

PPP UNIT OF THE NATIONAL TREASURY

The Public Private Partnership
between the

*Eastern Cape Department of Health
and
Life Healthcare Group
in
Humansdorp District Hospital*

Document Comparison
by
Wits Business School



Bid no: 010/06

Wits Business School

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1. Background

- 1.1 This project was initiated on 26 April 1999, before the promulgation of the Treasury Regulations under Public Finance Management Act (PFMA) 1999. The Eastern Cape Department of Health (ECDoH) set the process in motion by placing an advertisement in the Eastern Province Herald inviting proposals from the private sector. Four proposals were received, from Afrox Healthcare (Pty) Ltd (Afrox), Netcare, Dries Bekker and the Malesela Hospital Group respectively. After an evaluation procedure Netcare and Afrox were identified as complying with the minimum requirements and were shortlisted.
- 1.2 In order to differentiate further between the two proposals the ECDoH then formulated a wish list, on the basis of which the two parties were asked to update their proposals. These were duly submitted on 13 March 2000. In the EDCoH's opinion, Netcare's revised proposal amounted to a Private Finance Initiative, offering a loan to the state to fund the upgrading of the hospital. This failed to address the needs of the ECDoH, and was therefore not pursued any further. Afrox (or more particularly a joint venture between Metropol Hospitals, an Afrox Healthcare group company, and Season Star Trading cc, which later chose the name Metro-Star Hospital as its trading name) was accordingly identified as the preferred bidder in June 2000.
- 1.3 It is apparent from the project close-out report that a complete report regarding the process followed thus far was submitted to the tender board on 14 July 2000, requesting that a presentation be made to the board in order to proceed with the project.
- 1.4 However, the project came to a halt at this point, presumably due to the pending publication of the Treasury Regulations. Interest in it only revived after the regulations were promulgated on 9 April 2000. The project was then brought to the attention of the PPP unit, which recognised that there was value for money in it, and therefore recommended that it be pursued. (Note that the National Treasury PPP Manual was only published in 2004 and was not yet available.)
- 1.5 The PPP unit recommended that transaction advisors (TA) be appointed to facilitate the process and to ensure compliance with the regulations. The team was appointed in November 2001, comprising financial and legal advisors, on the understanding that the ECDoH would provide all medical expertise required by the TA in completing its tasks.

2. Feasibility Study

- 2.1 There is no feasibility study among the documents supplied to us, although it is apparent from correspondence and the project close-out report that the document was prepared. The purpose of the feasibility study is to demonstrate whether a PPP is the appropriate vehicle to use and whether the project is affordable by the government department, and whether it transfers appropriate technical, operational and financial risk to the private party, as well as whether it gives value for money.
- 2.2 According to the Project Close-out Report, the need for the project arose from rapid population growth in the Jeffreys Bay area and a consequent shortage of hospital beds. Furthermore, a needs analysis conducted by the Department of Public Works showed that the existing Humansdorp hospital was in desperate need of upgrading and renovation. The state's revenue collection was generally problematic, and for all these reasons the possibility of a PPP was investigated by the ECDoH.

- 2.3 The project outputs were:
 - 2.3.1 revitalisation, refurbishment and upgrading of the existing hospital;
 - 2.3.2 establishment of a private health facility at the existing hospital;
 - 2.3.3 shared use of medical facilities and services;
 - 2.3.4 facilities management services by the concessionaire at the hospital;
 - 2.3.5 revenue sharing by the concessionaire with the ECDoH; and
 - 2.3.6 socio-economic benefits.

- 2.4 The total capital investment of the project was relatively small, being R13 010 055.00 by the private sector and R1 500 000,00 by the ECDoH.

3. Treasury Approval: I

- 3.1 The Treasury Regulations of April 2001 were amended in May 2002, to provide for the three-step process of Treasury Approval I, Treasury Approvals IIA and IIB, and for Treasury Approval III.
- 3.2 Regulation 16.5.1 (as amended in May 2002) provides that “a written application for the feasibility study approval (Treasury Approval: I) must be submitted to the relevant treasury together with the feasibility study...”.
- 3.3 There is no TA: I among the documents supplied to us, although correspondence indicates that it was granted on 26 September 2002.

4. Treasury Approval: IIA

The next step is to prepare bid documents and on this basis to obtain TA: IIA. Regulation 16.6.1 provides that, “Prior to the issuing of procurement documentation to any prospective bidders, the institution must obtain approval from the relevant treasury for the procurement documentation, including at least the main terms of the proposed agreement, the aspects of affordability, value for money and risk transfer.” Regulation 16.6.2 goes on to say that this approval will be referred to as TA: IIA.

There is no application for TA: IIA on file, and the correspondence makes it clear that no application was made for such approval at this stage.

5. Request for Qualification (RFQ)

No RFQ process was ever followed, as the Treasury Regulations were not yet in force at the time that pre-qualifying bidders were selected.

6. Request for Proposal (RFP)

- 6.1 According to the document submitted by the ECDoH in support of the request for TA: IIB, the PPP unit of National Treasury identified a number of issues which required resolution prior to the granting of approval for the project. These related mostly to “uncertainties in the proposal from the preferred bidder and the absence of a draft project agreement”. Drafts of a concession agreement, a code of conduct, a service level agreement and a value for money and risk transfer report were duly prepared.
- 6.2 We have been provided with an undated RFP, which has some information still to be inserted, but which is almost a complete document. We have therefore worked on the basis that it is in substantially the same form as the final document. It is worth noting that it has been called a “Request for Final Proposal”, as it was apparently prepared so as to address some of the procedural issues which had to be complied with. As there is no provision in the regulations for a “request for final proposal”, we have regarded it as an RFP.
- 6.3 The correspondence indicates that this was submitted to the National Treasury PPP unit on 26 January 2003, and that changes were subsequently incorporated into the documents following on discussions between the ECDoH and the bidder. The documents were then issued to the sole bidder, Afrox, on 30 January 2003, with Afrox submitting its bid on 24 February 2003.
- 6.4 It is apparent from the documents that it was only during the course of the project that it became clear that optimal risk transfer could not be achieved if the private party only undertook the initial construction phase. The concessionaire was accordingly invited to make proposals for the facilities management of the entire complex, for the duration of the agreement. One could question whether this was a fair process, as no other bidders had been invited to submit proposals for this aspect of the project.
- 6.5 The RFP complies with most of the requirements set out in the PPP practice manual in that:
- 6.5.1 Section 2, headed ‘Project Scope’, provides general information to the bidder and makes it clear that the private partner is expected to construct certain exclusive use and other joint use facilities and to provide a number of services to the ECDoH.
- 6.5.2 Whether the RFP in this instance sets out the essential minimum requirements in such a way that the bidder understands the minimum that can be expected from the bid to meet the pre-defined project objectives, is debatable.
- 6.5.3 The service specifications are set out in sections 2.3 and 2.4. While the medical services are properly detailed in Annexure 3, there is no Annexure 4 in the draft which has been supplied to us (dealing with support services).
- 6.5.4 Section 3 deals with ‘Financial Arrangements’, but does not fully deal with the payment mechanism and penalty regime, as the manual recommends. Section 3.4, headed concession fee, has not been completed in the document supplied to us, and the extra detail has in all probability been included here in the final document.
- 6.5.5 The document which we have does not set out the ECDoH’s affordability limits, which the manual recommends should be done.

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- 6.5.6 The regulatory framework and legal requirements are very carefully set out in Section 5, and a draft concession agreement is attached. The bidder is instructed as to how to deal with this agreement.
 - 6.5.7 The bidder is told throughout the document how to give comment and feedback on the document.
 - 6.5.8 The evaluation of the proposal is dealt with in section 9 and evaluation criteria are clearly set out in 9.2.
 - 6.5.9 The document deals more than adequately with bid formalities.
- 6.6 A request for retrospective granting of TA: IIA was turned down on the basis that it cannot be given retrospectively. However, in a letter dated 24 March 2003, Aijaz Ahmad (acting head of the PPP unit in National Treasury) recorded that had the request for TA: IIA been received timeously, the approval would have been granted. He therefore gave permission for the project to proceed without it.
- 6.7 We have not been provided with the response to the RFP.

7. BAFO Documents

No BAFO procedure was followed in this project, although it would perhaps have been a more appropriate route than the “request for final proposal” which latter isn’t actually provided for in the regulations.

8. Treasury Approval: IIB

A request for TA: IIB was made in June 2003, which included a value-for-money report. Ahmad granted TA: IIB on 12 June 2003, noting that issues of final value for money, staffing and affordability would still have to be worked through with the bidder before the granting of Treasury Approval: III. According to the project close-out report, these differences were resolved during two days of intensive negotiations on 13 and 14 June 2003.

9. Value-for-Money Report

- 9.1 A value-for-money report accompanied both the application for TA: IIB and TA: III. We have commented on the report attached to TA: III.
- 9.2 This complies with the recommendations of the practice manual in that it:
 - 9.2.1 sets out the background to the project, the history of the procurement process and a PPP description;
 - 9.2.2 includes a value-for-money table, although it does not have a comparison with the public sector comparator (PSC) as the practice manual suggests. It does include details of the project infrastructure, operations and BEE component;
 - 9.2.3 deals with contingent liabilities;
 - 9.2.4 contains a risk analysis summary, but this does not include risk values as the practice manual says it should. It does, however, set out a risk matrix, allocating risks between the parties and providing comments in each instance. The standardised risk matrix supplied in the manual has four columns, headed “categories, description, mitigation and allocation”, which is not unlike the kind of detail which has been included in this report;

- 9.2.5 touches on affordability, and although it states what the unitary payment is, this section is not neatly and clearly set out, and does not include the kind of detail recommended by the manual; and
- 9.2.6 has a conclusion and a justification for that conclusion.
- 9.3 The report does not deal with sources and conditions of funding, and does not talk of a legal due diligence or a management plan (although we have been supplied with the latter), which the practice manual says it ought to do.

10. Treasury Approval III

- 10.1 A request for TA: III, dated June 2003, is on file. This contains the same value-for-money report as was used in the request for TA: IIB, though with slight amendments and variations.
- 10.2 Ahmad granted TA: III on 26 June 2003, saying: “I thank you for the most cooperative manner in which you have worked with the staff of the PPP unit. It is apparent that the Department has set a precedent worthy of emulation throughout the country. We congratulate you for your efforts and wish you well for the project.”

11. The Concession Agreement

- 11.1 The Concession Agreement between the ECDoH and Metro Star Hospital-Afrox Healthcare was duly signed on 27 June 2003. A comparison between this agreement and the standardised PPP provisions contained in practice note 01 of 2004, indicates substantial compliance with all the standard requirements. More particularly:
 - 11.1.1 Clause 4 contains suspensive conditions which are not advocated by the practice note, but which in reality are very difficult to avoid. In any event, clause 4.2 states that these conditions may be waived by the ECDoH, because they are entirely for its benefit.
 - 11.1.2 Throughout the contract the concessionaire (private party) purports to take on full risk. This is standard procedure in construction contracts of this nature, and is therefore not unique to the concession agreement or this particular PPP contract. Nor does it necessarily mean that there is a full transfer of risk (see 10.3.23 and 10.3.24 below).
 - 11.1.3 Clause 7 states that the concession period is 21 years. This is long, and therefore presents more opportunity for affordability by the institution than if it were a short-term period. However, the downside of such a long concession period is that with time comes risk. The status of the concessionaire may change and it may no longer be suitably qualified to perform the services in terms of this agreement.
 - 11.1.4 Clause 10.3.3 states that pursuant to a due diligence, the concessionaire takes full risk and liability for any unforeseen costs or damages arising in relation to the execution of its obligations under the agreement.
 - 11.1.5 In clause 10.8.1, the concessionaire takes on the concession area, as well as the structures erected thereon, *voetstoots*, which means ‘as they stand’. It therefore accepts risk for latent defects. The practice manual states that the question of who should bear such risk should be decided on a project-by-project basis, depending on the condition of the existing site and its prior use, and on affordability and value-for-money issues.

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- 11.1.6 In terms of clause 11.3, ownership of the project facilities vests in the ECDoH. Clause 11.3.2 goes on to provide that at the end of the concession period the ECDoH becomes owner of all the project facilities except for those listed in Schedule 8. The risk matrix in the value-for-money report states that residual value risk lies with the ECDoH.
- 11.1.7 Clause 11.4.2 provides that in respect of the existing project facilities, the concessionaire contracts out of liability for existing defects. Once again, therefore, it assumes liability for latent, but not patent, defects. The manual recommends that such liability be determined on a project-by-project basis.
- 11.1.8 Clause 12.2 provides for the ECDoH to make service payments to the concessionaire from the commencement date for services, which is consistent with the recommendations of the practice manual.
- 11.1.9 The concessionaire accepts entire responsibility for maintenance of the project facilities in clause 12.8.1. Clause 12.10 allows the ECDoH to monitor the facilities on the 5th, 10th and 15th years of the concession period. The practice manual advises that monitoring provisions should not be too prescriptive as this affects the transfer of risk, and this course of action would appear to have been followed in this agreement. In addition, the on-demand bank guarantee provided for in clause 17, gives the ECDoH security in respect of the condition of the facilities.
- 11.1.10 In terms of clause 12.11, all project facilities are returned to the ECDoH at the end of the concession period.
- 11.1.11 The manual points out that performance levels required of the concessionaire are relevant in determining risk transfer.
- 11.1.12 Clause 14.5 provides for the ECDoH to make a one-off cost contribution of R1 500 000 to the concessionaire on completion of the construction of the additional facilities. To this extent there is no transfer of risk, or a lesser transfer of risk, as if the project fails the ECDoH has lost its money. The manual, however, notes that current international trends support the use of government funding in PPPs, and states that National Treasury's view is that such funding should only be considered on a clear demonstration of value for money. Furthermore, these funds should not cover the entire capital costs (as they do not in this case), and should be for the provision of ring-fenced assets that will revert to the state on termination of the PPP agreement (which this agreement ought to have specified). Note that this contribution was determined to prevent a sticking point in the negotiations, arising out of R3 million discrepancy between costs and affordability.
- 11.1.13 Clause 16.3.3 provides that the institution's architect is the party who issues the certificates of practical and final completion, as opposed to an independent certifier who is recommended in the standard provisions. The latter would seem to be a preferable course of action to follow, as the institution's architect may be perceived to be biased. Furthermore, the manual states that although the concessionaire appoints and pays the independent certifier, the contract should specifically say that this won't affect his independence.
- 11.1.14 In terms of clause 17.1.2 the concessionaire pledges the additional project facilities to the ECDoH for the duration of the agreement, as security for its performance. In addition, clauses 17.2.2.1 and 17.2.3.2 require the concessionaire to secure a works performance bond and a termination performance bond respectively. Both are to remain in force until 90 days after the expiry of the latent defects liability period. The former secures the

construction works, while the latter secures the condition in which the project facilities are handed back to the ECDoH. The manual recommends that performance bonds should be considered on a project-by-project basis, as they affect considerations of affordability and value for money. There would seem little doubt that they are appropriate in the circumstances of this project.

- 11.1.15 The indemnities and liabilities are fairly standard, although the concessionaire does not indemnify the ECDoH against any breach of a statutory duty as the manual recommends. However, one might argue that this is covered in other undertakings throughout the agreement, as well as in the insurance provisions.
- 11.1.16 Clause 18.4.1 excludes consequential damages or indirect loss from the indemnities, while 18.4.2 limits the ECDoH's liability to instances of gross negligence. This is consistent with what the manual advises.
- 11.1.17 Clause 20 passes insurance risk entirely to the concessionaire. It does not provide for proceeds of claims to be paid into a joint account set up for these purposes, as the manual recommends, but to the concessionaire to use directly. The former would seem to be a preferable course of action, as this makes it easier to monitor the appropriation of the funds.
- 11.1.18 The matter of non-vitiating protection is not covered, but the manual suggests that this is something which should be determined on a project-by-project basis, taking into account considerations of value for money.
- 11.1.19 The insurance clause does not deal with reinstatement as the manual recommends, but this is covered by a separate section headed 'damage or partial destruction'.
- 11.1.20 Clause 20 should specify what will happen to uninsurable risks (which it does not do), or what will happen in the situation where the concessionaire is underinsured.
- 11.1.21 The PPP manual recommends that there should be a provision for relief events, compensation events, and force majeure. These are instances where the concessionaire is not able to provide services from the stipulated commencement date, through no fault of its own, and the manual recommends that in these circumstances the private party should be excused from liability for failure to provide services. This concession agreement does not address this issue.
- 11.1.22 The manual recommends that the private party should have 40% black equity, which should be active participation. 40% of management of the private party should be black, 15% of which in turn should be women. There must be an employment equity plan which complies with all applicable laws, and bidders must present a clear skills development plan in their bids. The manual is not prescriptive about BEE in subcontracting arrangements, but recommends that cash-flow benefits, ownership, management, women, employment equity, skills development and procurement commitments can all be targeted for strong BEE results in this area. The manual also stipulates that PPP projects must be directly beneficial to the people in whose neighbourhoods they operate.
- 11.1.23 Schedule 27 to the agreement deals with the concessionaire's empowerment plan. While it does not comply entirely with the practice manual's recommendations, the commitments it makes come very close to them. HDI (South African citizens historically discriminated against) ownership will be

25% for years one to five of the concession period, growing to 40% by year 11. 50% of the money spent by the concessionaire on all construction works will go to HDIs and HDEs (enterprises which are at least 81% beneficially owned and controlled by one or more HDIs). Between years one to five, 20% of money spent by the concessionaire in the provisioning of services will go to HDIs and HDEs, 10% to women and 10% to SMMEs and local people. These figures will grow to 25% for HDIs and HDEs from years six to 10, and 30% from year 11 onwards. The figures for women will reach 15% from year six, while SMME and locals' participation will reach 15% from year 11. As well as annual reporting about compliance with these undertakings to the ECDoH, the concessionaire undertakes to develop training and skills transfer programmes together with the department.

- 11.1.24 While the termination clauses are also fairly standard, covering what will happen in the event of termination by either party, an important test for transfer of risk applies to the amount of money paid out by the institution to the concessionaire when the former takes possession of the concession area and project facilities on early termination. If the concessionaire is placed in the same position as it would have been in had it continued with the project, the institution ultimately bears the risk. If however, the concessionaire bears a loss in this process, there is true transfer of risk. The amount of default termination compensation to be repaid in each of these instances will determine risk allocation.
- 11.1.25 The risk matrix included in the application for TA: III states that the ECDoH bears the risk that the concessionaire fails to complete the project or abandons it prior to completion, which risk is heightened by the fact that the concessionaire is a special purpose vehicle "with no real substance". It does point out, however, that this risk has been largely mitigated by the provision of construction bonds from the contractor to the concessionaire, which have in turn been ceded to the ECDoH, and by the provision of a limited surety for 60% of the estimated construction cost. The risk matrix states that the ECDoH bears residual value risk, as the facilities revert back to it on termination of the concession period.
- 11.1.26 The method by which penalties are calculated, is also an important factor in determining transfer of risk. If the penalty point system is very onerous, the concessionaire bears more risk, whereas if it is more lenient, the institution is shouldering some of the risk. The risk matrix states that the concessionaire runs the risk of penalties if it does not complete the public facilities timeously, as well as the loss of revenue if it fails to complete the private facilities timeously. The concessionaire also bears the risk of incurring penalties if it fails to make facilities available to the ECDoH in terms of the service level agreement, while both parties run the risk of penalties if they fail to deliver in terms of the service levels specified in the service level agreement.
- 11.1.27 The concession agreement does not provide for termination in the event of corrupt acts, which is recommended in the standard provisions.
- 11.1.28 The contract does not set out what will happen in the event of termination by force majeure, which it ought to do.
- 11.1.29 The concession agreement also fails to provide for a re-tendering procedure in the event of default by the concessionaire, and the institution wanting to replace it with another concessionaire. Such re-tendering procedure is recommended in the standard provisions, but may not be appropriate in this particular case.

12. Contract Management Plan

- 12.1 Treasury regulation 16.7.1(b) provides that the institution must “submit a management plan that explains the capacity of the institution to effectively enforce the agreement including monitoring and regulating implementation of and performance in terms of the agreement.”
- 12.2 We have been provided with a marked-up contract management plan, dated June 2003, which we have been instructed to treat as the final document.
- 12.3 It appears to comply broadly with all the requirements of the Treasury Regulation in that:
 - 12.3.1 The ECDoH head of Department, as the accounting officer, is the person ultimately responsible for the project.
 - 12.3.2 The director: financial administration is appointed as the compliance officer.
 - 12.3.3 It provides for the establishment of a construction management team to monitor the construction works; the fact that this team is to be led by the Department of Public Works suggests that it will have the necessary expertise to do so effectively.
 - 12.3.4 It provides for the appointment of an operational implementation team, to monitor the implementation phase, comprising hospital and district representatives.
 - 12.3.5 It provides for the appointment of a chairperson of the liaison committee (in accordance with clause 21.1 of the concession agreement), as well as the hospital and nursing manager to sit on that committee. It suggests that this should be a district led team, thereby giving the provincial representatives on the liaison team the opportunity to maintain a certain level of independence.
 - 12.3.6 It provides for the appointment of a management board responsible for community health issues and liaison with the community.
 - 12.3.7 The contract specifically states that the liaison committee will provide means of informal dispute resolutions, which may then be referred on for mediation and arbitration as the case may be.

13. Project close-out Report

- 13.1 Following financial closure, the terms of reference for the transaction advisors require that it must provide a project close-out report, for the confidential and complete records of the institution. The report is intended to become a key document in managing the PPP agreement.
- 13.2 The document in this instance provides a clear and informative oversight of the project proceedings, from inception to contractual close. It is perhaps not quite as detailed as the practice manual requires it to be (bearing in mind that the manual had not been published when the report was prepared), but succeeds more than adequately in giving a broad oversight of the tender and negotiation phase of the project.

- 13.3 Although the report does not include lessons learnt at the end of each subsection, as the practice manual recommends, it does end with conclusions and recommendations which are worth noting:
- 13.3.1 Where facilities management services are to form part of the project scope, the TA team should include facilities management specialists, unless such technical assistance can be provided by government. However, insufficient expertise is usually found at this level in government.
 - 13.3.2 Negotiators should have authority to take decisions regarding key negotiation and commercial issues.
 - 13.3.3 Government's empowerment requirements for PPPs should be standardised to ensure similar treatment of all PPPs.
 - 13.3.4 An interactive negotiation process with an experienced and committed preferred bidder can result in significant value-add to the project and create a win-win situation for both parties.
 - 13.3.5 A short negotiation period can be achieved if firm milestone dates are given.

14. Conclusion

- 14.1 Our final comment is to question whether a fair tender process was in fact followed in this project. The real evaluation of the bids took place before the issue of the Treasury Regulations, and without RFQs or RFPs being issued. Once the RFP was compiled, it was only submitted to Afrox, which had already effectively become the preferred bidder by this stage of proceedings. Furthermore, only Afrox was given the opportunity to provide proposals for facilities management, as this was not originally part of the project scope.
- 14.2 Bearing in mind that current Treasury Regulation 16.5.3 provides specifically in subsection (a) that the procurement procedure must be in accordance with a system that is fair, equitable, transparent, competitive and cost-effective, the question of whether a fair tender process was in fact followed, seems a reasonable one to ask.
- 14.3 We recommend that on completion of any future projects, a full list of final documents should be compiled, and that these should be stored in a systematic manner, so that they are more easily accessible and better ordered than these documents have been.