringing in foreign investors.

5.13.5 Implementation issues

Imatu believes that in the event that a municipality decides to corporatise its water services, the union should try to protect its members' conditions of service. The union should therefore be involved in the process through the Municipal Bargaining Council. The interviewees acknowledged that this is not always easy to achieve.

5.13.6 Lessons from international cases

The Imatu interviewees were positive about the Dutch experience of corporatised municipal water utilities, believing that these utilities had a good track record on issues such as environmental protection and water quality. They supported the Dutch view that basic necessities should not be managed on a for-profit basis.

By contrast, they believe that the experiences of India and Bangladesh where the rich have water and the poor do not are a result of private sector involvement.

5.13.7 Views on tentative conclusions

Commenting on the tentative conclusions reached in this project's first draft research report, the Imatu interviewees were in agreement with the views that local corporatisation initiatives have lead to a high level of politicisation, and that municipalities should ensure that they have

sufficient financial, managerial and political capacity to see the process through before embarking on a corporatisation exercise.

The interviewees also agreed that the corporatisation model may also be a workable option in cases where a municipality requires a partner to invest in a defined component of a water system (such as a wastewater treatment plant). However, the interviewees felt that the partner's equity stake should be limited (say 20%) in order for the ownership and control would remain with the Council.

In general then, Imatu appears to accept that the corporatisation of water services is an option for municipalities, but feels that there are significant risks which would have to be addressed. In particular the union felt that the utility should be owned and controlled by the Council.

5.14 Financial and accounting considerations

5.14.1 Trading basis and distribution of income

In reviewing possible legal options for corporatisation for the Cape Metropolitan Council PricewaterhouseCoopers provide the following useful information on trading basis and distribution of income (PwC 1999:3-12).

Table 21 Trading basis and distribution of income

Option	Trading basis and distribution of income
Local authority department	Can make surpluses, which the local authority is free to retain within the department or redistribute to other services via the general rates fund.
Section 21 (non-profit)	Can make surpluses, which would go into the company's reserves and cannot be distributed outside the company except on winding up when reserves have to go to a similar organisation.
Private company ((Pty) Ltd)	Trading surplus or loss can be distributed to shareholders.
Public company (Limited/Ltd)	Trading surplus or loss can be distributed to shareholders.

5.14.2 Tax status

PwC also comment on the various forms of taxation which would apply to a corporatised water utility (PwC 1999:13).

Table 22 Tax liabilities.

Option	Company tax	RSC levies	Rates	STC[7]
Local authority department	No	Yes	No	No
Section 21 (non-profit)	Can be exempt	Yes	Yes	No
Private company ((Pty) Ltd)	Yes	Yes	Yes	Yes
Public company (Limited/Ltd)	Yes	Yes	Yes	Yes

5.14.3 Financing investment and expansion

PwC point out that an important consideration when corporatising water services is the issue of how capital will be raised to fund the expansion of services. Broadly speaking there are two options available, *equity* – contributed by the owner(s) of the company and *debt* – borrowed from lending institutions. The various legal options are reviewed in terms of their potential for raising finance.

[7] STC – Secondary Tax on Companies is currently levied at 12.5% on distributions to shareholders (e.g. dividends).

Table 23 Financing investment and expansion.

Option	Sources of finance
Local authority department	Both equity and debt-funded investments are possible. Equity is derived from internal reserves (either general Capital Development Funds or dedicated funds). Debt may be raised from a wide range of sources.
Section 21 (non-profit)	Owner may contribute equity. Loan finance is also possible. Difficult to involve equity partners due to legal status.
Private company ((Pty) Ltd)	Both equity and debt-funded investments are possible. Equity partners are legally possible.
Public company (Limited/Ltd)	Both equity and debt-funded investments are possible. Equity partners are legally possible.

5.14.4 Accounting issues

The PwC report notes that the establishment of a corporatised entity under the Companies Act would require a shift from municipal fund-based accounting systems to the normal General Accepted Accounting Practices (GAAP) system. The key difference between these two systems is the treatment of assets. In the municipal system assets are general financed through the city's capital development and loans fund. As these loans are repaid the net value of the asset, as recorded in the financial statements, is reduced by the cumulative amount of the annual redemption charges. Under the GAAP system assets are capitalised at their historical cost and then depreciated over their useful lives. Thus an asset that lasts 20 years, but which was financed with a 10 year loan, will still show a value on the balance sheet after 19 years, whilst under the municipal system it would show no value after 10 years.

The difference between the two systems is apparent in the income statement. The municipal annual financial statement will include interest and redemption, whilst the GAAP system will show interest and depreciation. Depreciation is an allowable expense for tax purposes, whilst redemption is treated as a capital item.

This seemingly minor difference has significant implications for local authorities considering corporatisation. Although the municipal accounting system is set to change itself to align with GAAP standards (through the adoption of the Generally Accepted Municipal Accounting Practices system – GAMAP) most local authorities do not have adequate asset registers. Hence the construction of an accurate opening balance sheet will generally be a costly and time consuming process. This is usually accomplished by estimating the modern equivalent asset value (MEAV) of each individual asset. That is, the cost of replacing that asset with an asset of equivalent capability using current materials and technologies in line with best management practice (PwC 2000:41).

A corporatised entity will therefore almost certainly need to establish full new financial systems.

5.15 Reflections on the South African environment for corporatisation

This research report has deliberately avoided glossing over the details of the legal framework applicable to the corporatisation of water services in order to convey the enormous complexity inherent in the process. Municipalities wishing to corporatise water services are, effectively, treading new ground. Not only are there limited precedents, but the legal framework has itself shifted fundamentally in the last five years. As creatures of statute municipalities are obliged to follow each of these laws and regulations to the letter. The fact that many of these laws were not drafted with corporatisation in mind does not help. The

overlaps and potential conflicts between Acts does not help either. Johannesburg's experience will, no doubt, shed light for others to follow. Nonetheless, a considerable investment is required to firstly understand the Johannesburg experience, and secondly to interpret and apply these lessons to another municipal context.

That said, whilst the current legal framework obviously represents a significant obstacle to corporatisation, national government has signalled its intention to minimise this obstacle. Successive policies, acts and regulations are slowly clearing the way in an effort to facilitate innovation in municipal service delivery.

At the same time, however, it must be acknowledged that the policy/legal framework is just one dimension of the environment facing local authorities interested in corporatising their water services. Other factors which need to be considered at the political/stakeholder environment, the financial/economic environment and the technical environment. At this stage the project has not undertaken any detailed research into these environment, partly because they are less defined and less uniform than the policy/legal environment and more likely to depend on local circumstances. Instead, the next section of the report will examine the experiences of corporatisation in two South African municipalities. The last section of the report will then address the process by which a municipality may wish to follow in reaching a decision on corporatisation and implementing a corporatisation exercise.

6 South African Case Studies

6.1 Introduction

This section focuses on the last research question:

> Q9. What is the experience of corporatisation in South African to date?

In so doing, it is hoped to gain further insights into the research questions tackled in the preceding section which reviewed the environment for corporatisation in South African, namely:

> Q3. What factors in South Africa may help or hinder corporatisation?
> Q4. What forms may corporatisation take?
> Q6. What process should a municipality follow to determine whether or not to corporatise water services? What factors should be considered? Who should be involved? How long should it take? What might it cost?
> Q7. Once a decision is taken, what steps have to be taken to corporatise municipal water services?
> Q8. What municipal responsibilities remain following corporatisation?

This section of the research report reviews the following case studies:

Major case studies:

- The long-established East Rand Water Company (Erwat)
- The recent establishment of the Johannesburg Water Utility

Minor case studies:

- The Cape Metropolitan Council's investigations into the feasibility of corporatising its bulk water functions
- The Durban Unicity Committee's considerations on service delivery.

6.2 Erwat case study

6.2.1 Formation and history of Erwat

The East Rand water care company was formed in September 1992 when the then Transvaal Administrator passed a proclamation in the government gazette to make wastewater conveyance and treatment a regional function in the East Rand.

Previously, wastewater treatment has been undertaken by authorities, such as Benoni and Boksburg. This decentralised approach was seen as a problem, in that many of the municipalities could not afford to build the necessary treatment plants. Regionalisation was thus seen as the key to achieving economies of scale.

Erwat was subsequently incorporated in terms of section 21 of the Companies Act (not for profit), with the owner of the company being the regional services council (then the East Rand Services Council) and the 22 local authorities in the East Rand area. The founding agreement permits Erwat to perform water treatment functions for a period of 30 years from 1993. Thereafter, the agreement shall continue indefinitely until terminated by mutual consent or by expiry of three years, written notice given by either party.

The restructuring and rationalisation of local government in 1996 brought this number down to nine local authorities (some of them metros). Following the 5 December 2000 local government elections all of these local authorities have been merged into the new East Rand Metro.

6.2.2 Erwat's vision

Erwat's vision is to create and enhance shareholder wealth by pursuing and capitalising on business opportunities in the wastewater industry.

6.2.3 Board of directors

The Board consists of six non-executive Directors, all of whom are local Councillors, and the Managing Director. The Board meets monthly to consider issues, make resolutions and take note of departmental activities. The directors are elected for a period of 36 months. The annual general meeting takes place in October.

As a result of this arrangement Erwat faces the potential problem of major shifts in the composition of its board whenever the political balance changes due to municipal election results.

6.2.4 Executive management structure

The composition of the executive Management Structure is as follows:

1. Group Managing Director
2. Executive manager (Human Resource)
3. General Manager (ERTEC Pty Ltd)
4. General Manager (Water Business)
5. Company Secretary
6. Khulumanzi (Pty.)Ltd (JV 49% Shareholding)
7. Executive manager (Operations)
8. Company marketing and Communications
9. Cosme SA (Pty) Ltd, (JV 49% Shareholding)
10. Executive Manager (Development)
11. Head of Research and Development
12. Managing Director (Aquafrica (Pty) Ltd)
13. Executive manager (Laboratory Services)

6.2.5 Applicable legislation

Erwat is conducting investigations into the impact of the new water legislation on expenditure requirements within the water treatment industry. Attempts are being made to carry out capital upgrading that is needed to comply with the requirements of the different water acts. Erwat supports the intentions of both the Water Services Act and the National Water Act and it contributes wherever possible towards the finalisation of the regulations in respect of achievable quality standards.

6.2.6 General conditions

The founding agreement requires each council to contribute proportionately to the running expenses of Erwat on the basis of a formula set out in an annexure. However, Erwat can amend the above mentioned formula from time to time and such amendments are binding on the council, provided that such amendments are in line with normal business practice in

respect of purification works, main sewerage disposal pipelines and re-usage systems, and the policy of Erwat.

6.2.7 Duties and obligations of the councils

Councils remain responsible, in their areas of jurisdiction, for the construction and maintenance of all reticulation and link sewers at their own cost, up to the connection point provided by Erwat. Erwat is responsible for the construction of regional sewers from these points.

Municipalities are obliged to regularly (at least once in every two years) examine and clean their sewer reticulation systems to prevent sand, silt, solid articles or any other obstructions from entering Erwat's regional sewers and waste water treatment works.

Local authorities are also expected to take reasonable precautions, to prevent and guard against the entrance of stormwater into the sewer system. In this regard, inspections of all premises which discharge into Erwat's regional sewers are carried out once every two years.

6.2.8 Requirements of Erwat

Subject to any other contractual arrangements entered into between the local authorities and Erwat, the control, management, maintenance and operation of all regional sewers and water care works operated by Erwat is vested entirely and solely in Erwat. This includes the following:

1. The waste water to be accepted and discharged by Erwat consists of domestic sewage from sewered premises and industrial effluent.
2. Waste water is accepted upon such terms and conditions as Erwat and the local authorities may determine from time to time, subject to the conditions contained in Annexure C of the agreement. This annexure is applicable at each point of discharge and can be amended by Erwat in consultation with the affected local authority from time to time and such amendments are binding on both parties.

6.2.9 Discharge of industrial effluent

Erwat has the following responsibilities with respect to the discharge of industrial effluent into the system from premises within the control of any of the local authorities:

- Erwat is entitled to obtain information from the owner/occupier and carry out inspections in order to assess the strength of industrial discharges.
- Erwat is indemnified by the local authorities from any loss or damage that may be incurred or sustained due to the discharge of industrial effluent from properties within the area of the local authority.
- Vacuum and septic tank contents and night soil are accepted into Erwat's regional sewers and treatment works on various terms and conditions.
- Erwat has the right to inspect the sewerage installations and bulk flow meters connected to the sewer, including those on private property, and to sample waste water and effluent, provided that such inspections are carried out in collaboration with the local authority. The local authority is entitled to the same rights as Erwat in this regard.

6.2.10 Financial results

The Erwat group's financial results for the 1999/2000 and 1998/1999 financial years appear below.

Table 24 Erwat group results (ERWAT Annual report 2000).

Group Results (R m)	2000	1999
Total income	125.5	127.8
Expenditure	105.0	127.8
Retained Earnings	20.5	22.0
Depreciation	8.2	7.7
Net surplus	12.3	14.3

In 2000 accumulated funds increased by R12.3 million to R84.6 million. R37.2 million of this amount was used to finance major capital development programmes.

Although Erwat is a non-profit organisation it regards these financial achievements as vital for its financial independence in the medium and long term.

6.2.11 Credit rating

Erwat's A1 short term rating and A- long term rating were reaffirmed in the 1999/2000 financial year, with the assessors stating that,

> "The company (ERWAT) remains exposed to the capacity of local authorities to pay for their services. While considered possible that support from external government agencies could be forthcoming given the nature of ERWAT as an essential service provider, such support cannot be assured. Financial risk is diluted by healthy coverage levels, a robust balance sheet and the predictability of the sustainable income stream. However, substantial capital expenditure over the next three to four years will constrain financial flexibility."

Interviews with Erwat staff indicate that the organisation intends to improve its financial position by exploiting opportunities in the larger water market in sub-Saharan Africa. By diversifying away from South African income the organisation expects to reduce its dependency on municipal income and, in the process, positively influence the company's long term credit rating.

6.2.12 Funding plans

Erwat anticipates a severe strain on the company's capital resources with major developments forthcoming in Welgedacht and Waterval. Future capital requirements are estimated on the basis of a facilities development plan and a long term financial model. These are used to forecast cash flows, timing and tariff impacts, and to inform negotiations with funders. The intention is to keep tariff increases to a minimum. Over the past seven years Erwat has repaid R60m in loans which were taken over from the local authorities at establishment.

6.2.13 Tariffs

By 1st of April each year, Erwat gives notice of the tariffs for the ensuring year, based on the pro rata portion of the total volume and load discharged by local authorities into Erwat's regional sewers and conveyed to the treatment works over the period 1 January to 31 December of the previous year.

Tariff levels are determined on the basis of the total cost of conveyance and waste water treatment, less any operating grants or subsidies to be received by Erwat. Local authorities are invoiced one-twelfth of the annual charge on a monthly basis.

Erwat reserves the right at any time to amend the charges set out in the agreement signed between the two parties at the beginning of the contract. However, Erwat must show that tariff increases are based on reasonably incurred costs in line with normal business practice and its own policies. Erwat must give 120 days' notice of any proposed amendment to charges.

6.2.14 Performance

On establishment in 1992/93 the average wastewater treatment tariff was 51.2 cents per kiloliter (c/kl). Allowing for consumer price inflation over the following seven years the 1999/2000 treatment cost should have been 86.62 cents per kiloliter. However, as a result of economies of scale, the average 1999/00 tariff was only 61,34 cents per kiloliter, equivalent to a nominal annual increase of only 2.5%. In effect this translates into a saving over the seven years of approximately R167 million for the local authorities concerned.

This result is a strong indication that the establishment of Erwat has been of benefit to the local authorities in the area.

6.2.15 Staff composition

The labour framework has provided ERWAT with the opportunity to transform its policies and deal with the racial imbalances of the past. In consultation with stake holders, ERWAT has attempted to transform its work force. At the same time attempts have been made to focus less on "counting heads" and more on providing an environment for people development.

6.2.16 Training and development

Erwat has created an enabling environment for strategic investment in skills development. The company runs an adult literacy and basic education programme. By the end 2000, 24 employees were busy with computer based training and 11 had successfully completed the Independent Examination Board exams at Levels 1 to 3, with pass rates of between 80% and 100%. Training of operators is continuing with a further 20 employees having completed the WEFTEC course. Through the Erwat study assistance scheme four employees have completed their B.Tech degrees while another one has obtained a Master's degree. This scheme has also helped Erwat to employ its first black female operator.

6.2.17 Future challenges

A major challenge for Erwat is outcome of the local government demarcation process which has transformed its constituent local councils into one metropolitan municipality covering the Rand. Given this development Erwat's role is under review.

6.2.18 Ertec (Pty) Ltd

Erwat's engineering and equipment technology activities have been contracted out to a wholly owned subsidiary, Ertec, which focuses on engineering, procurement and maintenance. Ertec also undertakes work for other clients. By the year 2000 it had an order book at the R40 million level. Ertec offers a rage of services from affordable basic skills through to sophisticated expertise. Over the years it has registered growth in areas such as COSME screens, Landustrie aerators and a variety of other related products.

6.2.19 Laboratory services

Erwat operates accredited laboratory services, and is currently considering the commercialisation of the laboratory function in order to reach new target markets. The laboratory unit focuses mainly on the industrial effluent market but wishes to broaden its customer base and diversify its products.

Existing products include comprehensive industrial monitoring surveys, complete with programmes, evaluation of effluent within the larger area, treatment plant quality monitoring systems and integrated quality evaluation studies of complex pollution situations.

6.2.20 Municipal Financial Management Bill

The municipal financial management bill may potentially constrain Erwat's ability to borrow funds, in that the company would have to gain the permission of the Council. This could have the effect of reducing Erwat's independence.

6.2.21 Conclusion

Since Erwat's establishment in September 1992 the company has seen growth in all areas. Its financial position has improved, its treatment capacity and reliability has increased, and its environmental impact control and human resources development and productivity have improved. Based on the above the Erwat model appears to present a feasible option for situations where multiple municipalities are able to realise economies of scale by merging their bulk waste water treatment operations.

Nonetheless, Erwat faces significant challenges. Firstly, shifts in municipal boundaries have undermined the original rationale for its establishment. Secondly, the composition of the Board can change significantly as a result of municipal elections, potentially leading to instability and short-termism. Finally, Erwat's growing identity and commercial aspirations pose a challenge for its new owner – the East Rand Metro. In depth studies will be required to chart an appropriate way forward for the utility.

6.3 Johannesburg case study

6.3.1 Introduction

Johannesburg's decision to corporatise water services was taken in the midst of local government's transition to democracy, a period when legislation, policy and the demarcation of administrative boundaries were amended radically and simultaneously. The context for the corporatisation decision also included rising demand for services, a major financial crisis and serious capacity limitations. Furthermore, it should be borne in mind that decisions on water and sanitation were just one of the many challenges confronting the city.

1997 saw the Greater Johannesburg Metropolitan Council grappling with an ever-deepening financial and administrative crisis. Part of the proposed solution to the overall problem was the creation of a Water and Sanitation Utility company – in the hope that this would secure efficient service delivery and harness much needed financial income for the Council. The model that was adopted – a utility company coupled with an external management contractor – was intended to solve a range of problems. The ensuing implementation process had to ensure continuous provision of this essential service, within a context of ongoing changes to the structure of local government.

At the time of writing this case study the Utility is in its first year of existence. There is thus little basis on which to evaluate Johannesburg's choice at this stage. Nonetheless, there are important lessons to be learnt about the *process of corporatisation* which Johannesburg followed. The case study based on interviews with key participants in the process of establishing the water utility and on documents produced during the process.

6.3.2 Background

The creation of the Water and Sanitation Utility in Johannesburg must be seen against the backdrop of a fundamental reform of the local government system, and a specific set of Johannesburg-related crises.

South Africa's local government system has been substantially transformed since 1994. The thrust of this reform has been two-fold. On the one hand, it has been directed towards a more rational arrangement of local government boundaries and demarcations, and on the other hand towards establishing foundations for good governance through accountable, transparent and measurable systems and procedures for service delivery. Part of this transformation has entailed a new vision for municipal services, which provides for a wider range of service delivery mechanisms, and a clearer definition of local government's roles as owners, operators and regulators of the various service functions. This vision includes the option of private sector participation in municipal service provision.

In Johannesburg local government slid into a financial hole, partly of its own making and partly as a result of structures and practices inherited from the apartheid past. The Greater Johannesburg Metropolitan Council (GJMC) and four metropolitan councils were formed through the consolidation of thirteen local authorities in June 1996. Right from the start they faced numerous problems. These included confusion and duplication of roles; complex bureaucratic systems; poor financial administration; and the collapse of services following the withdrawal of provincial funding from disadvantaged areas such as Alexandra, Orange Farm and Soweto. Escalating arrears from non-payment of rates and service charges compounded these problems.

By 1997 local government was financially paralysed and the Province intervened to establish new crisis-management structures. One structure lead to another and in December 1998 the Transformation Lekgotla emerged to spearhead a new strategy of recovery. The Transformation Lekgotla subsequently appointed a high-powered City Manager, Khetso Gordhan, to develop and drive a strategy to resolve the city's financial and organisational problems. In turn Gordhan and his team developed *Igoli 2002,* an ambitious three-year plan.

Igoli 2002 identified the following financial problems. The financial crisis took the form of R1,2 billion arrears in unpaid rates and service charges, growing at R33 million per month; depleted cash reserves; R2,8 billion long-term debt; operating budgets funded by R395 million call bonds that cost R71 million annually in interest charges; and a cumulative deficit of well over R500 million. The consequence of this situation was inadequate capital and operating expenditure, escalating backlogs and an inability to borrow due to poor credit ratings.

Beyond the figures lay a fragmented, inefficient, complex and unfocused bureaucracy, lacking management and business skills. The absence of commercial imperatives meant that resources were wasted, stores were overstocked, controls were weak and the business focus was predominantly internal rather than customer-oriented. Rigid and complicated procurement procedures, a lack of flexibility and an absence of performance management systems made for a wasteful and incompetent organization.

Igoli 2002 proposed the corporatisation, commercialisation or outright privatisation of various components of Johannesburg Council's operations. In effect the Councils would establish eleven Municipal Business Enterprises, to be accountable to a single future unicity Council, to

be owned by that Council as the sole shareholder, and to operate on commercial principles. The Water and Sanitation Company would be one of these Utilities, to operate with its own board of directors overseeing company management.

6.3.3 The challenges facing the utility

In addition to dealing with the problems outlined above, the Water Utility had to plan for more efficient use of its current resources and to accommodate projected future demand. The following are some of the key challenges facing the utility:

Infrastructure: The GJMC covers an area of 1380 square kilometres. Water and wastewater services distribution services had historically been managed by the four metropolitan local councils, according to political boundaries which did not coincide with the two topographical drainage basins that govern wastewater services. The Greater Johannesburg Metropolitan Council was responsible for bulk water, which it bought from the Rand Water Board. There is no shortage of water supply and the quality is adequate. The GJMC was also responsible for all waste water treatment. Altogether the GJMC and the four local councils had 8,250 kilometres of water mains, 8,149 kilometres of sewers, six wastewater treatment works, and one regional sludge-handling facility south of the city.

Population: Estimates of the population of Johannesburg vary widely, but the best estimate at the time was about 2.8 million people. Growth projections estimated that by 2010 the Water and Sanitation Utility would have to service 3.3 million people. Modelling of water demand was, however, based on *consumer units* as a more useful measure than population estimates. The exact number of consumer units was difficult to determine for the following reasons:

- There was no single definition of a consumer unit amongst the five councils
- There was no consolidated billing database
- There were many known data problems in the four existing billing systems

At the time that the utility was being planned the GJMC's draft housing strategy proposed a future housing programme to deliver 261,000 housing units over the next ten years – equivalent to a rate of 26,000 new customer units per year. The manner in which these new connections would be funded was unclear.

Bulk water and demand management: Future provision of water services would have to accommodate existing contractual arrangements with Rand Water. In particular, the GJMC was considering the sale of some of its bulk water assets to Rand Water. At the time the GJMC and local councils had agreed to a water-conservation policy, the key elements of which were an attempt to put in place a demand-management strategy. The implementation of this strategy would require the establishment of a single, accurate information system to inform demand management activities. This represented a major challenge, given the fragmented state of the management information systems within the different councils. A key challenge facing the to-be-established water utility was thus a requirement to integrate, standardise and harmonise the existing management information systems.

Bureaucratic procurement procedures: At the time procurement procedures appeared to be focused on central control through bureaucratic procedures, rather than on speedy purchase from cost-effective suppliers. This resulted in long delays in procurement and consequent

cost increases due to management's difficulty in scheduling maintenance and purchases. To overcome this, a more effective and flexible procurement system was required.

Inadequate performance management and incentive systems: The existing personnel management and remuneration system offered no incentive for staff to take personal ownership of problems and to find solutions to them. Over the years many years performance management options had been contemplated, but never implemented. This was partly due to union opposition to individual performance appraisals and to the salary differentials that would arise. Given that water provision is an essential service the unions had had a very strong negotiating position and had insisted on salary scales that were centrally negotiated and unrelated to individual performance or responsibility.

6.3.4 The process

Private-public partnerships were considered seriously prior to the establishment of *Igoli 2002*. The Southern Metropolitan council, with the financial support of Rand Water, had embarked on a process of financial ring-fencing and technical modelling which was intended to lead to a service concession. At the time that the process of forming the new utility began the ringfencing process was being extended to the other local councils. The real energy for change though arose from the financial crises and the appointment of a dynamic new city manager. The key steps are summarised below.

- In January 1999 the Greater Johannesburg Metropolitan Council appointed a *City Manager*, who was given both authority and a budget to drive the process of Transformation for the council.
- The City Manger convened a "Bite the Bullet" *workshop* to look at ways of saving money across the council.
- The first Lekgotla was convened with about 50 senior managers. These included the five executive committees of the different councils, the Strategic Executives and the Chief executive officers.
- From there *Igoli 2002* was developed and approved by the Councils on 16 March 1999.
- The City Manager and Transformation Lekgotla appointed *internal project managers* from the existing structures for each utility. Three managers were allocated to the water utility.
- In February 1999 each utility team arranged a large *international workshop* to discuss the utility and the way forward. Rand Water sponsored the water utility workshop.
- Following the workshop, a *comprehensive business plan* on the way forward was drafted.
- In May 1999 the water utility team then *visited Australia* to see successful utilities in operation. This visit was financed by the City Manager's budget. A report of the visit and its findings was presented to the Transformation Lekgotla.
- In September 1999 the Transformation Lekgotla agreed to the formation of an *advisory board* to guide the establishment of a water utility. A transparent and democratic process was followed in appointing the board. Due consideration was given to representivity and allowed for advertising for appropriate people as well as internal nominations.
- The GJMC then advertised for a *lead consultant* in Water to be paid from the City Manager's budget.. There was a competitive bidding process and an internal team and a political panel assessed the prospective consultants. The Transformation Lekgotla approved the recommendation and the Council in September 1999 appointed a UK firm, Halcrow Management Services.

- The GJMC simultaneously advertised for a *Transition Manager* who was appointed by the City Manager after approval by the Transformation Lekgotla in October 1999. In the same month a *Transition Strategy* was prepared and approved by the Advisory Board.
- The internal managers then began the process of preparing documentation that would be used in the *first step of the bid process*. This first step was to identify prospective institutions who would be suitably qualified to bid for the management contract.
- Five sets of *consultants*, with specific expertise in human resources, finance, revenue, and communications, assisted the internal project managers and lead consultants in preparing the *request for qualification documentation*.
- The request for qualification was advertised and seven joint ventures qualified.
- Following this, the lead consultant and a Canadian lawyer with expertise on utilities prepared the *pre-bid documentation*.
- The GJMC then advertised a *request for proposals*. This was implemented through a two-envelope system whereby financial bids were only considered after a thorough *evaluation of technical proposals*. Five of the qualifying seven joint ventures submitted proposals. A six-week technical evaluation was undertaken, including a probity expert.
- The Advisory Board and the Political Adjudication committee approved the recommendation of the evaluation process that three of the five bidders be considered.
- Financial bids were then assessed against an agreed formula and the *preferred bidder* was announced.
- The team and the preferred bidder then spent three days *negotiating* the final terms and conditions of the contract.

Three other processes ran parallel to the above. These were the preparation of the legal agreements for forming the utility, negotiating with staff and communicating the process both internally and externally:

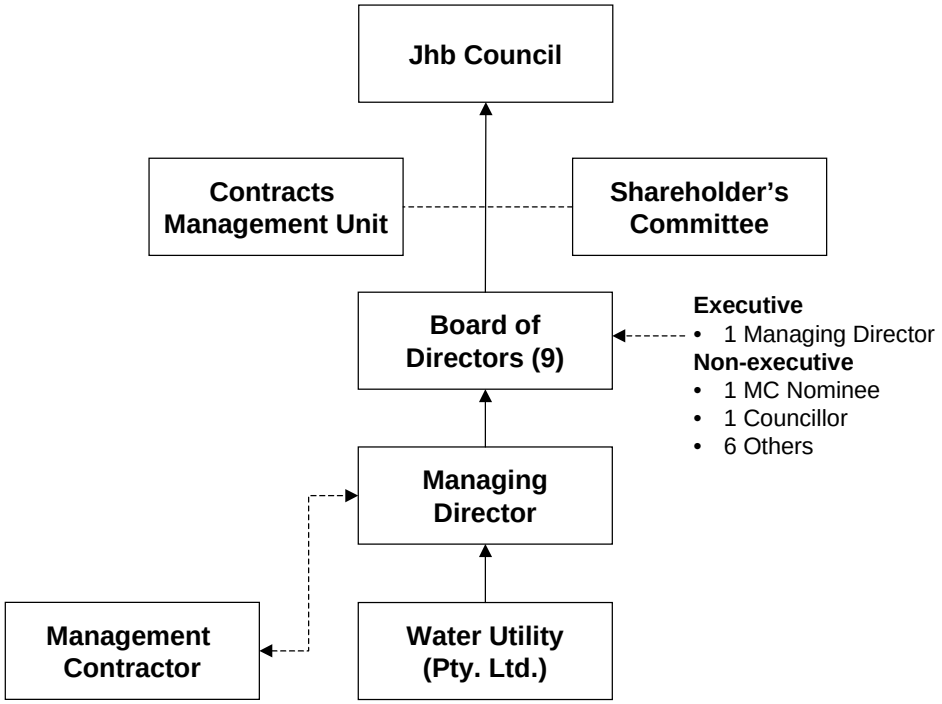
- The legal team worked on four crucial documents. The *Articles of Association* for the Company, the *Utility Contract*, the *Sale of Business Agreement* and the *Service Level Agreement*. Each of these required approval by the Council. Given that the local government elections took place in the course of this process, the Council only gave in principle approval to the Sale of Business and Service Level Agreements and insisted that the new Council should give final approval.
- Staff and union negotiations were undertaken collectively across all the Council's new utilities to address labour issues, most notably pension issues.
- A communication company was appointed which produced newsletters and conducted information meetings and assisted with setting up a communication network and system.

On 1 January 2001 the Company was incorporated.

6.3.5 Structure and governance

The basic features of the utility's governance structure are shown in the following diagram. A key feature was the GJMC's decision to appoint an external management contractor for a five year period.

Figure 11 Johannesburg Water – Company structure.



Ownership: The Water and Sanitation Utility is a company fully owned by the City of Johannesburg. In terms of the Municipal Systems Act the Council is required to retain ownership and control of the company. In theory then the Council could still give up 49% of the shares.

Transfer of staff and assets: The current assets, including infrastructure, moveable assets, office equipment and the debtors' book have been sold to the company in terms of a sale-of-business agreement. The asset value is set at around R1.6 billion and is based on a discounted net present value of the projected income stream, rather than on replacement costs which were closer to R6.5 billion (based on a modern equivalent asset value approach). The Utility has also taken over R1 billion of debt, being its share of the overall Council debt arising from physical assets that it is taking over. Staff currently employed by the Council to provide water and sanitation services have been transferred to the company as their new employer.

Governance: The company is governed by a board of directors, which will have a maximum of nine members. Since the City of Johannesburg holds 100% of shares it appoints all of the directors. At the time of writing this case study five directors had been appointed. The former Transition Manager was appointed as the managing director with executive responsibility. A Councillor will be appointed to the board and the management contractor may also nominate an expert in the field to the board. The Council may approve or reject this nomination. The question of the management contractor's role at board level was the subject of much debate. The bidding firms initially pushed for full control over the board and the appointment of executive directors.

Regulation: The Council retains all regulatory functions including the setting of tariffs, but all other operations are the responsibility of the company. These are set out in the service-delivery agreement that has been concluded between the Council and the company. The

Contract Management Unit is responsible for monitoring the utility's performance, and also the performance of all the other utilities. To reinforce the unit's 'independence' the CMU will be located in an office outside of the Council. The *Shareholder's Committee* will act in the interests of the Council as the sole owner of the utility (all of its utilities in fact). This committee will take policy proposals to Council, for instance dealing with dividend policies. This committee will consist of the Executive Mayor, the Executive Director: Finance, one Councillor, and two independent business people (probably including the former city manager, Khetso Gordhan, now in banking).

6.3.6 External management contractor

The appointment of an external management agent is an interesting feature of the Johannesburg model. This choice is based on a belief that that an experienced water operator will speed up the commercialisation of the Utility. In other words, the Council wants to benefit from international expertise without relinquishing control to it.

The alternative option considered by the Council was to grant a long term concession to a private company. This option would, however, require accurate revenue data in order to determine the value of the concession. In the absence of certainty around future revenue streams the risk for potential concessionaires rises, leading to higher prices for the Council. The Council therefore chose to take the mid-way route of a short term management contractor, thereby retaining flexibility for future institutional arrangements.

A contract has been concluded with Northumbrian-Lyonnaise, the successful bidder, in terms of which the management contractor will be remunerated in three ways. These are intended to provide both stability and incentives to perform. Firstly, the contractor will receive R25 million over five years as a basic fee for restructuring the service, as detailed in 29 specific deliverables. Secondly, the contractor will receive R20 million over five years on achievement of annually agreed performance targets in the following areas:

- Reduction of environmental spillages
- Delivery within time and budget of annual capital expenditure
- A human resources plan that includes training and restructuring
- Customer satisfaction
- Improved plant maintenance

Thirdly, the management contractor will receive a percentage of the incremental operating margin (i.e. part of the improvements in profitability). Bidders had to specify this percentage as part of their bids.

In practice, the success of this model will be a function of the relationships that are built between the management contractor and the company's senior management team; given that the contractor has to deliver to certain outcomes whilst the company employs the staff who carry out the functions.

6.3.7 Legislative issues

The Water and Sanitation Utility was formed prior to the passing of the Municipal Systems Act. It is a private company in terms of the Companies Act (less than 50 shareholders). Section 17D of the Promotion of Local Government Affairs Act No 91 of 1983 gives authority for incorporation as a company. The main objective behind that legislation was to move the delivery of services to fully privatised entities along New Zealand and Australian

lines, in the belief that this would substantially improve the performance of service function. For this reason it has a provision requiring that although the Local Authority must always retain the casting vote, it is required to reduce its shareholding over time. This is not what the GJMC required.

In order to deal with the problems created by this provision and by labour's opposition to a gradual loss of Council control, a Council Resolution was passed which prevented any change in shareholding from taking place within a five-year period. The company's articles of incorporation provide for the abolition of this provision once the Municipal Systems Act comes into effect. The articles of incorporation will then comply fully with the new legislation and ensure the desired level of Council control. As it is the Council holds 100% of the shares and the contracting agent is accountable to the board of directors of the company.

The other legal avenue that could have been used to establish the Utility, rather than using the 1983 legislation, would have been to utilise the constitution that establishes local government as a separate sphere of government with its own defined set of powers. The GJMC legal advisors were wary of following this route because of the risk of a Constitutional Court challenge delaying the process.

Further legal processes in the establishment of the company required the drafting of and agreement to a memorandum and articles of association. In terms of these, the Council has restricted authority. Moreover, a sale-of-business agreement had to be drafted. This had to be aligned with the provisions of the Labour Relations Act.

The greatest legal difficulty in the establishment of the Utility arose from the need to ensure compliance with Section 197 of the Labour Relations Act. The Inland Revenue Act of 1962 included a definition of local government that made it possible for local-government employees to qualify for tax exemption on their pension pay-outs. The establishment of the Utility and the transfer of staff from a local government employer to a Utility employer raised the possibility that this tax exemption would fall away. This possibility fuelled labour's opposition to the Utility's establishment.

Similar issues arose relating to the utility's tax liability, and the implications for Council.

The legal complications experienced in the establishment of the Utility indicated a strong need for a clearer legislative framework. In effect the fragmented legal framework did not provide for a legal creature such as the Utility.

6.3.8 Human resource issues

The central human-resources challenge in establishing the Utility was to secure the participation and support of the trade unions. This was a difficult process affected by broader tensions between national government and the trade union movement. These tensions relate to the government's desire to rationalise, restructure and downsize the public service, and the union movement's commitment to maintain its constituency's jobs and wage levels.

Given this context, the negotiation was destined to be complex. The unions had a history of opposing Johannesburg's privatisation initiatives prior to the *Igoli 2002* programme, and had refused to participate in consultations around the establishment of public-private initiatives on the basis that assets rightfully belonging to the public were being stolen. This position was supported by an arbitration award in Cape Town which overturned the outsourcing of refuse

removal - although the Labour Court later set aside this award. The establishment of a private water concession in Nelspruit during this period further aggravated union-management relations. Given Cosatu's opposition to GEAR and the fear of job losses, the stage was set for a very difficult process around the establishment of the water utility.

The above difficulties were compounded by the fact that the establishment of the Unicity would inevitably lead to the merging of the five councils' individual water and sanitation departments. Since 1997 the unions had resisted various rationalisation proposals. By the time Igoli 2002 proposed a series of utilities, agencies, corporatisations and privatisations, the Unions were thoroughly sceptical.

The unions had substantial reasons for their ongoing opposition. Within the context of high national unemployment, prospects for retrenched staff were bleak. Experiences in other parts of the world had fuelled fears that retrenchment would be an inevitable outcome of the process. As a result management and labour remained locked in dispute with the Council having to obtained interdicts against proposed strikes on two occasions.

The actual transfer of Council to the Utility was accomplished in terms of Section 197 of the Labour Relations Act. This section makes provision for the transfer of staff from a going concern to another going concern provided there is no change in the conditions of employment and that staff will not find themselves in a worse position than under their old employer. Under these circumstances no consent from employees is required. Decisions taken by the old structure are deemed to have been taken by the new.

6.3.9 Communication

The utility establishment process was supported by an intensive internal communication programme. This programme was undertaken by an external communications company whose brief was to help communicate to staff what the transfer would mean in practise. Given the fears around privatisation, the union/government power struggle and the history of mistrust it was extremely difficult to deal with the detail of the Utility establishment.

The communication programme faced the problem that communication systems within the existing water and sanitation services sections were poor with little culture of management reporting to staff. In an effort to improve this situation two communicators were identified at each depot so that there would always be a person who could bring forward questions and communicate answers.

A variety of communication tools were developed. These included:

- The regular production of an internal newsletter in English, Zulu and Sotho.
- The production of a video which was screened at depots
- Depot communicators received training and resource packs
- A corporate image was designed
- Regular newsletters were circulated to key stakeholders such as DWAF and the portfolio committee

Initially the communication campaign tried to deal with broad messages, but these were not well received by staff. Staff mistrust as to what was really happening continued and it was recognised that this problem could not be resolved by a communication campaign. The message then shifted to the specifics of the Water and Sanitation Utility process.

Once the utility was formed the message shifted again, towards establishing a clear brand, based on the new utility name *Johannesburg Water*. A key element in this process was the establishment of a new head office outside of traditional Council buildings.

6.3.10 Financial issues

Defining revenues: The utility faced significant problems in establishing a clear picture of its existing revenue stream. For instance, the four existing billing systems each took different approaches to the allocation of partial consumer payments (i.e. the priority by which services are allocated payments if a consumer does not pay the complete consolidated bill).

Debtors: The utility decided to take the entire water services debtors book on to its balance sheet, even though it included a significant portion of prescribed debt (over three yeas old). This decision was based on a realisation that the utility would be more likely to collect outstanding debt than the Council, and that the utility could adopt more creative measures to encouraging debtors to pay than the Council could. For instance the utility could offer to cancel three months debt for every new month paid.

VAT: The utility received a directive from the South African Revenue Service (SARS) permitting it to continue paying VAT on the payment method, rather than the invoicing method. This was a very significant concession from SARS, since companies are usually obliged to pay VAT on amounts invoiced, rather than just on amounts received. In the utility's case, with payment levels running somewhere around 85%, the difference would be very significant. The concession was permitted on the basis that the utility is a wholly owned municipal entity, and that water is constitutionally defined as a water function.

Transfer duties: The utility was not obliged to pay transfer duties, on the grounds that it was sold as a going concern. Transfer duties, at 10% on a R6.5 billion asset base, would have stopped the deal. The utility did have to pay conveyancing costs.

Company tax: At the time of writing the case study SARS had still to decide whether it would exempt the utility from company tax. This decision will have a material impact, since municipal water trading activities have not paid a tax on surpluses to national government in the past.

Tariffs and free services: The promulgation of tariffs will still be performed by a Council bye-law. The utility's business plan expected that tariff increases should be kept below inflation levels. The first increase, in July 2001, was expected to be at the inflation rate, since it had not been possible for the utility to establish a sufficiently clear picture of its financial position to make any major shifts in tariff policy. The only exception to this approach will be the introduction of a 'free service' policy, in the form of an adjustment to domestic tariffs to make the first 6kl per month per household free.

Capital budgeting: At the time of writing this case study the utility was entering its first round of capital budgeting. This exercise was testing the new Council-Utility relationship, in that the Council was unilaterally determining time-frames for the capital budgeting process which the utility was unable to meet (partly because the new management contractor had still to take up its position). As part of the restructuring into a unicity the Council had formed 11 internal regions, each with their own manager. The utility will therefore have to interact with each of these offices during the capital budgeting process.

6.3.11 Transition costs

The total cost of the transition process (including direct and indirect costs) has not been estimated. Direct costs, as measured by the cost of the transition manager, advisory board and consultants, were of the order of R20 million. It has not been possible to distinguish between costs attributable to the procurement of the management contractor as opposed to the process of Utility formation.

6.3.12 Reflections on the Johannesburg case study

The context: The process followed in setting up the Johannesburg Utility was influenced by forces from a number of levels: the overall transformation of the public service; the transformation of local government; and the Johannesburg-specific *Igoli 2002* programme. In other words municipalities choosing to embark on the corporatisation route will face location-specific issues which may led to different outcomes.

Legislative environment: The Johannesburg experience clearly demonstrated that the legislative environment was not supportive of the corporatisation process. The subsequent enactment of the Municipal Systems Act will have addressed some of these problems though.

The importance of champions and effective decision-making: The Johannesburg case study demonstrates that effective decision-making is a crucial factor in achieving a successful outcome. In Johannesburg's case this was largely the product of strong political mandates, powerful change champions and clear lines of accountability.

Utility-Council relationship: Although a lot of attention was paid to governance relations during the utility formation process the bulk of the argument focussed on the relationship between the board and the management contractor. At formation the relationship between the utility and the Council remained a relatively unexplored area. The experience in the first few months of the utility's life has shown the importance of this area. On the utility's side management is trying to establish autonomy and a new way of doing things. On the Council's side the newly formed Contracts Management Unit (the council's multi-service regulator) is still finding its feet. The role of Councillors may also need some revisiting.

The value of documenting learning: The Johannesburg team generated a vast amount of documentation and learning which could be useful for other municipalities contemplating the corporatisation of their water services. Mechanisms should be found to transmit this learning to other local authorities.

6.4 Lekoa Vaal Water Company

The proposal to create a ring-fenced corporatised water company in the Lekoa Vaal area has yet to come to fruition. Nonetheless, the following steps towards corporatisation were identified by Booz Allen, a consulting company (Booz Allen).

6.4.1 Institutional Work

1. Design statutes of Section 21 Company
2. Design Company name and corporate ID
3. Register Company
4. Sebokeng transfer proclamation
5. Sebokeng sub consultants agreements
6. Sebokeng interim management

7. Sebokeng loan transfers and agreements
8. Design GHJB agreement
9. Design EGSC/neighbour agreement
10. Develop customer service agreements
11. Develop concession agreement with MCMLC
12. Transfer assets and loan agreements from MLCS
13. Do permit applications for works
14. Do permit applications for operator registration
15. Conditions of employment
16. Personnel appointments
17. Appoint auditors
18. Auditors fees to oversee LWSS1'97
19. Auditors to LWC
20. Assign sub contracts where necessary
21. Arrange servitude transfers – sewers
22. Arrange servitude transfers – water
23. Arrange land transfers
24. Purchase additional land for irrigation and sludge
25. Find partner for the Lekoa Water Company

6.4.2 Human Resources Work

1. Appoint elected directors
2. Elect chairperson
3. Recruit managing director
4. Recruit/appoint pp directors (labour & community)
5. Recruit/appoint senior managers
6. Transfer GP staff
7. Transfer local government staff
8. Recruit (if required) additional staff
9. Negotiate with labour organisations
10. Capacity building
11. Staff orientation and training
12. Develop pension and benefit schemes
13. Medical insurance and medical aid schemes
14. Organisational development

6.4.3 Financial Work

1. Finalise long term financial plan
2. Finalise capex budget
3. Finalise opex budget
4. Secure capital finance
5. Develop billing system
6. Prepare invoices and submit to GJHB
7. Prepare invoices and submit to EGSC
8. Develop integrated costing system
9. Develop integrated accounting system
10. Develop purchasing system
11. Arrange short-term finance
12. Develop guarantees
13. Assets register and valuations

14. Payroll set-up

6.4.4 Corporate work

1. Office facilities
2. Furniture and equipment
3. Telecom systems
4. Instrumentation upgrades
5. Facilities planning model
6. Performance management system
7. Company strategy plan

6.4.5 Operations

1. Environmental monitoring systems
2. Laboratory services arrangements
3. Instrumentation review
4. Chemicals and consumables
5. Planned maintenance program
6. Operation “bottleneck”
7. Operation “Leak-no-more”
8. Operation “Stop-a-block”

6.4.6 Public Relations and Marketing

1. Stakeholder communications
2. Press releases
3. Launch
4. Brochures and fact sheets

6.4.7 Performance Auditing & Project Management

1. Develop performance standards
2. Install performance auditing system
3. Project programming and reporting
4. Deviation reporting and adjustment
5. Develop and operate IT system
6. Other (project management)

Although many of these steps are context-specific, the extent of the range of work provides an indication of the scale of complexity involved in a corporatisation exercise.

6.5 Cape Metropolitan Council corporatisation investigation

The Cape Metropolitan Council (CMC) has commissioned PricewaterhouseCoopers to undertake two significant pieces of work into the feasibility of corporatising the Council’s bulk water and wastewater treatment facilities (PwC 1999, PwC 2000).

PwC provides the following argument as the basis of their recommendation that the CMC should corporatise its bulk water and wastewater functions:

1. the need for *more focused management* than the Council can provide;
2. the need for *private sector skills and expertise*, particularly at senior management and Board level;

3. the desire to *remove the activity from political pressures and interference*, acknowledging that this may not be achieved as a result of Council representatives on the Board, and particularly if the Company reports to a Council Committee;
4. the possibility that corporatisation may somehow *facilitate investments* that would not otherwise be possible due to the Company being seen as too closely aligned with the Council; and lastly the argument
5. that the *activity does not fit with the rest of Council's activities* (PwC 2000:7).

The validity of some these arguments is fairly questionable. To be fair though, PwC was not tasked with making the case for corporatisation, since the Metro Council had already made an in-principle decision on the matter.

At this stage the process of merging Cape Town's six MLCs with the CMC into a single unicity has halted the investigation into this option.

6.6 Durban Unicity Committee perspective

The Durban Unicity Committee has published a document which suggests that decisions on the most appropriate institutional form for service delivery should be guided by the imperatives of:

- Carrying out the constitutional mandate of developmental local government, especially in the eradication of unmet social and economic needs.
- Ensuring cost-effective and good quality services for consumers.
- Ensuring financial sustainability.
- Ensuring that the social goals of the Council are achieved and that the poor and most marginalised of our society are not further marginalised.
- Recognising that municipalities operate in an increasingly pluralist society characterised by differing wants and needs,
- Harness the strength of civil society, labour unions and the popular political process – by involving these parties in review and change processes.
- Involving all role players and stakeholders (including the community, business, organised civil society and labour) to engender appreciation and support of local government's activities.
- Ensuring that the vision and development objectives contained within the Council's integrated Development Plan are achieved (Durban Unicity Committee 2000:27).

Whilst it is known that Durban Metro Water has undertaken extensive investigations into the option of corporatisation, amongst other options, these reports are not presently in the public domain and are therefore not reviewed in this research report.

7 Process Considerations

7.1 Introduction

This section attempts to answer in greater detail the following research questions:

Q6. What process should a municipality follow to determine whether or not to corporatise water services? What factors should be considered? Who should be involved? How long should it take? What might it cost?
Q7. Once a decision is taken, what steps have to be taken to corporatise municipal water services?

This section draws on three key resources,
1. The recently enacted *Municipal Systems Act*
2. The World Bank's *Toolkits for private sector participation in water and sanitation*, and
3. The American Water Works Association's CD-ROM resource, *Balanced evaluation of public/private partnerships*.

7.2 The Municipal systems act

Chapter 8 of the Municipal Systems Act provides a detailed process framework for decision-making on municipal services, and for on-going responsibilities following any decision to corporatise or out-source services.

7.2.1 General duties of a municipality

The chapter commences by noting that a municipality must give effect to the provisions of the Constitution and,

- give priority to the basic needs of the local community;
- promote the development of the local community; and
- ensure that all members of the local community have access to at least the minimum level of basic municipal services (DPLG, 2000c: clause 73(1)).

The same clause notes that municipal services must

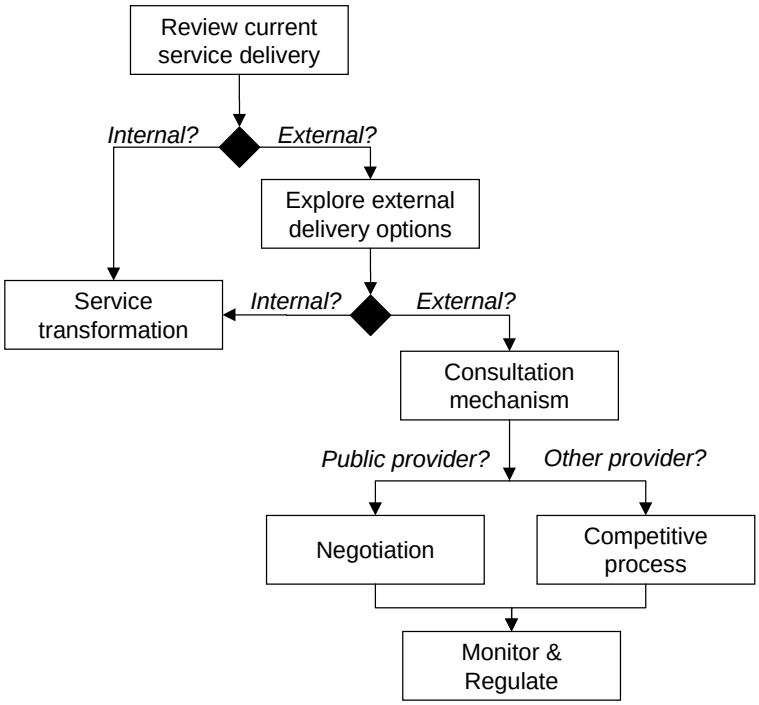
- be equitable and accessible;
- be provided in a manner that is conducive to—
  (i) the prudent, economic, efficient and effective use of available resources; and
  (ii) the improvement of standards of quality over time;
- be financially sustainable;
- be environmentally sustainable; and
- be regularly reviewed with a view to upgrading, extension and improvement (DPLG, 2000c: clause 73(2)).

These provisions thus form a guiding framework for all service-related decisions. The Act then goes on to lay out more detailed decision-making criteria and procedures. The bulk of this process is concerned with the process of selecting between *internal* or *external* service providers options.

7.2.2 Process overview

The entire process contemplated in chapter 8 is summarised in the following diagram[8].

Figure 12 Municipal service decision-making process (DPLG, 2000c)



Each of these stages are reviewed below.

7.2.3 Occasions for the review of current service delivery

The Act obliges municipalities to review service delivery when the following circumstances arise:

- when preparing or reviewing its integrated development plan
- when providing a new municipal service
- when upgrading, extending or improving a service
- when performance evaluation requires a review
- when municipal restructuring takes place
- when requested by the local community
- when instructed by provincial executive (DPLG, 2000c: Section 77)

These are fairly onerous requirements, which could lead to multiple and repetitive reviews.

7.2.4 Criteria for the review of current service delivery

The Act states that the review must take the following criteria into account:

- direct and indirect costs and benefits
- municipal capacity
- potential for re-organisation and HR development
- impact on development, job creation and employment
- views of organised labour
- trends in the provision of municipal services (DPLG, 2000c: Section 78(1)).

[8] For a more detailed review of this process see the accompanying guidelines for municipalities in creating corporatised water utilities.

The Act does not specify the level of detail that a municipality must engage in when reviewing each of these criteria. Such factors will no doubt be tested in practice and in the courts over time.

7.2.5 Scope of the review

Service scope: Surprisingly the Act provide no definition of a *municipal service*. There is thus no clear guidance as to when the process contemplated in Chapter 8 has to be followed. For instance, a decision to contract out a very small portion of work (repairing a burst main) could be construed as requiring a full Municipal Systems Act process.

Geographic scope of the review: The Act appears to assume that service reviews will generally take place over the entire municipal area. Two distinct exceptions are allowed for:

Internal municipal service districts: which are really intended for the provision of 'top-up' services in clearly defined areas, such as a central business district of a city.

Multi-jurisdictional municipal service districts: which are intended to cover service provision across municipal boundaries, i.e. covering all or part of two or more municipal areas.

The Act does not seem to allow for the case where a municipality may wish to review service delivery in part of its area.

As far as possible a decision on the scope of the service review should be taken at the outset in order to facilitate effective data gathering, consultation and decision making.

7.2.6 Review outcomes

The Act allows for two outcomes to the service review, in that a municipality may—

- decide on an appropriate *internal mechanism* to provide the service; or
- before it takes a decision on an appropriate mechanism, *explore the possibility of providing the service through an external mechanism*.

The nature of these internal and external mechanisms is spelled out in great detail in the act,

> **76.** A municipality may provide a municipal service in its area or a part of its area through—
> (a) an internal mechanism, which may be—
> (i) a department or other administrative unit within its administration;
> (ii) any business unit devised by the municipality, provided it operates within the municipality's administration and under the control of the council in accordance with operational and performance criteria determined by the council; or
> (iii) any other component of its administration; or
> (b) an external mechanism by entering into a service delivery agreement with—
> (i) a municipal entity;
> (ii) another municipality;
> (iii) an organ of state, including
> (aa) a water committee established in terms of the Water Services Act, 1997 (Act No. 108 of 1997);

(bb) a licensed service provider registered or recognised in terms of national legislation; and
(cc) a traditional authority;
(iv) a community based organisation or other non-governmental organisation legally competent to enter into such an agreement; or
(v) any other institution, entity or person legally competent to operate a business activity (DPLG, 2000c).

A municipal entity is further defined as,

82. (1) If a municipality intends to provide a municipal service in the municipality through a service delivery agreement with a municipal entity, it may—
(a) alone or together with another municipality, establish in terms of applicable national or provincial legislation a company, co-operative, trust, fund or other corporate entity to provide that municipal service as a municipal entity under the ownership control of that municipality or those municipalities;
(b) alone or together with another municipality, acquire ownership control in any existing company, co-operative, trust, fund or other corporate entity which as its main business intends to provide that municipal service in terms of a service delivery agreement with the municipality; or
(c) establish in terms of subsection (2) a service utility to provide that municipal service.
(2) (a) A municipality establishes a service utility in terms of subsection (1)(c) by passing a by-law establishing and regulating the functioning and control of the service utility.
(b) A service utility is a separate juristic person.
(c) The municipality which established the service utility must exercise ownership control over it in terms of its by-laws (DPLG, 2000c).

A corporatised utility would thus fall clearly into the category of a 'municipal entity' and would thus be regarded as an *external* option.

7.2.7 Decision to select an internal service provider option

If the review reaches the conclusion that internal service provision is appropriate then the Act requires the Council to,

- allocate sufficient human, financial and other resources necessary for the proper provision of the service; and
- transform the provision of that service in accordance with the requirements of this Act (DPLG, 2000c).

7.2.8 Decision to explore external options

Should the internal review indicate the need to explore external options then the Act obliges the Council to,

- give notice to the local community of its intention to explore the provision of the service through an external mechanism; and
- assess the different service delivery options in terms of section 76(b), taking into account—
  (i) the direct and indirect costs and benefits associated with the project, including the expected effect of any service delivery mechanism on the environment and on human health, well-being and safety;
  (ii) the capacity and potential future capacity of prospective service providers to furnish the skills, expertise and resources necessary for the provision of the service;

(iii) the views of the local community;
(iv) the likely impact on development and employment patterns in the municipality; and
(v) the views of organised labour (DPLG, 2000c: clause 78(3)).

7.2.9 Decision to adopt an external option

Following the review of external options the Council may decide to adopt an internal or an external service provision mechanism. It is at this point in the process that Council will take a final decision on the end-goal, should it elect to go for a corporatised water services provider. Council's decision should be defendable in terms of both process and content.

7.2.10 Process requirements

The appropriate extent of stakeholder consultation in the course of taking this decision is likely to be a function of local conditions.

At the time of writing only one legal challenge is known to have taken place around a Council decision, taken in terms of the Systems Act, on outsourcing a municipal service. In this case the trade union Samwu had challenged a decision by Sedibeng District Council to 'privatise' six cemeteries[9] on the grounds that they had not been adequately consulted. Ruling on the matter the arbitrator declared that the union is "entitled to be consulted and that the agreement between council and the contractor be suspended until the process of consultation is completed" (Samwu, 2001).

Beside the System Act's process requirements municipalities must also comply with any applicable legislation or regulations applying to the service under consideration (DPLG, 2000c: clause 78(5)).

Once a decision is taken to opt for an external service provider, but before a service delivery agreement is finalised, the Act obliges the municipality to put in place "a mechanism and programme for community consultation and information dissemination regarding the service delivery agreement. The contents of a service delivery agreement must be communicated to the local community through the media" (DPLG, 2000c: clause 80(2)).

In the event that the Council decides on a non-public service provider the municipality is obliged to follow a competitive selection process, including the requirements of the Preferential Procurement Act. A decision to corporatise the municipal water service would, however, be exempt from this provision, since a corporatised entity would be regarded as a Municipal Entity. The municipality would only be required to "negotiate and enter into such an agreement with the relevant municipal entity" (DPLG, 2000c: clause 80(1)).

Once the service delivery agreement has been finalised the municipality must—

- make copies of the agreement available at its offices for public inspection during office hours; and
- give notice in the media of—
  (i) particulars of the service that will be provided under the agreement;
  (ii) the name of the selected service provider; and
  (iii) the place where and the period for which copies of the agreement are available for public inspection (DPLG, 2000c: clause 84(3)).

[9] The exact nature of the contractual arrangement is not known, however it is clear that it involved an external service provider.

7.2.11 Regulatory responsibilities

If a Council elects to provide a municipal service through a service delivery agreement the municipality remains responsible for a range of matters. It must

- regulate the provision of the service, in accordance with section 41;
- monitor and assess the implementation of the agreement, including the performance of the service provider in accordance with section 41;
- perform its functions and exercise its powers in terms of Chapters 5 and 6 if the municipal service in question falls within a development priority or objective in terms of the municipality's integrated development plan;
- within a tariff policy determined by the municipal council in terms of section 74, control the setting and adjustment of tariffs by the service provider for the municipal service in question; and
- generally exercise its service authority so as to ensure uninterrupted delivery of the service in the best interest of the local community (DPLG, 2000c: clause 81(1)).

The Council is allowed to assign certain activities to the service provider through the service delivery agreement, including responsibility for:

- developing and implementing detailed service delivery plans within the framework of the municipality's integrated development plan;
- the operational planning, management and provision of the municipal service;
- undertaking social and economic development that is directly related to the provision of the service;
- customer management;
- managing its own accounting, financial management, budgeting, investment and borrowing activities within a framework of transparency, accountability, reporting and financial control determined by the municipality, subject to applicable municipal finance management legislation;
- the collection of service fees for its own account from users of services in accordance with the municipal council's tariff policy in accordance with the credit control measures established in terms of Chapter 9 of the Act (DPLG, 2000c: clause 81(2)(a))

Other matters that the service delivery agreement may cover include:

- provision for the municipality to pass on to the service provider, through a transparent system that must be subject to performance monitoring and audit, funds for the subsidisation of services to the poor;
- the transfer or secondment of any of its staff members to the service provider, with the concurrence of the staff member concerned and in accordance with applicable labour legislation;
- ensuring continuity of the service if the service provider is placed under judicial management, becomes insolvent, is liquidated or is for any reason unable to continue performing its functions in terms of the service delivery agreement; and
- provision, where applicable, for the municipality to take over the municipal service, including all assets, when the service delivery agreement expires or is terminated (DPLG, 2000c: clause 81(2))

Further responsibilities spelled out in the Act include:

- The municipal council has the right to set, review or adjust the tariffs within its tariff policy. The service delivery agreement may provide for the adjustment of tariffs by the service provider within the limitations set by the municipal council.
- A service delivery agreement may be amended by agreement between the parties, except where an agreement has been concluded following a competitive bidding process, in which case an amendment can only be made after the local community has been given—
  (a) reasonable notice of the intention to amend the agreement and the reasons for the proposed amendment; and
  (b) sufficient opportunity to make representations to the municipality.
- No councillor or staff member of a municipality may share in any profits or improperly receive any benefits from a service provider providing a municipal service in terms of a service delivery agreement (DPLG, 2000c: clause 81(3)-(5)).

7.2.12 Summary

The Municipal Systems Act is a very new piece of legislation, formed in a context of major policy shifts, and a hard-fought ideological battle between the government and some trade unions. As a result the section of the Act dealing with decisions on municipal service provision focuses mainly on the choice between internal and external service providers, with significant processual provisions to safeguard the interests of stakeholders such as labour. The workability of the Act has still to be tested in practice. Certainly there would appear to be a significant flaw in the lack of attention paid to defining a 'municipal service'. Without some clarity on this matter any decision involving external providers may be held up in terms of the process contemplated in the act.

7.3 World Bank Toolkit 2 – Designing and implementing an option for private sector participation

7.3.1 Limitations of the toolkit

The toolkits is, unfortunately, largely written with national government staff and advisors in mind and does not specifically address the issues faced by municipalities. Also, the toolkit is mainly focused on private sector options. Nonetheless, there are many aspects of the process described in this toolkit which are generic to a municipal corporatisation exercise, whether it includes a private partner or not.

7.3.2 What is a good process?

The toolkit warns that the quality of the process of designing and implementing organisation reform can determine whether or not the reform succeeds. Processes cost money and take time and governments face a trade-off between the potential benefits to their citizens from getting the best possible arrangement and the costs of the extra refinements in both time and money. A good process is one that produces a satisfactory outcome for consumers without unnecessary costs or delays. A good process should also allow flexibility to respond to unforeseen events, without losing track of the original objectives. And it should assure stakeholders that it is fair and transparent, reducing the risk of legal or political disruptions later on (World Bank, 1997b:1).

The toolkit points out that where a government is seeking to involve the private sector, it will need to establish a unit to work through the options outlined in toolkit 1 (described earlier in this report in the section on defining corporatisation). This unit will probably need to hire independent advisers to assist in refining and implementing the proposed private sector

arrangement. (See below for a section on managing the process which covers issues relating to the structure and mandate of this unit and the hiring of advisers).

The toolkit notes that a sound proposal is one that has political support, both within government and among interested stakeholders. The political viability of a chosen arrangement will depend in part on how well it meets technical problems. But it will also depend on such factors as:

- the presence of a *political champion*, willing and able to provide high-level support for the project throughout the preparation and bidding.
- the government's *capacity to mobilise support* for the arrangement within its own ranks.
- support from the *utility's management and labour*, to allow a smooth transition.
- the identification of *key stakeholders* and the development of a plan for responding to their concerns.
- the *transparency and fairness* of the process of implementing private sector participation (World Bank, 1997b:1).

According to the toolkit experience around the world with efforts to reform and restructure water and sanitation utilities shows that, as with any other reform, political commitment is absolutely crucial to the success of a transaction. Political commitment is essential, for example, to ensure a genuine response to the concerns of stakeholders, particularly government utility employees.

The toolkit goes on to outline six main areas of work, over a nominal 12 month period, each of which is described in more detail in the following diagrams and sections.

Figure 13 Policy formulation (World Bank, 1997b:4).

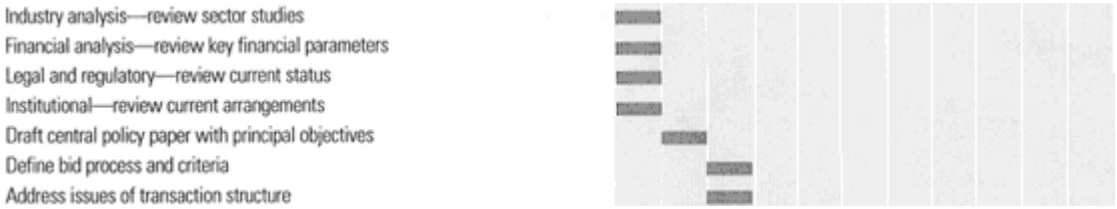


Figure 14 Technical analysis (World Bank, 1997b:4).

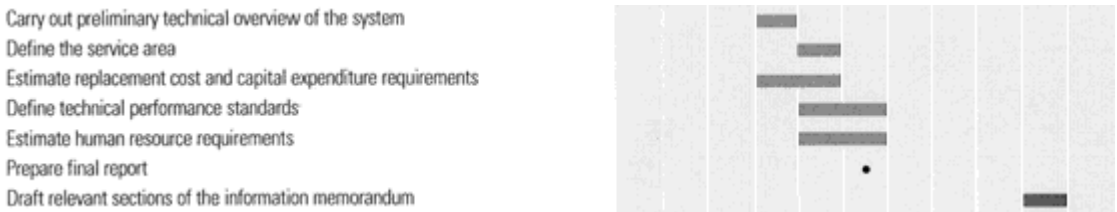


Figure 15 Legal and regulatory work (World Bank, 1997b:4).

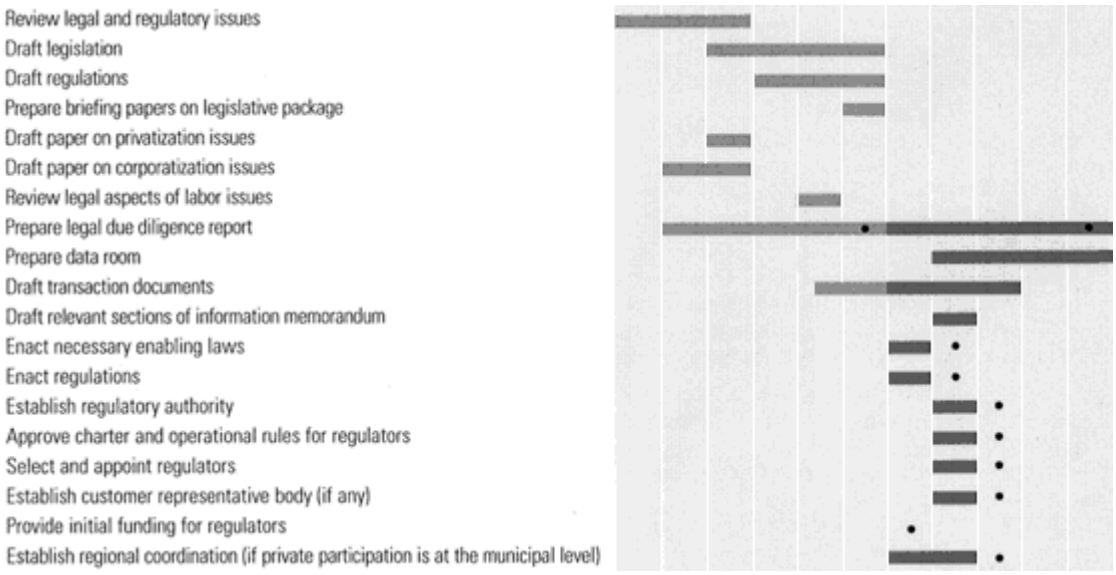


Figure 16 Economic and financial analysis (World Bank, 1997b:4).

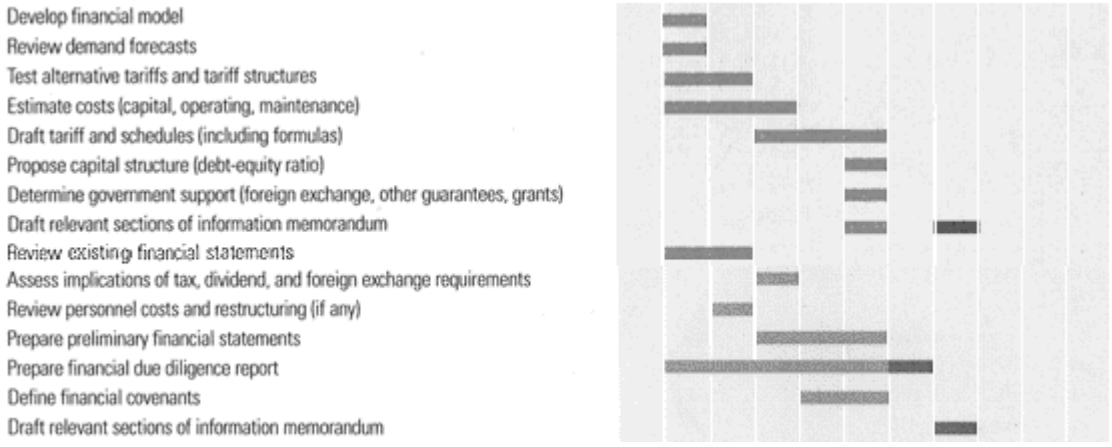


Figure 17 Public relations (World Bank, 1997b:5).

Figure 18 Human resources (World Bank, 1997b:5).

Figure 19 Workshop 1: Structure and policy issues (World Bank, 1997b:5).

Figure 20 Workshop 2: Transition strategy (World Bank, 1997b:5).

Figure 21 Transaction (World Bank, 1997b:5).

7.3.3 Policy formulation

The toolkit states that the cornerstone of the reform is the central policy paper in which the government sets out its main policy objectives and the broad parameters of the proposed transactions. This policy paper should draw on several inputs:

- a review of completed sector studies.
- a review of the key financial parameters on which the government will base policy decisions on such matters as the financial support that it is prepared to give to projects.
- a review of the legal framework relating to the sector.
- a review of the institutional framework of the sector (World Bank, 1997b:3).

In South Africa's case various central government departments have played a role in establishing the policy framework for corporatisation and the involvement of private sector players in the delivery of water services. The review of the environment for corporatisation has shown that although significant steps have been taken the legal framework still probably represents more of an obstacle than a support for corporatisation initiatives.

7.3.4 Technical analysis

The toolkit recommends that during the preparation phase input from technical engineering consultants should be obtained to estimate the expenditures needed to achieve realistic performance standards in such areas as water quality, pressure, water losses, and service

coverage (for further information see the section in toolkit 1 on assessing the current state of the utility). This input is critical in developing reasonable performance targets and methods for measuring performance and will aid in valuing the assets at the end of the contract should a private sector partner be involved.

The results produced by the technical consultants provide key inputs for the financial consultants. The technical consultants' assessment of the assets' physical condition, judgement on the assets' remaining useful life, and estimate of the capital expenditure required to meet the performance criteria will all serve as inputs to the financial model. And the technical consultants' estimate of the human resources required to provide safe, efficient service will feed into the analysis by the lawyers and financial analysts of the likely effect of retrenchment compensation on tariffs and financial feasibility. The results on human resource needs will also go to the human resource consultants, who will manage this information and present it to the workers and their unions in a way that ensures transparency and a clear flow of information (World Bank, 1997b:6).

7.3.5 Legal and regulatory work

Once broad policy decisions have been made about what form of private sector participation is preferred, what areas and functions will be covered, and how private sector participation will operate within the national structures for water resource management and regulation (see the section in toolkit 1 on the regulatory framework), further work on legal and regulatory aspects is required to prepare for the transaction. This work, carried out by lawyers, consists of two groups of tasks, the first relating to the legal and regulatory framework and the second to the transaction strategy.

The first group of tasks involves:

- Identifying the areas within existing laws, regulations, and decrees that constrain the transaction or increase its cost (reduce its value) and either preparing amendments or proposing safeguards within the transaction.
- Examining the continued regulatory tasks of the public sector and advising on how these should be accomplished (by contract, by sector-specific regulation, by legally specified duties of a regulatory agency, or by some combination of these).
- Based on a review of existing institutional arrangements, clarifying the roles of different agencies in relation to the private company and advising on the development of new bodies and mechanisms for co-ordination, for example, among municipal, provincial, and national functions, between economic regulation and environmental and health regulation, and between infrastructure development and land use planning.
- If restructuring the utility company is a policy option, evaluating the necessary legal and political measures (World Bank, 1997b:6).

In the second group of tasks the lawyers should develop, in conjunction with the other advisers, the principal transaction strategy—including key papers on corporatisation, tax, labour transfer, and bidding process issues—and present this strategy to key policymakers. In addition, the lawyers will be responsible for developing all the transaction documents. Different private sector options will require different suites of contracts and instruments (World Bank, 1997b:5).

In the event that a private sector partner is to be involved a contract package will have to be put together. A contract package for a typical concession might include the following:

- The request for proposals or tender document.
- The concession contract.
- The license or other regulatory documents.
- The asset sale and purchase agreement.
- An implementation agreement on the government's support (if any) to the project.
- A disclosure letter against any warranties and indemnities given in other contracts.
- Bulk water supply and sewage treatment contracts (World Bank, 1997b:7).

7.3.6 Economic and financial analysis

The toolkit notes that economic consultants, working with financial analysts, will play a key part in developing the tariff formulas and base tariffs for the transaction documents. They will also assist in developing the general legal framework. They will examine demand projections and willingness-to-pay information, prospects for growth, the current tariffs and tariff structure, and the method for calculating tariffs. Their output will be an input to the final transaction documents and the final laws and regulations for the sector. The economists should also be able to assist in evaluating the current institutional capacity for regulation and to advise on how best to configure the sector to maintain competitive pressures after the transaction closes.

The financial advisers will usually play a wide-ranging role—from pre-marketing (identifying and discussing with potential private investors the possible transaction options), to co-ordinating inputs from other advisers, to marketing the transaction. The financial advisers will assist the government in determining the effects of changes in the tariff on the likely price or value of the assets or concession fee. This analysis will entail developing a financial model and discussing with the government the policy assumptions that should be included in the model. The model will be used to test the viability of the proposed service objectives and their impact on the tariff. Once an option has been selected, the model can be used to develop the financial specifications for bids and as a reference for contract negotiations (World Bank, 1997b:6).

The toolkit provides a checklist for financial modelling:

Review demand forecasts: Review the forecasts of residential, commercial, and industrial water consumption for the utility's existing service area and any proposed extensions. Are they based on credible assumptions about the willingness of customers to pay for services? Do they take account of customers' response to tariff increases?

Incorporate costs: Incorporate the construction schedule, the equipment procurement schedule, and the operating and maintenance costs of existing and proposed facilities into the model. Determine the impact on tariffs of changes in the construction schedule. Evaluate the construction management plan, especially as it relates to lender requirements.

Incorporate assumptions about capital structure: Analyse the appropriate mix of private equity and debt to finance the project. Provide assumptions about:

- Minimum rates of return on equity.
- Interest rates and tenor of senior, subordinated, and shareholder loans.
- Foreign exchange rates over the life of the loan (if applicable).
- Debt service coverage ratios (senior and subordinated debt).
- Priority distribution of tariff revenues to debt (senior and subordinated, principal and interest payments) and equity (dividend pay-outs).
- Depreciation and tax benefits.

Determine government financial support: Determine how the government could provide financial support. Some of the possible ways:

- Direct grants (or waiver of a transaction fee).
- Loans.
- Foreign exchange and convertibility guarantees.
- Loan principal and interest guarantees.
- Delinquent payment coverage.
- Supply and purchase guarantees (take-and-pay or take-or-pay contracts for bulk supply).
- Tariff subsidies for specific user groups (these may be time-bound).
- Tax relief.

Test alternative tariff structures: On the basis of the cost inputs, capital structure assumptions, and demand forecasts, evaluate alternative tariff structures and identify the structure that meets government objectives and is capable of financing the project.

Draft tariff schedules and adjustment formulas: On the basis of the tariff structure, evaluate alternative tariff schedules and a formula for adjusting the tariff. Those selected will depend on the basis on which the contract is awarded and must be consistent with the regulatory framework (World Bank, 1997b:8).

The financial advisers will need the input of the legal and regulatory advisers, because the draft contracts will affect the commercial and financial viability of the proposed project. The financial advisers will review the demand forecasts, test alternative tariff structures and technical solutions, and estimate capital, operating, and maintenance costs. They will advise on the capital structure for the new entity (debt-to-equity ratio), and any covenants that should be applied with regard to financial ratios and potential collateral for lenders. They will also advise on the preparation of the information memorandum for the transaction and later assist in evaluating bids.

7.3.7 Public relations

Public relations consultants, preferably with good knowledge of the local area, can be retained to act as official spokespersons for the process, keeping the public informed of the proposed transaction structure. Through regular team meetings, these consultants should be kept fully up to date on the details of the proposed transaction, and briefed on which matters are confidential and which may be disclosed. It is usually a good idea to have the public relations consultants run a general corporate awareness campaign to ensure that the public is aware of the reform process and the underlying government policies. Such a campaign is important to assure the electorate that the reform process is taking care of their legitimate concerns as consumers (World Bank, 1997b:6).

7.3.8 Human resources

Human resource consultants should also be retained, to help organise interactions with unions and employees and identify ways of meeting their concerns. Like the public relations consultants, these consultants need to be kept fully briefed on how the proposed transaction is evolving and on which matters are confidential and which may be disclosed to employees and their union representatives (World Bank, 1997b:6).

7.3.9 Process management

The toolkit goes on to look at the political and technical aspects of managing the reform process.

7.3.10 Managing the politics of reform

The toolkit notes that the success of any process of involving the private sector in the provision of water and sanitation services will depend on a belief among potential bidders that:

- There is a firm political commitment to the process among the key decision makers in the government.
- This political commitment will be sustained once the transaction is completed.
- The government has taken action to deal with the main politically sensitive issues that surround the transaction.

Should a corporatisation not involve private sector interests it is possible that the politics will be less sensitive, however this need not necessarily be the case.

The toolkit notes that if political commitment appears weak, bidders may stay away or raise the price of their involvement. If the government mismanages politically sensitive issues, it risks delays, increased uncertainty, and reduced chances for a strongly positive outcome. The political problems raised by the process of involving the private sector often turn out to be more difficult to solve than the technical or conceptual problems of the contract design. Identifying possible issues early and developing a careful program for managing them are essential. Several steps are critical in this process:

- Identify key stakeholders in the reform and the primary nature of their interest in the design and the outcomes of the process.
- Identify up front issues that are likely to be politically sensitive or to require policy decisions or political action.
- Identify substantive policy decisions needed.
- Identify ways to secure stakeholder input and commitment to the reform process. (Here it is important to distinguish between the stakeholders who need to be consulted by virtue of their legitimate interests in the reform process and those whom it is simply politic to inform, through public relations campaigns.) For each measure identified, the costs—and who should bear them—will also need to be identified.

Table 25 Possible stakeholder issues and policy responses (World Bank, 1997b:11).

Stakeholder group	Possible Issues	Policy decisions required	Ways to get inputs
Employees	Is retrenchment likely to be needed?	Retrenchment packages Employment requirements for the private operator	Representation in the reform process Regular consultation
Consumers	Which consumers will receive new works first? Which consumers are willing to pay?	System for planning extensions Tariff methodology Design of a subsidy scheme if needed	Public relations campaigns and opportunities for consultation
Environmentalists	Will new works have major environmental consequences?	Environmental standards have to be applied Identification of who will bear cleanup costs from past pollution	Consultation on key issues

Stakeholder group	Possible Issues	Policy decisions required	Ways to get inputs
Existing government agencies	Will restructuring or shifts in responsibilities be required?	Identification of which agency will have regulatory authority, and how it will co-ordinate with other agencies	Opportunities for consultation
Other citizens	Will new works require resettlement?	Resettlement policy	Direct consultation with affected groups

7.3.11 Managing the process of reform

The toolkit suggests that for a reform to proceed smoothly government will need to establish a unit responsible for day-to-day process management. The skills of the people appointed to this unit will be critical. While the unit may consult with interested stakeholders or representative forums, it must be able to view the process from a broader, social perspective, focusing above all on the interests of water and sanitation consumers (World Bank, 1997b:11).

In designing the management unit, the government needs to address the following questions:

What will be the legal and organisational status of the unit?
- Will it be a ministerial working group or committee?
- What will be its legal powers?

Where will the unit be located?
- Will it be attached to a government department?
- A ministerial office?
- A mayor's office?

How will the unit be staffed?
- What sorts of skills and experience will be needed?
- What are the reputations of the key staff?
- Will they be seen as independent?
- Who will head the unit?

How will the unit obtain the resources it needs?
- What will its funding base be?
- What procedures must the unit follow to secure funds and procure goods and services?

To whom will the unit answer?
- A single politician, charged with oversight of the process?
- A parliamentary committee?
- A bureaucratic steering committee?

What mechanisms will be used for holding the unit accountable?
- Reporting on progress against the critical path?
- Financial reporting?
- Incentives for performance?

How will the unit obtain key information and co-operation from elsewhere in the public sector?

What kind of access will the unit have to key political decision-makers?

- Will it be direct or mediated?

The toolkit points out that there is no single set of right answers to these questions. Political and institutional structures, prior experience with private sector projects, and the extent to which the necessary skills are available domestically will all shape the structure a government chooses (World Bank, 1997b:12).

In deciding how to set up the unit, the government's objectives should be to:

- Ensure that the unit has sufficient autonomy, both managerial and financial, to carry out its task cost-effectively.
- Shield the unit's staff from political interference in their day-to-day tasks.
- Give politicians and relevant government agencies confidence that the task is proceeding as intended and that any major policy issues are dealt with as they arise—by putting in place reporting and accountability mechanisms (World Bank, 1997b:12).

7.3.12 Hiring advisers

The toolkit places great stress on the role of expert consultants and advisors. Designing and implementing private sector participation in water and sanitation requires substantial economic, financial, technical, and legal expertise, and the co-ordination of that expertise. The process requires detailed work—first refining the option to be implemented and the legal and regulatory measures needed to support it, then preparing many complex documents, such as the regulatory framework law, the bidding documents, and the draft contracts. Preparing the documents often involves several iterations, as preliminary versions are distributed to prospective private partners for comment and then modified in accordance with these comments and with the government's policy concerns (World Bank, 1997b:11).

The toolkit notes that governments usually lack the full range of expertise within the civil service to carry out these tasks. Even where earlier privatisation projects have helped build up a body of skilled staff, these staff are unlikely to have the full range of skills needed to see through every aspect of the process. Some countries may have few of the necessary skills available locally and will need international advisers. All governments will need to contract out at least some of the tasks to external advisers. Managing these advisers then becomes a primary task of the government unit (World Bank, 1997b:11).

7.3.13 What kind of advisers might be needed?

The toolkit suggests a range of potential advisors.

Economic and regulatory consultants, to advise on:

- How the market might be structured.
- How competition might be promoted.
- How tariffs might be structured and adjusted.
- What regulatory and monitoring mechanisms are needed.
- What instruments will be needed to promote efficient use and allocation of water (in co-ordination with the environmental consultants).

Legal consultants, to prepare:

- Legislation and regulations.

- Bidding documents.
- Draft contracts.

Technical consultants and engineers, to:
- Undertake a technical assessment.
- Prepare the technical specifications and requirements of contracts and regulations.

Environmental consultants, to:
- Prepare environmental studies.

Investment bankers and financial consultants, to:
- Prepare financial projections.
- Determine the bankability of the project.
- Prepare the information memorandum and prospectus.
- Undertake sales promotion (World Bank, 1997b:13).

7.3.14 Selecting advisers

Once the government has decided which kinds of advisers it wishes to hire, it needs to set up a selection process, which will include:
- Preparing terms of reference setting out the objectives, scope of work, and expected outputs from each group of advisers.
- Preparing a letter of invitation setting out the process for submitting proposals and the criteria that will be used to evaluate proposals.
- Identifying a shortlist of qualified advisers.
- Evaluating bids and finalising contracts (World Bank, 1997b:14).

The terms of reference for each group of consultants will depend on such factors as the kind of private sector involvement planned (if any); the extent to which local staff are available to work with external consultants on some issues; local social, institutional, and hydro-geographic factors; and the structure of the advisory process (for example, will it cover both design and implementation phases?).

The toolkit notes that there are general sets of issues that will typically need to be covered regardless of local conditions, and provides useful sample terms of reference for economic, legal, technical and engineering, and financial consultants. These are reproduced in annexes 1 through 4. These terms of reference can be packaged in one or several contracts, as discussed below.

The letter of invitation should clearly describe the process for submitting bids and the criteria against which bids will be evaluated. Again, the form will vary according to how advisory functions are grouped and what kind of project is planned.

After preparing the terms of reference and evaluation criteria, the next task is to invite proposals from a shortlist of qualified consultants. Limiting the number of firms allowed to bid makes evaluating the proposals more manageable. It also tends to encourage firms to devote time and resources to developing good proposals—because they feel that they have a serious chance of winning. A government may have a list of experienced consultants if it has had experience in private sector contracting. But if it does not, it can publish a notice in the international press seeking information on firms' qualifications and experience, which it can

then use to establish a shortlist. In the interest of maintaining clear competition at a later stage, the government may wish to short-list only consultants that are not affiliated with companies interested in bidding for the private sector contract.

There are two broad options for evaluating proposals. If price is to be a factor, firms may be required to submit technical and financial proposals in separate envelopes. The technical proposals are opened first and scored according to such factors as the firm's experience, its proposed work program, and the qualifications and experience of the proposed team. Firms scoring below a predetermined number may be dropped at this stage. The financial proposals are then opened and again scored against predetermined criteria. The contract is awarded on the basis of the combined technical and financial scores. If price is not a factor (for example, if a maximum budget is determined beforehand), proposals may be evaluated solely on a technical basis.

In some cases (generally in hiring investment banks), potential advisers may be requested to make presentations to the government outlining their qualifications, experience, team, and intended approach. This type of presentation, often referred to as a "beauty contest," is designed to give the client better knowledge of the proposed personnel and approach.

Opinions on the merits of beauty contests vary. In their favour is that they can reveal how the potential consultants will work and whether the necessary chemistry exists between the consultant team and the government—this is important, since the government must work closely with its advisers. But there are concerns that beauty contests can weaken the competitiveness of the hiring process by making it harder for all firms to be considered on the same terms. This problem can be alleviated by specifying in advance the questions that will be asked during interviews and the criteria for evaluating responses. Alternatively, the beauty contest can be held before bids are opened (World Bank, 1997b:15).

7.3.15 Packaging the advisory contracts

The toolkit notes that a key issue in hiring advisers is how to package the contracts. Some governments have opted for contracting out advisory work in a single assignment to a consortium of firms with the requisite legal, financial, economic, and technical skills. The consortium is often led by an investment bank that takes the lead in preparing the transaction.

One advantage of the consortium approach is that it allows the government to delegate to the lead firm much of the complex task of managing and co-ordinating the advisory work. That can help ensure that the work proceeds more smoothly and minimise inconsistency in content and approach—a help when the government has limited human resources and little experience with private sector participation projects. Another advantage is that the lead firm or consortium can be made fully accountable for advisory services, avoiding situations in which, for example, a financial firm fails to perform its task and blames delay on another task group, such as the engineers.

But the consortium approach has some drawbacks. A consortium of several firms may have areas of weakness if it was selected on the basis of its overall qualifications and price rather than on the basis of its expertise in each area. And the approach can lead to conflicts of interest if the government wants to create different incentives for different members of the consortium. For example, it might want the investment bank leading the consortium to maximise the value of the transaction. But this outcome might conflict with developing a sound set of regulatory arrangements that maximises competitive pressures.

For these reasons, some governments have opted for hiring advisers through several different contracts. In principle, this should result in higher-quality advisers in each area and in clearer mandates, but it places a heavy co-ordination burden on the government. Consequently, many governments have chosen a hybrid approach, packaging some but not all tasks. For example, governments may separate tasks related to developing the regulatory framework from tasks related to completing the transaction. Governments may also hire advisers in two stages—the first relating to broad policy advice on industry structure and regulatory design, and the second to implementation (World Bank, 1997b:15).

7.3.16 Structuring the advisory fees

Establishing appropriate fee structures for advisers is an important and potentially complex task. A poorly designed fee structure can have unintended consequences for the kind of advice given.

Economic, legal, technical, and environmental consultants are usually paid on the basis of outputs specified in the terms of reference or on a cost-plus (daily) basis. Both methods require a well-defined set of outputs.

Investment banks are often paid on the basis of a success fee for completing the transaction. This fee is often a percentage of the sales price or transaction size, although it can also be fixed. The bank may also be paid a monthly retainer to cover its expenses in the preparation period, which may be deducted from the final success fee.

The virtue of a success fee is that it provides a strong incentive to complete a transaction and, if it is variable, to maximise the value of that transaction to the government. But variable fees raise a risk in the water sector because the entities in which private sector participation is sought generally have monopoly characteristics: in such cases, the value of the transaction may be maximised by having weak regulatory arrangements, an outcome at odds with the interests of customers. To avoid this problem, the government has several options: fix the tariff, competition, and regulatory arrangements before hiring the investment bank; hire regulatory advisers separate from the investment bank; or pay the investment bank a fixed success fee, independent of the final price of the transaction (World Bank, 1997b:16).

7.3.17 Checklist for hiring advisers

The toolkit provides a useful checklist to use when hiring advisors.

Issues

- What types of advisory services are needed to complement the government's in-house skills?
- How should these services be structured—that is, how many contracts or assignments should there be?
- How should a shortlist be developed?
- How should the proposals be evaluated?
- How should the advisers' fees be structured?

Outputs

- Terms of reference.
- Letters of invitation.
- Shortlists (World Bank, 1997b:16).

7.3.18 Bidding procedures and relationship management

The toolkit provides an extensive overview (11 pages) of the different possible bidding approaches that can be utilised in the course of selecting a private sector partner. Since this research project is not directly concerned with private partnerships this content is not reviewed.

The last component of the toolkit (2 pages) discusses issues associated with managing the relationship with a private sector partner once a decision has been taken.

7.4 World Bank Toolkit 3 – What a private sector participation arrangement should cover

7.4.1 Background

The last toolkit provides a checklist of issues for three kinds of contract:

- Concession arrangements;
- Build-Operate-Transfer arrangements; and
- Management contracts.

For the sake of space only the third (and simplest) of the three is reproduced below (World Bank, 1997c:35-44).

7.4.2 Management contracts - legal, financial, and regulatory issues

A management contract might be chosen as a means of improving operational efficiency in a mature water and sanitation utility, where there is no need for substantial new investment, or where there is insufficient political support for moving to a lease arrangement (in which the private sector would take on commercial risk).

More often, however, management contracts are seen as an initial step toward more substantial private sector involvement in countries or cities where initial conditions are not conducive to private sector investment and risk-taking because, for example:

- The information available about the state of the system is poor.
- Tariffs are below cost recovery levels and can be raised only slowly, and there are no government budgetary resources for substantial subsidies.
- The government lacks the capacity to administer a complex arrangement for private sector participation over the long term.
- The government has no track record as a regulator, or a poor one, and there is no credible regulatory framework.

In such cases a management contract can allow gains in the efficiency of service delivery and in the quality of services, and provide a "window" during which deficiencies in the regulatory framework can be remedied and information about the system improved.

7.4.3 Who are the parties to the contract?

- Who owns the assets to be operated and maintained, and who can grant the management contract?
- Are the water and sewerage infrastructure and the operating assets split between different parties? If so, who should be parties to the contract?

7.4.4 What are the object and scope of the management contract?

- Does the management contract include:
  - The production and transport of drinking and non-drinking water and the supply of water to consumers?
  - The collection of sewage from customers, including the pumping, purification, treatment, and discharge of sewage and the disposal of sludge and waste?
  - The collection, transport, and evacuation of rain water runoff and wastewater—and their treatment, if applicable?
  - The maintenance of the water distribution and sewerage networks, pumping stations or potable water treatment plants, wastewater treatment plants, and all installations constituting service assets?
  - Renewal of installations, pipes, and plant relating to the water and sewerage services?
  - The construction of private connections and pipe-works?
  - Responsibility for the technical, administrative, financial, and commercial aspects of the water and sewerage services?
- Are the water and sewerage services to be provided described in sufficient detail?
- Do the operation and maintenance obligations require the operator to guarantee that it will meet specified standards or merely operate "with a view to ensuring" that the project achieves these standards?
- Is the operator to be granted exclusivity in operating the water and sewerage services?
- Is the management contract flexible enough to allow amendment as circumstances change?

7.4.5 What is the area to be served?

- Can the area be expanded during the lifetime of the contract?
- Is a map of the area annexed to the contract?
- How will the infrastructure interface and interconnect with other water and sewerage systems?
- Will there be exclusivity of supply?
- Will water and sewerage be provided by different entities?

7.4.6 What is the duration of the contract?

- Can the grantor change the duration of the contract? In particular, can the contract be extended, and if so, how? If it is extended, can the public authority amend it?
- Is the duration of the contract contingent on certain events?
- What conditions apply upon expiry and will they be set out in the contract or imposed later?
- What factors would allow the grantor to extend the contract? Typical ones are force majeure events, political risk events (disruption of construction, strikes), delays caused by the grantor during construction or operation, and operating problems that are beyond the control of the operator and are not force majeure events (lack of appropriate materials and supplies).
- When do the operator's obligations begin?

7.4.7 What are the rights and obligations of the operator?

- Will the grantor of the management contract be given the right to substitute itself for the operator in contracts with third parties?
- What are the security, safety, environmental, and public health requirements that the operator must comply with?

- What warranties will be given by the parties?
- Will the operator be given free and safe access to the site and public thoroughfares?
- Can the operator subcontract or delegate its obligations?
- Will the operator be required to give a guarantee or performance bond?
- How are the operating and infrastructure assets to be provided to the operator for its use?
- Will the operator acquire any rights relating to these assets?
- Is there an inventory of assets to be handed over to the operator?
- Will there be any leasing arrangement relating to the operator's use of assets?
- How will the assets be transferred back to the grantor at the end of the management contract?
- Who will have the right to restructure the organisation, including altering terms and conditions of employment, hiring new employees, and terminating existing employees?

7.4.8 Who will be responsible for capital expenditure?

- Who will decide on and be responsible for maintenance, repair, and upgrading of the water and sewerage system and construction of new infrastructure?
- Will the operator be responsible for works up to a certain value?
- Do works carried out by the operator require approval?
- Is competitive tendering required for works?
- How will contractors be granted access for works, and will the operator be compensated for additional operating and management costs resulting from works?
- What are the obligations and responsibilities relating to capital expenditure for major water and sewerage facilities and distribution and collection networks?
- How will replacement equipment and spares be provided?
- If construction work is required (replacing pipes, extending water or sewerage networks, making emergency repairs), what procurement procedures must the operator follow?
- Who is responsible for meeting requests from government agencies for the extension, relocation, or provision of water and sewerage networks?
- Will the operator have any expenditure limits for major maintenance?
- How will new construction be financed—from retained earnings from fees, by direct government grants, by the operator, or from a combination of sources?
- If the operator finances construction, will the government provide lines of credit or working capital loans? What are the terms and conditions of the credit lines or loans?
- Does the law allow each funding provider to furnish funds to a private operator?
- Will the government offer financing, grants, or other support to users to pay for private connections and pipes? Will the operator be responsible for connecting new users to the system? If so, how will the operator recoup its costs—through tariff rates, instalment payments, or lump sum payments? What recourse does the operator have if a user does not pay?
- How are payments to be made to the operator for new construction?
- If the operator is responsible for new construction, what procurement procedures will it have to follow in awarding the contract? Will it be required to award the contract to the lowest, most responsible bidder? Will payment be on the basis of cost reimbursement plus a fixed fee? Will the cost be incorporated into the tariff rate?[10]

[10] Recovery of capital expenditures through increases in tariff rates is more common in concession contracts, although it can also be specified in a management contract.

- If the government pays for new construction, how will it disburse the funds? Will it reimburse the operator on the presentation of invoices or advance it funds? Who will monitor the construction? Will the monitoring agent approve the invoice before payment?
- How will the government charge residential, commercial, and industrial users for direct connections—through cost reimbursement or by incorporating the cost into the tariff?

7.4.9 Who will be responsible for billing customers?

- What are the method and currency of revenue collection?
- Is the contractor responsible for collecting water and sewerage fees?
- How often will customers be invoiced?
- How will non-payment be dealt with?
- What authority will the contractor have to collect delinquent payments and enforce user sanctions?
- What regulations cover reconnection for delinquent users who have paid their debts to the utility? How will the government monitor compliance with them?

7.4.10 What will happen if the operator fails to meet operating standards?

- How will customers be compensated?
- Are there provisions for changes in operating standards following changes in the quality of raw water and the flow of sewage?

7.4.11 What are the obligations of the grantor - How will the operator's fee be calculated?

- Will the operator be paid by the government on a cost-reimbursable basis (the operator's cost plus a fixed fee) or according to an annual maximum budget or other contract payment procedure—or compensated through the water and sewerage revenues collected?[11]
- How are operating incentives to be implemented?
- How will operating cost overruns be dealt with?
- What is the definition of operating and maintenance expenses? How will unit costs for these expenses be compiled, and what are the required reporting and auditing procedures?
- What will be the treatment of taxes and depreciation by the contractor?
- Is there a schedule of fees for other services provided by the contractor, such as engineering consulting for major works undertaken by third parties?
- If the contract is based on a maximum annual or monthly budget cap, what method will the government use to establish the annual budget? Will it negotiate unit prices, base the payment on annual audits, or make payments on a cost-reimbursable basis? If the government selects the auditing method, what accounting procedures will it use to determine unit prices for such items as payroll, utilities, chemicals, motor fuel, maintenance supplies, laboratory supplies and equipment, overhead (administration, legal fees, computer services), and construction (repair, replacement, connections)? Will it use fund accounting to aggregate expenditures (for example, operating, renewal and replacement, and investment accounts) or some other accounting method?
- Will the government require the operator to create reserve and renewal accounts? If required by the government, will these accounts be funded from tariff revenues?

[11] If payment is taken directly from tariff revenues, the government must define the base tariff rate, collection of delinquent fees, and normal tariff adjustments and adjustments resulting form system expansion, changes in regulations, and other factors that increase cost.

- Will the government require the operator to maintain a reserve account for operations? For construction?
- If reserve accounts are required, how will they be funded? By tariffs? By government contributions? When will the operator be required to establish the operating fund, before operations, or during operations with periodic deposits?
- If reserve funds are used, what claim can be made on tariff revenues to replenish them?
- How will the government determine the annual fee paid to the contractor under a fixed fee, lump sum payment contract? How frequently will the operator invoice the government and on what basis?
- What cost components will be used to adjust the initial budget—payroll, utilities, supplies, overhead? What inflation indices will the government use to adjust the coefficients? How often will the coefficients be adjusted—monthly, quarterly, annually, or every several years?
- If the operator is responsible for capital expenditures, how will its annual budget be adjusted to accommodate the expenditures?
- How will the cost of operating new works be incorporated into the annual budget regardless of whether the government or the operator builds them? Will the same pricing method used in the original budget be used to determine the budget increase?
- What accounting method will the government use to compensate the operator for emergency repairs and operations not covered in the scope of services?
- What auditing method will be used to reconcile the budget with actual expenditures?
- Will the contract include incentives to reduce costs, such as sharing savings if actual expenditure falls below the approved budget? How will the amount of the savings be determined? From annual financial reports or audited financial reports?
- Will the operator's compensation include a management fee?
- Will the government pay the operator a fixed monthly fee based on services rendered? On what basis will the cost of these services be determined—audit, unit prices, or a one-twelfth share of the agreed annual budgeted amount? Can the contractor petition for an increase in the monthly payment? What factors (for example, unexpected increases in consumption) would allow an increase?

7.4.12 Who will take the operation and maintenance risk?

- Who will distinguish between routine maintenance and capital expenditures?
- Is there joint and several operating liability among the operating contractor and subcontractors?
- What sanctions and penalties would the operator face for non-compliance with environmental and other regulations?
- Will the operator have incentives for improving productivity? What method will be used to measure productivity improvements?

7.4.13 How will responsibilities and liabilities be allocated between the public sector and the private contractor?

- How will the security and quality of raw water supply be assured?
- What are the compensation rules for public sector failure? And are there safeguards for the public sector if inadequate supplies to customers result from private sector failure to maintain the system?
- Who is responsible for allowing new connections to the water and sewerage system and liable if such connections result in failure to meet such performance standards as supply security and pressure?

- Who is responsible for land drainage and liable when interconnections between surface water and foul water systems cause foul water flooding and exceed the sewage treatment plant's capacity?
- Who is responsible for allowing new connections to the sewerage system that introduce waste components untreatable at current facilities and for protecting the contractor from resulting failure to meet treatment standards?
- What compensation rules apply if the public sector permits connections that ruin the ability of the treatment plant to process normal waste?
- Who has the operational and financial responsibilities for routine system maintenance (as opposed to system renovation, which can involve considerable capital expenditure)?
- Is there a clear dividing line between system maintenance and system renovation? What are the safeguards for the private contractor if inadequate financing results in failure to meet performance standards or targets?
- Who is responsible for billing and collection?
- What are the safeguards for the private operator if non-payment or non-collection reduces its expected revenue share or delays payment of the operation and maintenance fee?
- Who is responsible for ensuring access to assets and customer's premises to effect repairs, read meters, and the like, and who is liable for any damage—to roads, for example—that results from such access?
- Who bears the cost for damage arising from events beyond the private operator's control, such as extreme climatic events, unlawful discharges to the sewerage system, and national labour disputes?
- Who is liable for past environmental and health damage and for damage occurring after the contract enters into force?

7.4.14 How will performance be measured and monitored?

Management contracts can take different forms and can be used for different reasons. The more activities a management contract covers, and the more sophisticated its incentives for efficient performance by the contractor, the more regulatory sophistication will be required.

Many management contracts establish performance indicators and provide for paying bonuses to the contractor if it meets or exceeds the performance targets. Such indicators must be readily measured and largely indisputable—that is, their measurement should not provoke debates, and poor performance should not provoke debates about who is at fault. For example, if unaccounted—for water is used as an indicator, disputes may arise both about how it is to be measured (especially if metering is incomplete or inadequate) and about whether poor performance stems from inadequate investment by the government in rehabilitating the system, or from substandard performance by the management contractor.

In establishing regulatory requirements, there is always a need to establish clear regulatory limits—the regulator must not become a business manager. Therefore, it is normally best to avoid detailed technical specifications in contracts. The focus should be on what the contractor needs to achieve, not on how to achieve it.

In countries that adopt management contracts as a first step toward greater private sector involvement, monitoring and regulatory capacity may be very limited at the beginning of the contract period. A government facing such capacity constraints could contract part of the monitoring task to an auditing company and reconfigure its task as monitoring the auditor.

- Who will monitor performance against service standards and improvement targets specified in the contract?
- What margins of sampling error will be used?
- What penalties will there be for performance failure?
- Who will be compensated for performance failure—customers or the grantor?
- What appeals procedures are in force?
- How will fault be established in performance failures?
- How will the tariff structure be established? And what process will be used for raising tariffs?
- Can comparative competition be used in determining tariff increases?
- Can other efficiency bonuses be built into the system—for example, a share of additional revenue collected?
- What access does the regulator have to company information?
- What customer relations and complaint procedures need to be in place?
- What payment options and debt collection procedures need to be in place?
- Are any subsidies or cross-subsidies required?
- How will unpredicted costs be dealt with?
- Who is responsible for the monitoring and oversight of new construction?
- What technical information will the operator be required to report? Typical requirements include:
  - Volumes (forecast, production, distribution, amounts sold and bought, the number and types of customers).
  - Delinquent payments.
  - New works and major maintenance completed and new connections.
  - Emergency repairs made.
  - Special requirements and new installations.
  - Meters installed and repaired and the allocation of the costs between the operator and users.
  - The results of laboratory tests of water and wastewater samples.
- What financial information will the operator be required to report? Some typical requirements:
  - Accounting for the expenditures listed above.
  - Income from water sales and sewage treatment (tariff income, bulk sales, or both) and revenues from major customers.
  - Historical and projected income trend analysis.
  - Overdue and delinquent payments, by type of customer—residential (single and multifamily), commercial, industrial.
  - Annual financial statements—profit and loss and income statements and a balance sheet in the format required by the regulatory body.

7.4.15 Renegotiating contract conditions and re-tendering contracts

For short-term contracts renegotiation should be unnecessary if adequate and automatic safeguard procedures for changes in conditions have been built into the contract. But in the real world governments change hands, and the new political masters may be dissatisfied with the initial contract terms. So it is prudent to clearly specify renegotiation procedures and to allow independent arbitration if necessary.

Incumbent contractors will undoubtedly have an advantage when retendering for the contract. But to maintain competitive pressures "for the market," non-transparent recontracting

agreements should be ruled out and proper provisions made for retendering. To minimise the disadvantage to new tenderers, explicit rules need to be established requiring disclosure of certified information.

7.4.16 Basic operating issues for management contracts

A management contract may need to cover some or all of the following operational issues:

- Measurement and monitoring of the flow of water and sewage.
- Disposal of sludge.
- Analysis and sampling of water and both influent and effluent sewage.
- Safety, reliability, and hygiene.
- Cleaning of pipes, sewer connections, and water and sewerage facilities.
- Records of maintenance and water distribution and treatment, including the day-to-day operation of water and sewerage facilities.
- Reports based on such records.
- Maintenance of files and technical literature.
- Operation and maintenance manuals and provisions regarding revision of such manuals.
- Storage of spare parts and treatment chemicals.
- Inspection rights for the concessionaire and the concession grantor.
- Provision of emergency services in the event of breakdowns and accidents.
- Safety equipment and instructions.
- Insurance requirements.
- Flood control provisions.
- Division of support between regional offices and the head office.
- Means of transport from the facility to the ultimate disposal site for sewage, sludge, and other waste.
- Provisions applicable to works on public roads and other areas open to the public.
- Provision of properly experienced and trained personnel; staffing requirements, remuneration, and training.
- Liaison with other parties.
- Updating of maps of the plant and water and sewerage network as necessary.
- Preventative maintenance in accordance with equipment manufacturers' recommendations and guidelines.
- Protective clothing and safety equipment.
- Civil defence regulations.
- First aid, fire fighting, and rescue.
- Monitoring of works.
- Auditing, accounting, and reporting procedures.

7.4.17 What consents are required to operate the facility?

- Who will be responsible for obtaining permissions for operation of the facilities?
- How will intellectual property rights regarding the use of facilities be protected?

7.4.18 Who will be responsible for environmental liabilities?

- Who will be responsible for any contamination of raw water supplies?
- Who will be responsible for the satisfactory disposal of sewage and sludge?
- Who will be responsible for past liabilities relating to the operation of the water and sewerage services?

- Who will be responsible for any environmental liabilities attached to assets to be transferred to the operator?
- If when the assets are transferred, operating practices cannot immediately be altered—as is often the case with such assets—who will be responsible for liabilities arising from such practices? Is an "environmental holiday" appropriate?

7.4.19 How will disputes be resolved? - What will be the jurisdiction for dispute resolution?

- Are the judgements of the chosen forum enforceable against all the parties?
- What is the appropriate method for resolving disputes—arbitration, court proceedings, appointment of experts, or alternative dispute resolution?
- If arbitration is chosen, which international rules should apply—those proposed by the International Center for Settlement of Investment Disputes (ICSID), the International Chamber of Commerce (ICC), or the United Nations Commission on International Trade Law (UNCITRAL), or other rules?
- Are all the parties from countries that are signatories to the New York Convention on the Enforcement of Arbitral Awards, which provides for reciprocal enforcement of international arbitration awards?
- What are the local legal provisions in the countries in which the parties are resident regarding enforcement of such awards?

7.4.20 What will be the governing law?

- What are the advantages and disadvantages of the choice of law?
- Is the governing law other than the law of the country in which the dispute resolution proceedings are taking place recognised in the proceedings?

7.5 World Bank Toolkit 3 – Key risks

The third World Bank toolkit also contains a section on the key risks associated with different kinds of private sector participation arrangements. Many of these risks apply whether the private sector is involved in a corporatisation exercise or not. The entire risk analysis is therefore reproduced below (World Bank, 1997b:45).

The toolkit notes that the success of any private sector participation project is dependant on the appropriate allocation and mitigation of risk. The assessment of risk for a project and the allocation of that risk will depend on the project conditions—including the type and location of the project, whether bulk water supply and off-take agreements are used, the negotiating position of the parties, and the proposed technology. The risk matrix below is not intended to be exhaustive, but it highlights many of the key risks and details, how they may arise, how they can be mitigated, how remaining risks are typically allocated, and what steps can be taken to minimise them. In allocating risk, two general issues should also be borne in mind:

Does the agreement provide a fair balance in allocating risks among the parties?

Are the risks allocated to the parties best able to bear them?

Timing also matters. Early action to identify and mitigate risk can often be far more effective in reducing its seriousness than similar action taken later. And risks tend to change, so it is important to review risks and mitigation strategies regularly.

Table 26 Key risks (World Bank, 1997b:46-50).

What is the risk?	How does it arise?	What steps can mitigate the risk?	Who typically bears the remaining risk?	In what types of contract does the risk arise?	What steps can minimise risks?
Design and development risk					
Design defects in water or sewerage plant.	Design fault in tender specifications.	Require the public sector to provide a remedy or compensate the project company.	The public sector.	BOT, concession (especially with new infrastructure).	Check tender specifications.
	Design contractor fault.	Include provisions in the design contract requiring the contractor to provide a remedy or pay damages (insurance cover).	The design contractor. Once liquidated damages are exhausted, finance from project lenders is drawn down.[12]	BOT, concession (especially with new infrastructure).	Monitor design work; replace contractors insurance.
Construction risk					
Cost overrun.	Within the construction consortium's control—inefficient working practices, waste of materials.	Provide for cost overrun in fixed lump sum price in the construction contract.	The construction contractor. Once liquidated damages are exhausted, standby finance is drawn down.	Concession, BOT.	Monitor and inspect construction work; provide for early warning mechanisms in the contract.
	Beyond the construction consortium's control—changes in a law, delays in obtaining approvals or permits, increased taxes.	Allocate cost overruns in the concession contract; purchase business interruption insurance.	The insurer. Once insurance proceeds are exhausted, the investor's return might be eroded because of timing effects.	Concession, BOT.	Obtain approvals in advance; anticipate problems and allocate risk in contract; use insurance.
Delay in completion.	Within the construction consortium's control—lack of co-ordination of subcontractors.	Require liquidated damages from the turnkey contractor under the construction contract (sufficient to cover interest due to lenders and fixed operating costs).	The constructor. Once liquidated damages are exhausted, standby finance is drawn down.	Concession, BOT.	Monitor and inspect construction work; provide for early warning mechanisms in the contract.
	Beyond the construction consortium's control—insured force majeure event.	Draw on proceeds from business interruption insurance policy.	The insurer. Once insurance proceeds are exhausted, standby finance is drawn down, debt service coverage ratios will be reduced, and investor's return might be eroded.	Concession, BOT.	Rely on insurance.

[12] Liquidated damages are payments that the contractor or operator is required to make to the sponsor of the project if specified performance targets or milestones are not reached. They are capped at a percentage of the contract's value. The amount of the liquidated damages is agreed at the contract's signing.

What is the risk?	How does it arise?	What steps can mitigate the risk?	Who typically bears the remaining risk?	In what types of contract does the risk arise?	What steps can minimise risks?
Failure of plant to meet performance criteria at completion tests.	Within the construction consortium's control—quality shortfall, defects in construction.	Require liquidated damages payable by the construction consortium, supplemented by insurance.	The construction consortium and, once liquidated damages are exhausted, the insurer. Once insurance proceeds are exhausted, investor return is eroded.	Concession, BOT.	Monitor and inspect construction work; provide for early warning mechanisms; use insurance.
Operating risk					
Operating cost overrun.	Change in operator's practices at project company's request.	Require project company to provide a remedy or compensation under the operating contract.	The project company bears the risk under the operating contract; debt service coverage ratios are reduced; sponsor's return is eroded.	Operation and maintenance, concession, BOT.	Build flexibility into contract; cost changes in practices in advance; define acceptable reasons for changes; provide for changes in remuneration after initial period.
	Operator failure.	Require liquidated damages payable by the operator under the operating contract.	The operator. Once liquidated damages are exhausted, debt service coverage ratios and return are reduced.	Operation and maintenance, concession, BOT.	Monitor and inspect operating practices; provide for early warning mechanisms.
Failure or delay in obtaining permissions, consents, approvals.	Public sector discretion.	Allocate risk in the operating contract.	The public sector. Where there is no public sector discretion, licenses are processed quicker by the project company, so the project company bears the risk.	Operation and maintenance, concession, BOT.	Obtain approvals in advance where possible; ensure clear division of responsibilities in the contract.
Shortfall in water quality or quantity.	Operator's fault (malpractice).	Require liquidated damages payable by the operator.	The operator. There is no effect on other parties until liquidated damages are exhausted, when debt service coverage ratios are reduced and the owner's return is eroded.	Operation and maintenance, concession, BOT.	Monitor and sample water quality and quantity; provide for early warning mechanisms.

What is the risk?	How does it arise?	What steps can mitigate the risk?	Who typically bears the remaining risk?	In what types of contract does the risk arise?	What steps can minimise risks?
	Project company's fault.	Require liquidated damages payable by project company to the public authority.	The project company. There is no effect on other parties until payment of liquidated damages completely erodes shareholder returns, when cash flow may become insufficient and the project company's return is eroded.	Operation and maintenance, concession, BOT.	Quantity: ensure security of supply; enter into bulk water supply contract. Quality: monitor and sample water quantity; provide for early warning mechanism.
Revenue risk					
Increase in bulk water supply price.	Service difficulties; no security of supply.	Allocate risk by contract; adjust tariffs; if there are off-take and bulk water supply agreements, both guaranteed by the government, pass through the price increase.	As allocated by contract; bulk water supplier.	Lease, concession, BOT.	Fix price by contract and pass through price increase.
Change in tariff rates.	Fall in revenue.	Risk depends on extent of government support. There is usually no market risk in water prices if an off-take agreement is in place. If not, owners may use hedging facilities such as forward sales, futures, and options.	The project company. There is no effect unless there is no common off-take agreement and unless hedging facilities are not in place or do not compensate for losses, in which case the return can be severely reduced.	Lease, concession, BOT.	Ensure a clear regulatory regime.
Water demand.	Decreased demand.	Risk depends on extent of government support. Use shadow tolls; use long-term take-or-pay off-take agreement that leaves the demand risk with the public utility (guaranteed by the government).	Risk depends on extent of government support. If there is no support and no off-take agreement, the risk is borne by the project company.	Lease, concession, BOT.	Ensure exclusivity of supply.
Financial risk					
Exchange rate.	Devaluation of local currency, fluctuations in foreign currencies.	Include in security package hedging facilities against exchange rate risks such as currency rate swaps, caps, and floors.	There is no effect unless hedging facilities are not in place or do not compensate for losses, in which case the return can be severely reduced.	Operation and maintenance, concession, BOT.	Require loans in local currency and same currency as revenue.

What is the risk?	How does it arise?	What steps can mitigate the risk?	Who typically bears the remaining risk?	In what types of contract does the risk arise?	What steps can minimise risks?
Foreign exchange.	Non-convertibility or non-transferability.	Have the government guarantee availability, convertibility, and transferability (with the ministry of finance a party to the contract); if the government defaults, the project company can terminate. Have the central bank ensure the continuing availability of foreign exchange.	The government. If the government defaults on its guarantee and the project company terminates, the government pays compensation for termination.	Operation and maintenance, concession, BOT.	Transfer funds offshore as much as possible.
Interest rate.	Fluctuations in interest rates.	Same as above (for hedging facilities against exchange rate risks).	See above (exchange rates).	Operation and maintenance, concession, BOT.	Negotiate fixed rate loans.
Force majeure risk					
Force majeure.	Flood, earthquake, riot, strike.	If risk relates to an insured event (such as earthquakes in certain regions), the policy is called; if not, standby finance is drawn down.	The insurer. There is no effect unless the event is not insured or is uninsurable. If the insurance policy is exhausted, there might be a severe impact on project returns.	Operation and maintenance, concession, BOT.	Use insurance and government guarantees; clearly define force majeure in contract; include provision in contract that if the changes are specific to the project (rather than general), the government bears the risk.
Legal and regulatory.	Changes in tax law, customs practices, environmental standards.	If during the operating period, adjustment is possible (see provisions in contract on compensation).	The project company or operator.	Operation and maintenance, concession, BOT.	
		If during the construction period, draw down standby finance.	The contractor. Standby finance could be required.	Operation and maintenance, concession, BOT.	
Political	Breach or cancellation of the concession.	The project company is entitled to terminate if the government defaults.	The government pays compensation to the project company if the company terminates.	Operation and maintenance, concession, BOT.	Use insurance.

What is the risk?	How does it arise?	What steps can mitigate the risk?	Who typically bears the remaining risk?	In what types of contract does the risk arise?	What steps can minimise risks?
	Expropriation.	Take out political risk insurance with official bodies, such as export credit agencies, with private companies, or involve multilateral agencies (IBRD, IFC) in the financial package.	Once the insurance policy is exhausted, the project company bears the risk. See clause in contract on expropriation.	Operation and maintenance, concession, BOT.	Use insurance.
	Failure to obtain or renew approvals.	See contract.	The government.	Operation and maintenance, concession, BOT.	Obtain approvals in advance where possible.
	Creeping expropriation (discriminatory) taxes, revocation of work visas, import restrictions.	See contract.	See contract. If the government has discretion, it should bear the risk.	Operation and maintenance, concession, BOT.	
	Interference causing severe prejudice (sometimes referred to as force majeure).	See contract.	The government.	Operation and maintenance, concession, BOT.	
Insurance risk					
Uninsured loss or damage to project facilities.	Accidental damage.	Insure against all the main risks.	Once standby debt finance is drawn down, the project company's return is reduced.	Operation and maintenance, concession, BOT.	Quantify and allocate risk in advance in the contract.
Environmental risk					
Environmental incidents.	Operator's fault.	Require indemnity from the operator.	The operator. There is no effect unless the operator's payments are exhausted and standby finance is drawn down, in which case the project company's return is reduced.	Operation and maintenance, concession, BOT.	Use insurance.
	Pre-existing environmental liability.	Provide for public sector cleanup or compensation.	The public sector.	Operation and maintenance, concession, BOT.	Carry out detailed environmental survey; use insurance.

7.6 World Bank Toolkit 3 – General contract clauses

The toolkit notes that every contract requires some general boilerplate clauses.

7.6.1 Provision of insurance

- Is there a transparent structure of local primary insurance, and is there access to the global markets for reinsurance?
- Who will be responsible for insurance, and what form should it take?
- What risks can be insured against?

- Who will be the loss payee?
- Who will be named on the insurance policy?
- Can environmental risks be insured against?
- To what extent can insurance policies be assigned?
- What types of insurance coverage will the contractor be required to carry—for example, workers compensation, comprehensive general liability, and automobile liability? What is the minimum coverage?

7.6.2 Force majeure provisions

- What events will trigger the force majeure provisions?
- Does the force majeure clause include political and labour risks, natural events, and operational risks?
- What events of force majeure may be under the control of the government? Will the public authority accept responsibility for such events?
- Does the force majeure clause include changes in the law that will affect the project?
- Does this clause deal with the consequences of force majeure, the parties' notification obligations relating to an event of force majeure, and provisions for mitigating the effects of force majeure?

7.6.3 Linking the force majeure provisions of contracts under concession and BOT arrangements

- The concession contract is the key project document, but it is important to remember, particularly in the context of force majeure, that it is just one of a set of documents under which the project will take place. If there is a force majeure event that leads to suspension of the concession contract, the event should also trigger the force majeure provisions in the other contracts so that parties to the suspended concession contract are not obliged to continue to perform under the others. For example, if a force majeure event under a water off-take contract did not trigger the force majeure provisions under the bulk water supply contract, the water and sewerage company would be obliged to take and pay for the raw water but would not be reimbursed by the off-taker. Avoiding such situations does not simply mean ensuring that all the force majeure provisions in the agreements mirror each other, however; each contract must be considered individually.

7.6.4 Termination provisions

- What are the termination rights of each party?
- To what extent can the contract be terminated in the initial stages?
- What are the provisions for compensation for early termination, and what are the limits to such compensation? How would this compensation be granted?
- In what circumstances would there be no compensation?
- How will the assets be transferred on termination?
- Does the agreement terminate on the termination of other agreements?
- Are there provisions enabling the grantor to intervene and run the project itself?
- What rights would the grantor acquire in relation to other contracts in cases of forfeiture?

7.6.5 Sovereign immunity

- If the contract is to be granted by a government entity, will that entity waive its right to sovereign immunity, enabling the contractor to bring the grantor before the courts to enforce the rights and obligations under the agreement?

7.6.6 Assignability

- Will lenders be given step-in rights in relation to the agreement?

7.6.7 Miscellaneous provisions

- Will the contract include provisions regarding notices, invalidity, confidentiality, amendment, waiver, language, counterparts, and the entire agreement?

7.6.8 Who will sign the agreement?

- Will the agreement be signed by authorised signatories of the parties?
- Where necessary, has the agreement been witnessed in the appropriate manner? Is notarisation necessary? Has the agreement been superlegalised with the appropriate stamps and certifications?
- Does the agreement need to be registered?

7.7 AWWA balanced evaluation of public/private partnerships toolkit

7.7.1 Introduction

The AWWA toolkit is explicitly structured around a decision making process, as a resource for water utilities to use "within their own culture to identify, understand, evaluate, and compare public-private partnership options that may benefit their customers.". The toolkit states that the underlying decision analysis theory "has been endorsed by the U.S. National Academy of Sciences … and is used regularly in private industry - particularly the water, power, petroleum, and chemical industries - to make decisions on high-risk issues." (AWWA 1999).

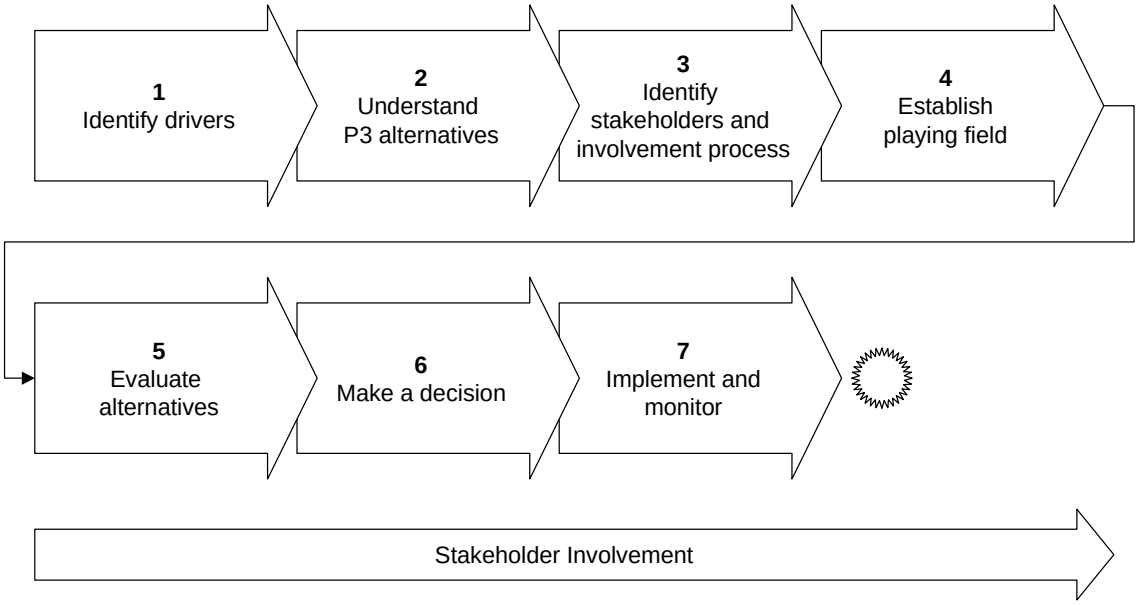
The CR-ROM contains a set of tools to assist in decision-making, including:

- a financial evaluation model;
- an evaluation matrix; and
- a database of P3 case studies.

7.7.2 Decision process

The AWWA P3 decision process is based on seven steps, as depicted below:

Figure 22 AWWA P3 decision process steps.



The decision process is described in a multi-media presentation, in a slide-show, and in a printable document.

A review of the AWWA decision process reveals a high degree of similarity with the process outlined in the Municipal System Act (described earlier). Although this resource is very focussed on US conditions, it also contains generic concepts which would be useful for South African municipalities considering external service provider options.

8 Tentative Conclusions

8.1 Introduction

The overall question addressed within this research report is,

> Whether corporatisation is a suitable option for municipal water service provision in South Africa?

The findings of the research report have informed the development of a *guideline* to assist those municipalities interested in the corporatisation of their water services.

8.2 Defining corporatisation

The research has shown that the concept of 'corporatisation' is not clearly defined, and that national and international definitions differ to some degree. The research has also shown that the process of corporatisation is often associated with private sector partnerships, such as the use of management contracts, but that this need not necessarily be the case.

For the purpose of this project, we have adopted a working definition of municipal water service corporatisation as:

> The creation of a separate, legal, 'corporatised' entity, owned and governed by one or more municipalities, with the explicit objective of providing water services to some or all of the municipality's water users. The corporatised entity may enter into a range of contracts with private or public partners to facilitate service delivery.

We have noted that this definition leaves considerable uncertainty around the issue of *control*, as manifested by the regulatory relationship between the municipality, the corporatised utility and any subsidiary partnerships.

8.3 International case studies

A range of international case studies were reviewed, drawn from low, middle and high income countries. Key insights arising from these reviews are that:

6. Corporatised water service utilities exist world-wide. In fact the use of separate legal entities is a fairly common approach across low, medium and high income countries.
7. The corporatisation of water services does not, however, guarantee success in its own right (Uganda and Ghana prove this).
8. Utilities succeed or fail for a wide variety of reasons. Success requires a combination of factors, especially good governance, managerial independence – and a measure of luck.
9. The regulatory framework is important, but will not in itself ensure a positive outcome. For instance Botswana has a very weak regulatory environment while Melbourne has a very strong regulator yet both are successful utilities. Both attribute their success, in part, to sound management practices.
10. A trend amongst with corporatised utilities is improve service delivery through increasing involvement of the private sector. This partnerships are more likely to entail service outsourcing and organisational development through the adoption of advanced management techniques then long term leases or outright asset transfers.

8.4 Governing and regulating corporatised utilities – International perspectives

The international literature review addressed the governance and regulation of corporatised utilities, concentrating on three areas:

- The regulatory problem;
- Utility ownership; and
- Utility governance.

The diversity of international experience and opinions on these areas makes it difficult to extract decisive lessons for the South African context. Nonetheless, the following insights were arrived at:

- That the South African regulatory system clearly still has to undergo considerable development, with national regulators likely to move from a mode of 'facilitating' to a mode of 'regulating' over time;
- That as regulators in their own right South African municipalities are expected to engage with complex economic and governance issues relating to the price and quality of water services – no matter whether these services are supplied by public or private companies. These functions are likely to tax even the most competent of municipalities;
- That in common with all regulators South African municipalities will face the problem of accessing adequate information on which to base decisions. Present day municipal accounting practices are likely to prove a major hindrance in this regard.

Some particularly persuasive insights into the reform of State Owned Enterprises were noted from a World Bank study. Namely that to be effective:

- reform must be politically desirable – the benefits to the leadership and its constituencies must outweigh the costs;
- reform must be politically feasible – the leadership must be able to enact reform and overcome opposition; and
- reform must be credible – promises that the leadership makes to compensate losers and protect investors property rights must be believable (World Bank 1995:176).

The report notes that the international literature review has not been exhaustive and that areas for potential further research include relationships between corporatised utilities and organised labour, and various financial management matters.

8.5 The South African environment for corporatisation

The report has provided an extensive review of the legal framework applicable to water services corporatisation, leading to the conclusion that South African municipalities wishing to corporatise their water services face an enormously complex legal environment. Not only are there limited precedents available, but the legal framework has shifted fundamentally during the last five years. The learning experience from Johannesburg's corporatisation will assist other municipalities, but even so a considerable investment will be required to understand Johannesburg's experience and to interpret and apply these lessons.

Whilst the current legal framework represents a significant challenge for those municipalities wanting to corporatise, it must be acknowledged that national government has signalled its

intention to remove an obstacles. Successive policies, acts and regulations are slowly clearing the way in an effort to facilitate innovation in municipal service delivery.

The report notes that the policy/legal framework represents just one dimension of the environment for corporatisation. The political/stakeholder environment, the financial/economic environment and the technical environment must also be considered. At this stage the project has not undertaken detailed research into these environment, partly because they are less defined and less uniform than the policy/legal environment and more likely to depend on local circumstances.

8.6 South African case studies

The report provides a preliminary review of the Johannesburg case, as well a minor report on Cape Metropolitan Council and Durban Unicity Committee outputs.

8.6.1 The Erwat case

The relevance of the Erwat case is limited, since the utility was created in a very different legal and organisational context to that which currently applies. For instance, shifts in municipal boundaries have rendered the original rationale largely irrelevant.

Nonetheless, the Erwat case demonstrates that a corporatised utility may be a sensible option for cases where multiple municipalities are able to realise economies of scale by merging their bulk waste water treatment operations.

8.6.2 The Johannesburg case

The research found that the process followed in setting up the Johannesburg Utility was influenced by the general transformation of the public service and local government, and by the *Igoli 2002* process in particular. Caution is therefore required in generalising from the Johannesburg experience.

The Johannesburg experience clearly indicates that some legislative changes are required to facilitate the corporatisation process. The new Municipal Systems Act has addressed this problem to some extent.

The case study also indicates that clear leadership and decision-making processes are crucial for success.

As the utility begins to operate the terrain of interest is shifting to the Utility-Council relationship. Many battles have still to be fought in the process of defining ‘management autonomy’ and the Council’s ‘regulatory role’.

In the course of the process of corporatising water and sanitation services the Johannesburg team generated a vast amount of documentation and learning. Attention needs to be given to transmitting this learning to other local authorities.

8.7 Process considerations

The report summarised process related issues from the Municipal Systems Act, a World Bank toolkit an American Water Works Association CD-ROM resource.

The Municipal Systems Act contains significant processual provisions to safeguard the interests of stakeholders such as labour and focuses mainly on the choice between internal and

external service providers. The workability of this Act still to be tested in practice. One significant flaw may be the lack of attention paid to defining the concept of a 'municipal service'.

The World Bank toolkits provide a detailed insight into the complexity of taking decisions on municipal service provision and the establishment and regulation of service delivery agreements.

The AWWA resource provides similar insights.

All in all the lesson from these process reviews is that the decision to corporatise is not to be taken lightly. Getting to the decision, and then implementing the decision, could take very significant financial, managerial and political resources.

8.8 Tentative conclusions

Before discussing any conclusions as to the suitability of corporatisation as a municipal water service provision option in South Africa it is worth noting the opinion of Monhla Hlahla, the recent CEO of government's Municipal Infrastructure Investment Unit (MIIU). In a recent paper on *Public-private partnerships: South African experiences and the influence of governance* (2000) she concludes that,

> It is not possible at this stage to provide data to support the conclusion that MSPs have positively influenced municipal governance so far. Most South African municipal partnership projects are young and do not offer a good testing ground to measure the extent to which an introduction of an MSP has affected the general governance structure and systems of the municipality. What is clear, however, is that both delivery and procurement policies have changed to suit the requirements of the new entrants, and that the resulting efficiency and monetary gains have challenged local government to re-define its role in service delivery (Hlahla, 2000:170).

The research team likewise agree that it is not possible to reach a broad-ranging conclusion on the suitability of corporatisation for the delivery of water and sanitation services, outside of the particular circumstances of each individual municipal case.

Nonetheless, this research has pointed to some useful conclusions, which are offered below.

8.8.1 The environment for corporatisation

3. The current environment for corporatisation in South African is not particularly favourable and transaction costs can be very significant. Despite advances in national government policy a considerable amount of uncertainty remains. Further legal reforms are still necessary.

4. Existing corporatisation initiatives have lead to a high level of politicisation, with stand-offs between government and labour, and even between different spheres of government.

8.8.2 The motives for considering corporatisation

4. Motives for examining the corporatisation option are likely to vary between municipalities. Some may wish to improve governance and financial reporting, whilst others may focus on service performance or some other factor. It is very important that municipalities define clear problem statements and a clear basis for a decision to choose this route.

5. The research team is of the view that corporatisation in itself will not *guarantee* performance. Whilst a shift in legal form from a municipal department to a stand-alone legal entity can make a difference this is not the only or major determinant of performance. Various objective factors and broader governance factors are likely to have a *greater impact* than simply legal form.

6. Where service performance is a consideration it will generally be sensible to consider the option of entering into some form of partnership (with either the public or the private sector) in conjunction with a corporatisation exercise. The scope of the partnership could take various forms.

8.8.3 The suitability of corporatisation as an option for municipalities

4. The research team is of the view that the corporatisation of municipal water services may be a suitable option for some municipalities. For capacity reasons corporatisation is only likely to be feasible within the large metropoles at this stage. As the experience base grows within South Africa, and transaction costs diminish, corporatisation may become feasible for smaller local authorities.

5. A possible exception to this conclusion may be the cases of multiple local authorities merging as a result of the demarcation process, or where the Structures Amendment Act has resulted in water functions being shifted from local authorities to District Councils who have previously held water service responsibilities. These radical, policy-induced organisational changes may create a one-off opportunity to consider corporatisation options which might not otherwise have arisen.

6. Another possible exception may be the case where a local authority requires a partner to invest in a defined component of the water services system (such as waste water treatment plants) and establishes a corporatised utility as a vehicle for the partnership. In a case such as this the issues of ownership and control would be particularly important.

8.8.4 The implementation process

2. Before embarking on a corporatisation process municipalities should assess whether they have sufficient financial, managerial and political capacity to see the process through.

8.9 Further work

The research team would like to point to the following issues as areas of potential further work:

Documenting learning: the Johannesburg experience has considerable learning opportunities to offer national policy makers and interested municipalities. Consideration should be given to documenting the whole process in greater detail and to building up a resource bank for other municipalities.

Interpreting the Municipal Systems Act: The implications of the process envisaged in chapter 8 of the Municipal Systems Act need to be better understood. Consideration could be given to developing a definition of 'municipal services' and to developing a deeper understanding of application of the various criteria defined in the Act.

Improving the regulatory framework: The regulatory framework for water services in South Africa is somewhat fragmented and confused. Overlapping and sometimes contradictory legislation and policy covering local government, water services and public finance matters all contribute to the regulatory framework. National government could do more to clarify this framework.

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Annex 1: Illustrative Terms of Reference for Economic Consultants[13]

Background

[This section provides background on the reform process, briefly describes the existing water and sewerage utility and regulatory framework, and sets out the government's core objectives in the reform.]

Objective

The economic consultants will provide advice to [name of client] and prepare for and deliver to [name] reports (as specified below) on all economic, tariff and regulatory matters arising as part of [restructuring or private participation in the water utility]. The utilities in which the private sector will be invited to participate include [name of entity or entities] (the "Water Utility").

Scope of work during the preparation phase

8.9.1 Regulatory and institutional issues

- Review existing regulatory framework for water supply and sewerage, including status and operations of the Water Utility and the [ministry for environment and water resources]; review industry structure and potential for restructuring to promote competition.
- Review responsibilities and relationships of relevant government entities at different levels and propose mechanisms to ensure proper co-ordination and co-operation.
- Define regulatory tasks necessary after the transaction, including advice on form of price control and related monitoring of service standards.
- Assess viability of [name] as a regulatory agency.
- Recommend institutional measures necessary for the regulatory agency to perform effectively the new set of regulatory functions, including board composition and operating procedures, institutional set-up, staffing, job descriptions, and equipment and other resources required.
- Recommend legislative changes as necessary and work with the government's lawyers to ensure that the legal drafting correctly reflects the recommended and accepted economic goals and principles.
- Comment on the draft legal documentation, including status of regulatory agency and any legislative changes prepared by the government's lawyers.
- Recommend the residual role and responsibilities of the Water Utility after the transaction.

8.9.2 Demand

- Develop forecasts of demand for water and sewerage services, by customer category. In collaboration with the financial advisers, adjust these forecasts on the basis of the tariff projections.

8.9.3 Tariffs

- Review current water and sewerage tariff structure and government policies as they relate to rate setting.

[13] This annex is extracted in its entirety from the World bank Toolkit 3 (World Bank, 1997c).

- Analyse existing and historic tariffs to determine the basis for rate setting, including the relationship between rates and costs (marginal versus average), the tariff adjustment process, and treatment of financial and social objectives.
- Analyse existing rates and costs for different categories of customers and determine whether there are subsidies; if so, identify their extent and nature; if not, determine whether they should be retained or reformed for certain customer categories.
- Consider whether tariffs should be set to ensure total cost recovery, including capital expenditures, or whether the government should subsidise certain costs.
- Review incentives to consumers implicit in the tariff regime and their impact on demand management.
- Review the different methods to set rates (cost of service, RPI-X, long-term marginal cost, rate of return) and their appropriateness for [name of country], and recommend a method.
- Assess the adequacy of current tariffs to support future requirements in the light of projected capital expenditures and demand.
- Recommend new tariff structure as appropriate, to be implemented before the transaction.

Scope of work during the implementation phase

Provide occasional support to the government's financial and legal advisers on regulatory, institutional, and tariff issues in the course of implementation.

Annex 2: Illustrative Terms of Reference for Legal Counsel[14]

Background

[This section provides background on the reform process, briefly describes the existing water and sewerage utility and regulatory framework, and sets out the government's core objectives in the reform.]

Objective

The international lawyers will, in conjunction with local lawyers, provide all legal advice to [name of client] and prepare for and deliver to [name] reports (as specified below) on all legal and regulatory matters arising as part of the [restructuring or private participation in the water utility]. The utilities in which the private sector will be invited to participate include [name of entity or entities] (the "Water Utility").

Scope of work

To achieve the objective(s) set out above, the international and local lawyers shall co-ordinate closely with each other to efficiently perform each of the main tasks assigned to them in the table below.

Deliverables

All reports and transaction documents will be prepared in the [English] language. Both the international and the local lawyers will receive full and prompt co-operation from the Water Utility and the government to facilitate the execution of their respective tasks.

Table 27 Allocation of legal tasks.

Task	Responsibility and action	
	Local lawyers	International lawyers
Preparation phase: Step 1		
Legislation and regulatory reform	Gather all relevant laws, Supreme Court decisions, ordinances, acts of Parliament or Congress, government resolutions and decrees relating to the sector, including the water laws, the laws establishing the utilities, laws and regulations relating to tariffs, environmental laws, health and safety laws, the Constitution, and relevant parts of the Civil Code.	
	Provide comments on the legal implications under national and local law of different methods of private sector participation (sale of shares, concession, lease, management contract, and so on).	Advise on the legal implications of different methods of privatising the Water Utility (sale of shares, concession, lease, management contract, and so on) and the proposed transaction structure.

[14] This annex is extracted in its entirety from the World bank Toolkit 3 (World Bank, 1997c).

Task	Responsibility and action	
	Local lawyers	**International lawyers**
	In conjunction with the international lawyers, review current institutional arrangements, legislation, government resolutions, court decisions relevant to the water sector, and the Water Utility's charter to identify key legal and regulatory issues that must be addressed in order to achieve acceptable international standards to facilitate the privatisation. This will involve taking comments from the international lawyers on the draft joint report (see below).	In conjunction with the local lawyers, review current institutional arrangements, legislation, government resolutions, court decisions relevant to the water sector, and the Water Utility's charter to identify key legal and regulatory issues that must be addressed in order to achieve acceptable international standards to facilitate the privatisation. This will involve commenting on the draft joint report, which will be finalised by the international lawyers according to international standards.
	In conjunction with the international lawyers, review the national and local laws and assist in preparing any amendments necessary to facilitate the proposed transaction. This will involve producing the draft joint report for review by international lawyers.	After the review, list key points and issues arising from the review and assist the local lawyers in preparing the necessary draft legislation to enable those key points and issues to be addressed. Attention should be paid to the institutional framework.
	Deliverable: Joint report on the legal and regulatory framework.	**Deliverable**: Joint report on the legal and regulatory framework.
Policy co-ordination (regulatory task)	Provide a supporting and advisory role on the practicality of implementing proposed new arrangements.	Review current and proposed future arrangements for regulation (institutional issues and methodology) in the light of international experience and standards.
Regulatory and sector structure policy options (regulatory task)	Advise on the implications of specified options under local law (for example, tax implications).	Advise on policy options for regulation of the sector (for example, municipal or national regulator) and highlight benefits and drawbacks.
Legislative changes	Assist in drafting legislative amendments to ensure consistency with other legislation and local legal practice.	Prepare necessary legislative amendments and supporting briefing papers in the light of the transaction structure and the proposed legal and regulatory framework.
	Provide detailed comments and drafting support on the briefing papers and at presentations on the proposed framework.	
Preparation phase: Step 2		
Transaction documents	Comment on the international lawyers' proposed documents; provide detailed input on the draft transaction documents (such as share purchase agreement, shareholders agreement, corporate statutes, bulk water supply agreements, and concession contract).	Recommend and draft the legal documentation required to implement the selected transaction structure. Provide comments on the draft documentation in reference to international experience and standards.
Regulatory body (regulatory task)	*If a regulator is to be established*: If required, develop detailed internal procedures and charter for a regulatory authority, reflecting the legislative amendments already made.	*If a regulator is to be established*: Outline the key issues to be addressed in the internal procedures and founding charter for a regulator. Provide comments on the detailed drafting in reference to experience from other countries.
Due diligence on corporate and debt issues	Conduct a due diligence exercise to review the Water Utility's existing contracts, agreements, arrangements, assets, liabilities, long-term debt, and other commitments to ensure compatibility with the approved legislative arrangements and assess how to deal with any remainder transfers.	Review and comment on the results of the due diligence exercise, with particular reference to the impact on the transaction documents and liability. Provide drafting assistance (if required) on developing suitable transfer schemes for assets, property, and liabilities.

Task	Responsibility and action	
	Local lawyers	**International lawyers**
Due diligence on labour-related issues	Review existing legal obligations of the Water Utility and any new companies to be established and assess the potential exposure of the Water Utility to, for example, redundancy or retrenchment compensation and pension liabilities as a result of the privatisation.	Review and comment on the results of the due diligence undertaken by the local lawyers, with particular emphasis on the transaction documents and guidance on how these matters should be addressed.
Due diligence on litigation and environmental and other issues	Review existing and potential liabilities.	Review and comment again, with particular consideration of the effect on the transaction documents.
	Advise on the transferability of assets, properties, and liabilities by breakdown into new corporate entities, long-term lease or concession, or management contract.	Review with the financial advisers and the government which assets, properties, and liabilities are to be transferred in the restructuring of the Water Utility in the light of the due diligence exercise and in order to conform to the new legislative arrangements.
	Comment on the documents of the international lawyers.	Draft the documents for transfer of title, with attention to tax-related issues.
	Deliverable: Interim legal due diligence report.	Comment on draft and final legal due diligence report, highlighting issues for the transaction documents (for example, the implications of warranties or indemnities).
Regulatory agreements	Review, comment on, and provide drafting assistance on the regulatory instruments under local law.	Draft the necessary regulatory instruments for the post-transaction Water Utility (concession and license agreements, for example) to ensure the documents meet international standards for the water industry.
Implementation phase: Step 3		
Pre-qualification procedure (including the information memorandum)	Review the documents relating to the pre-qualification procedure and co-ordinate all responses from bidders. Review the information memorandum and provide all assistance required by the government's financial advisers in relation to it.	Assist the government's financial advisers in drafting the information memorandum, taking into account the due diligence report(s) and the regulatory framework; assist in preparing the pre-qualification documents and the request for proposal (RFP) package.
Transfer scheme	Comment on and assist in finalising the transfer scheme in the light of the due diligence exercise.	Amend and finalise the draft transfer scheme.
Concession agreement (if adopted method)	Comment on the international lawyers' drafts of the concession agreement and provide local legal advice on specific issues as they arise.	Draft and negotiate the concession agreement.
Tender documents	Comment on the RFP package, particularly on issues of local procurement law (where applicable).	Develop the RFP package with the government and its financial advisers, drafting and negotiating the formal RFP documents and terms, the evaluation criteria, and the related appendices and attachments.
Corporate documents	Provide detailed comments and drafting assistance and advice on local legal issues for the corporate and transaction documents. Participate and assist in the "discussion rounds" on the draft RFP package.	Negotiate with the lenders and equity investors the concession contract, shareholders agreement, memorandum and Articles of Association, share purchase agreement (as applicable), and other corporate documents to form part of the RFP package.
Labour-related issues	Advise on local laws and draft and negotiate any employee share scheme.	Comment on any employee share scheme or other arrangement.
Ancillary agreements	Review all ancillary agreements and provide detailed local legal advice on issues arising.	Draft and negotiate ancillary (commercial) agreements as may be required, including shared facility, construction, operation and maintenance, supply, and sale contracts.

Task	Responsibility and action	
	Local lawyers	**International lawyers**
General	Provide general legal advice in relation to the above agreements and arrangements.	Provide general legal advice in relation to the above agreements and arrangements.
Public relations	Receive and respond to information on the public relations and corporate awareness program and comment on the program's impact (if any) on negotiations and the tender process.	Provide guidance on legal implications of information given in the course of any corporate awareness program and comment on the program's impact (if any) on negotiations and the process.
Technical information	Receive and respond to technical input during negotiations and the tender process.	Advise on the impact of technical inputs and terms in the transaction documents (for example, the link of any performance bond sought under the concession or license with the quality and coverage targets established as technical goals).
Negotiation to financial close	Assist in finalising the due diligence report. Complete the due diligence exercise.	Support the government and its financial advisers in the negotiations with the selected bidding consortium in order to finalise the contractual documents and supporting arrangements.
	Deliverable: Final legal due diligence report.	Review the due diligence report and advise on implications for the final transaction documents.
Financial close	Arrange the closing of the transaction (if to take place locally).	Arrange the closing of the transaction (if to take place abroad) and assist in finalising the transaction.

Annex 3: Illustrative Terms of Reference for Technical (Engineering) Consultants[15]

Background

[This section provides background on the reform process, briefly describes the existing water and sewerage utility and regulatory framework, and sets out the government's core objectives in the reform.]

Objective

The technical consultants will provide all technical advice to [name of client] and prepare for and deliver to [name] reports (as specified below) on technical matters arising as part of the [restructuring or private participation in the water utility]. The utilities in which private sector participation will be invited include [name of entities] (the "Water Utility").

Scope of work during the preparation phase

To achieve the objective(s) set out above, the technical consultants shall carry out the following principal tasks:

- Review the background studies and papers (prepared by the Water Utility), including any asset appraisals or analogous reports, and use them as a basis for the preparation of the engineers' report.
- Prepare and issue detailed questionnaires to the Water Utility in order to obtain accurate and detailed information as to the technical standards of operation and asset condition in respect of the Water Utility; conduct spot checks and tests of asset condition.
- Gather further information from the Water Utility in sufficient detail as to permit the formation of estimates as to the capital expenditure requirements and to formulate reasonable technical performance standards. This work will include:
  1. Assessments of water resource availability and cost.
  2. The preparation of demand projections, by type of service.
- For the Water Utility (or for each water utility to be restructured or privatised, if there is more than one):
  1. Prepare an engineers' report as described below.
  2. Review and comment on drafts of the initial and final information memorandums prepared by the government's financial advisers.
  3. Prepare a letter for inclusion in the final information memorandum to be prepared by the government's financial advisers (the "Final Information Memorandum").
  4. Prepare a letter to the government and the financial advisers commenting on the technical assumptions used in the valuation models.
- Provide technical advice on the development or review of any applicable technical operational codes.
- Provide technical advice, where required, on the terms of the contracts and licenses governing the performance of the Water Utility.
- Provide technical advice to the government and its financial and legal advisers during the investor's due diligence and bid clarification stage.

[15] This annex is extracted in its entirety from the World bank Toolkit 3 (World Bank, 1997c).

Deliverables

As a result of its activities the technical consultants will deliver to [the government] and its financial and legal advisers the following:

- For the Water Utility (or for each water utility, if there is more than one):
  1. Questionnaires for the Water Utility, together with mechanisms for the validation of data.
  2. Engineers' report.
  3. Comments on the initial information memorandum to be prepared by the financial advisers.
  4. Comments on the final information memorandum.
  5. Letters for inclusion in the final information memorandum.
  6. Letters to [the government] and its financial advisers confirming that the technical assumptions elaborated and provided by the financial advisers and used in the valuation models are appropriate.
- Comments on any operational codes.
- Comments on the proposed transaction documents and contracts.
- Comments on licenses or concessions from the technical perspective.
- Engineers' Report

The engineers' report will provide a review of the technical and operational aspects of the Water Utility and will highlight matters identified by the technical consultants as having an impact on the regulatory and contract terms, the valuation model, or the contents of the final information memorandum. The report will present the technical consultants' opinion, based on the information provided to it by the Water Utility.

The report will be based on the information contained in the draft information memorandum prepared by the government and its financial advisers and the Water Utility, additional documentation provided by the Water Utility and examined by the technical consultants, and interviews by the technical consultants with the Water Utility management.

The technical consultants will review documentation for completeness and consistency, and will use reasonable effort, within the resources and time available, to verify the technical contents by reference to source documentation and through interviews with Water Utility management and operational personnel. The technical consultants will visit selected Water Utility establishments and carry out a general visual inspection and a review of records. The purpose of these visits will be to provide the technical consultants' personnel with a general overview of the installations and to give an indication of the extent to which the reality agrees with what is in the documentation. The scope of services will not include testing or detailed examination and investigation of Water Utility assets or operations.

All reports will be prepared in [English]. The technical consultants will receive full and prompt co-operation from the Water Utility

The engineers' report will cover, among other things, the following topics:

- Description of assets.
- Metering.
- System losses (physical and commercial).
- Quality of supply (quantity, pressure, availability, raw and treated quality).
- Network safety.

- Network environmental compliance.
- Network maintenance, network operation, and associated standards.
- System planning.
- Network security and availability.
- Asset residual life.
- Technical appropriateness of planned investments and anticipated useful life.
- Contracting strategy for new investment.
- Operation and maintenance.
- Spares and supplies retained on site.
- Options at the end of the contract; decommissioning requirements.

Annex 4: Illustrative Terms of Reference for Financial Advisers[16]

Background

[This section provides background on the reform process, briefly describes the existing water and sewerage utility and regulatory framework, and sets out the government's core objectives in the reform.]

Objective

The financial advisers will provide all financial advice to [name of client] and prepare for and deliver to [name] reports (as specified below) on all financial matters arising as part of the [restructuring or private participation in the water utility]. The utilities in which the private sector will be invited to participate include [name of entity or entities] (the "Water Utility").

Scope of work during the preparation phase

To achieve the objective(s) set out above, the financial consultants, in conjunction with a local accounting firm, shall carry out the tasks below:

8.9.4 Regulatory and institutional issues

- Review the legal advisers' joint report on the legal and regulatory framework (see terms of reference for legal counsel, preparation phase, step 1, deliverable); comment on the financial implications of any existing or proposed private sector participation laws, regulations, and institutional structures.
- Evaluate the impact of any existing or proposed laws on the ability of the government to attract private sector participation and financing in water sector reform. Recommend changes to the proposed or existing legislation, if appropriate.

8.9.5 Policy co-ordination (financial assessment)

- Develop a financial model with inputs from the legal, economic, and technical consultants to assess the financial viability of alternative private sector participation options. The model will be used to prepare a financial policies paper and develop the financial parameters for the transaction, including sensitivity analyses required for the information memorandum. The model will include the following inputs:
  1. Demand forecasts and tariff structure provided by the economic consultants.
  2. Cost inputs—construction, operating, and maintenance costs, and schedules provided by the technical consultants.
  3. Capital structure—debt and equity sources of funds, domestic and foreign.
  4. Government financial support—the types of financial support the government will provide for the transaction.
- Evaluate the outputs of the financial model and, with assistance from the economic, legal, and technical consultants, prepare a financial policy paper that recommends:
  1. The type and extent of government financial support for alternative forms of private sector participation.
  2. Tariff structure, rates, and subsidies.
  3. Tax allowances (sales, income, value added, and so on) for private sector project sponsors.

[16] This annex is extracted in its entirety from the World bank Toolkit 3 (World Bank, 1997c).

4. Allocation of government funds for restructuring the Water Utility (if applicable), including redundancies and pension liabilities.
5. The financial feasibility of alternative options for private sector participation.
6. Financial basis of award for the contract (cost of service, rate of return, or price control).

Scope of work during the implementation phase

- Prepare financial aspects of the draft information memorandum. The financial advisers will prepare the draft information memorandum from information provided by the Water Utility, the legal advisers' due diligence report, the economic consultants' tariff report, the engineers' report, and its own review of the utility's financial statements. The financial advisers will critically evaluate the information from all the consultants to assess its impact on the financial feasibility of the proposed transaction. The draft information memorandum will contain the following items:
  1. A description of the service area, customer profile, and demand forecast.
  2. A description of the Water Utility, including:
     - A brief history of the organization and current management.
     - The services delivered by the utility (see terms of reference for technical consultants, engineers' report);
     - Capital improvement plans.
  3. Regulatory issues that may affect current operations and future investments.
  4. The financial condition of the utility based on a review of the financial statements, with an emphasis on:
     - Outstanding debt structure.
     - Operating results and debt service coverage.
     - Liabilities to other government entities.
     - Dependence on operating transfers from other government entities.
     - Tariff revenue history, major users, and payment delinquencies.
     - Significant accounting policies: depreciation, tax issues, asset valuation, construction in progress, and accrued pension liabilities and other benefits.
     - Regulatory issues and outstanding litigation.
     - Government financial support for operations and future capital expansion.
     - Tariffs, rate setting, and adjustment process.
     - Description of the proposed private sector participation option.
     - Restructuring of the Water Utility (if appropriate), including the relationship between the restructured unit and the private sector participation option.
     - Financial feasibility analysis. Using the financial model, prepare cash flow analysis indicating the financial feasibility of the project. Assess the capital structure, financial covenants, debt service coverage ratios, price elasticity of demand, and sensitivity analyses for the proposed private sector participation option.
- In conjunction with the legal advisers, prepare the pre-qualification documents and a marketing strategy for the transaction. This work includes the following tasks:
  1. Identify domestic and foreign companies that may be interested in the transaction.
  2. Evaluate the status of current and future private sector projects in the region, the country, and other countries.
  3. Assess the competitive position of the proposed option and restructure the transaction based on the market evaluation.
  4. Prepare marketing strategy memorandum.
  5. Recommend the pre-qualification criteria.

6. Recommend the timing for the release of the request for proposals.
7. Prepare the tasks, responsibilities, and schedule of activities for the road show or pre-bid conference.

- In conjunction with the legal advisers, prepare the request for proposals. This work includes the following tasks:
  1. Review the economic consultants' recommended method of rate setting for the transaction and comment on its financial implications for the transaction.
  2. Recommend the proposal's financial requirements, such as:
     - Format and content of financial pro formas, for example, cash flow, income statement, and balance sheets that indicate the financial viability of the project.
     - Amount of equity required for the project, timing of equity contributions, and evidence of access to credit or collateral for the equity contribution.
     - Financial commitments from banks and other investors for the required debt.
     - Ability to obtain the required insurance coverage.
     - Ability to obtain the required performance bonds, and other financial assurances for construction and operations.
  3. Assist the legal advisers in the preparation of related appendices and attachments by co-ordinating the inputs from the economic consultants, the engineers' report, and the Water Utility.
  4. Review the concession agreement and advise on the financial issues raised in the document.
  5. Prepare the final information memorandum.
- Clarify any financial issues presented in the bidding consortia proposals and confirm their financial feasibility using the financial model. Prepare the bid evaluation report, which recommends the winning bid to the evaluation committee.
  1. Verify the commitment letters from the financial institutions supporting the bids, including the reasonableness of the terms and conditions of any proposed loans, including interest rates, terms, security, amounts, and capacity of underwriters to support the transactions.
  2. Review the capital structure and shareholders agreement, and ensure that the bidders can provide any scheduled equity payments (from existing resources, bank credits, or other sources).
- Participate in the contract negotiations with the selected bidding consortium, providing financial advice on the major contract documents, such as the concession contract, shareholders agreement, articles of association, share purchase agreement (if applicable), and other documents that may be required for the transaction.
  1. Provide sensitivity analyses during contract negotiations for changes in project assumptions, using the financial model.
  2. Assess the marketability of the proposed debt instruments, based on the terms and conditions of the financing documents and the concession contract.
  3. Ensure that the concession contract is bankable, especially with regard to such terms and conditions as lenders' rights and security for lenders' market, political, and construction risks.
  4. Evaluate the private partner's marketing plan for loan obligations required to finance the project.
- Prepare the schedule of events for the transaction's closing and co-ordinate the work of the legal, economic, and technical advisers to finalise the transaction.

Deliverables

- Financial model.

- Draft and final information memorandum.
- Marketing strategy memorandum.
- Schedule of activities and responsibilities for pre-qualification; preparation, evaluation, and negotiation of bids; and financial closing.
- Bid evaluation report.