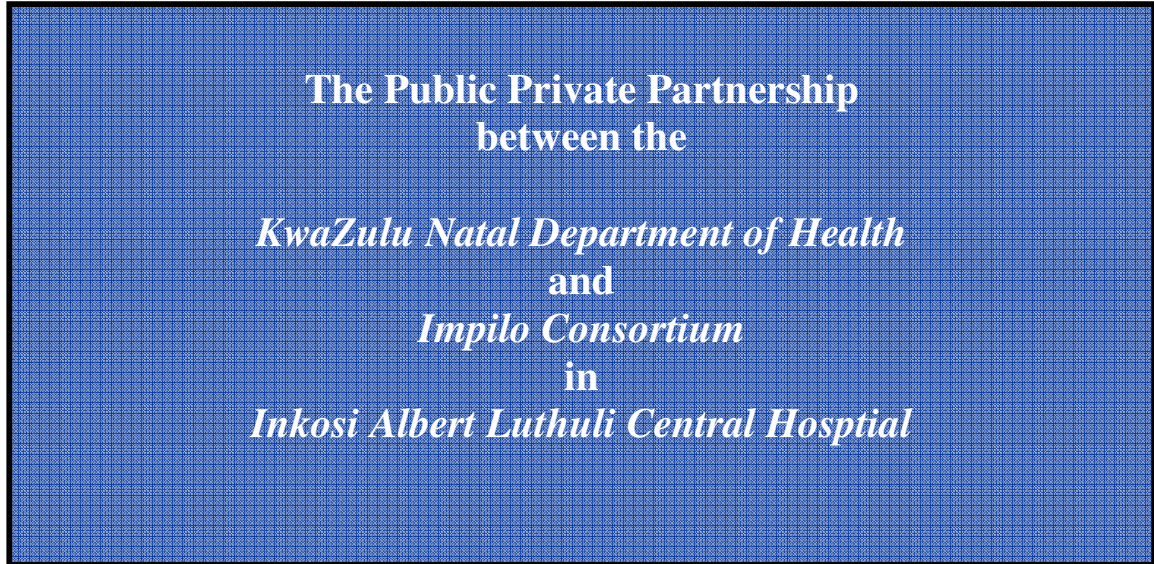


# PPP UNIT OF THE NATIONAL TREASURY



**Document Comparison**  
*by*  
**Wits Business School**



**Bid no: 010/06**

**Wits Business School**

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### **1. Background**

- 1.1 The idea of a large new hospital in the Cato Manor suburb of Durban began in the late 1980s, with the original plan being that it would be a teaching hospital with 1000 beds. However, this plan changed in the mid-1990s, when it was decided that it should rather be an 850-bed referral hospital and not an academic institution. The provincial government's vision was to create one of the best hospitals in the country, using cutting edge technology. It intended that this hospital become the flagship for the highest level of medical care in the province when it opened.
- 1.2 Construction of the building began in 1996 and was still being completed when the PPP process was initiated in 2000.
- 1.3 The Kwa-Zulu Natal Department of Health (KZNDoH) appointed a transaction advisor consisting of representatives from a number of different disciplines, and led by Pricewaterhouse Coopers, which set about conducting a feasibility study on the project. Herman Conradie, who was chief financial officer of the KZNDoH was appointed to the position of project officer.
- 1.4 The documents refer to this as a pathfinder project, one of the reasons being that it was the first PPP project to run its entire course under the regulations issued in terms of the Public Finance Management Act (PFMA) 1999 (which were published on 9 April 2000).

### **2. Feasibility Study**

- 2.1 At the time of concluding this report, we had not been provided with the feasibility study report, although it is clear from the correspondence and documents that one was prepared by the transaction advisor, the conclusions and recommendations of which were accepted by the KZNDoH in October 2000. However, we do have a 30-page power-point presentation summarising the feasibility study, dated 29 November 2000, as well as a document prepared by the transaction advisor called "Final draft Phase 1 Report", dated 8 November 2000, which contains some excerpts from the feasibility study. From these we have been able to make the following observations:
  - 2.1.1 According to the practice manual issued by the PPP unit of National Treasury (which was only published in 2004 and therefore not available to the parties at the time of conducting the feasibility study), the purpose of the feasibility study is to help determine whether or not a PPP is the appropriate vehicle for the project. It must therefore demonstrate whether the PPP choice is affordable, transfers appropriate technical, operational and financial risk to the private party, and gives value for money.
  - 2.1.2 The manual states that early considerations of suitability of the project for a PPP are:
    1. scale, which provides large enough cash flows for both public and private parties to achieve value-for-money outputs. IALCH is certainly a large project, requiring an initial capital investment of R900 million or more, and with a service fee over its life time of R4.5 billion at current monetary values;

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2. outputs, which must be able to be specified in very clear terms;
  3. risk transfer which is a primary driver of value for money in a PPP. Key members of the project team attended a risk workshop on 16 October 2000, where the possible cost impact of each project risk was identified;
  4. the project must be commercially viable and there must be a level of market interest in it.
- 2.1.3 The feasibility study should, according to the practice manual, include a needs analysis, which demonstrates that the project aligns with the institution's strategic objectives, identifies and analyses the available budget, demonstrates the institution's commitment and capacity, specifies the outputs and defines the scope of the project. This is followed by the solutions options analysis, which should list all the solution options that have been considered, evaluate each of these, and choose the best option. A project due diligence should then look at the legal issues, site enablement issues and BEE and other socio-economic issues. This is then followed by a value assessment including the public sector comparator (PSC), the risk-adjusted PSC, and should also look at affordability, value for money and risk transfer.
- 2.1.4 In the absence of the full feasibility study we do not know exactly what was done under each of these categories. We do, however, know that the Inkosi Albert Luthuli Central Hospital (IALCH) is an 846-bed hospital built by the Department of Public Works in the Cato Manor area near Durban, to provide central hospital services for referred patients. It therefore only deals with tertiary and quaternary health services, and its catchment area is the whole of KwaZulu-Natal and 50% of the Eastern Cape (approximately 12.5 million people).
- 2.1.5 The services which the DoH require from the private partner are supply of equipment, information management and technology (IM&T) and facilities management to support the operations of the IALCH. The private party will also be required to maintain and repair the equipment, as well as to replace it for reasons of technological advancement as well as obsolescence, and to ensure that the software for IM&T remains up-to-date.
- 2.1.6 In looking at medical equipment which was required, the transaction advisors took a room by room approach, which they believed would give a realistic budget. They also looked at the general costs of such equipment in South Africa and took into account lifecycle and other costs. They concluded that medical equipment had to be replaced every five years (based on the lifecycle used by manufacturers), and that the technology and software refreshment cycles had to be every three years (according to the industry norm).
- 2.1.7 They drew up an equipment budget based on what was required for each of the rooms, which came to a total of R326 491 150, and concluded that after budgeting for a variety of different scenarios, the initial capital requirement for IT was R92 million. This included

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PACS, image distribution throughout the hospital, ECG management, critical care systems for ICU, NICU, CCU and OTs, radiotherapy management system, financial administrative systems, and was tele-medicine enabled.

- 2.1.8 They also drew up a human resource summary which excluded facilities management staff, and which concluded that the annual total cost of staff would be R229 490 644, averaging out to R91 302 per staff member *per annum*. Assuming an 80% occupancy ratio (which had dropped from the initial 85% assumption), this yielded favourable staffing ratios when compared to Wentworth Hospital (in Durban) and a better nursing ratio, though worse medical staff ratio, than a Scottish teaching hospital with which comparisons were drawn.
- 2.1.9 Concern was expressed by the private party about the fact that it had identified certain skills shortages in the Durban region that might affect staff availability for certain specialities within the IALCH. The summarised feasibility study notes that this will be a matter of great concern in commissioning the IALCH. There was also concern over the fact that hospitals such as Addington, Wentworth, and King Edward would continue to provide secondary healthcare requiring specialist nursing staff. In summary, there would be a shortfall of about 200 theatre nurses alone. The feasibility study accordingly recommended that urgent efforts should be made to increase the supply of nursing students and hence graduates to overcome the staffing deficits.
- 2.1.10 In analysing facilities management (FM) the feasibility study looked at product, price, process and performance. For the product they assumed a full set of service specifications, user consultation, a base level that reflected good practice and legislative compliance, which was all output-based. The process was service specific, multi-skilled, and a one-stop-shop which would support clinical delivery. Performance would be based on availability, provision of service outputs, would be measurable and objective and penalty-linked, and would also have termination thresholds. Pricing looked at Opex, Capex, public sector comparator (PSC), costed maximum output specification and value for money in terms of risk transfer.
- 2.1.11 The feasibility study concluded that changing from conventional FM procurement (eg several different providers with no central control) to a PPP contract would, by changing traditional procedures and means of service delivery, provide efficiency and service gains to the hospital. It drew up a PSC, and concluded that the PPP option yielded value for money over the PSC. Further benefits of this approach would be better quality of service as well as risk transfer.
- 2.1.12 The key assumptions used in comparing the costing options were a 15-year contract period, five-year refreshment cycles on equipment, three-year refreshment cycles on IT, a real discount rate of 8%, inflation of 6%, conservative assumptions around costs, an 80% occupancy rate, assessment of the PSC versus the PPP delivery, and an assumption that payment would be based on availability of all services.

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- 2.1.13 According to their calculations the PPP option yielded R544 million value for money, which was in excess of 10% of the proposed contract value (note that this figure was considerably reduced by the time of signing the agreement).
- 2.1.14 The feasibility study recommends that the affordability ceiling should be disclosed in the tender documents, which is in accordance with the manual recommendations. The transaction advisor proceeds to construct a risk-adjusted PSC comparator as well as a risk-adjusted PPP reference model, which then makes it possible to conduct a meaningful comparison between the costs. It concludes that affordability ceilings can be reached, and better value for money yielded, provided that the KZNDoH contributes R360 million to the project up-front and interest-free.
- 2.1.15 The affordability assessment was based on an annual KZNDoH budget for central hospital services of approximately R560 million (escalating at 6%). Because the IALCH was the only designated central hospital in the province, this entire budget was allocated to it. The transaction advisors expressed reservations as feasibility study stage, concluding that “currently, the project is marginally affordable”, and stating that affordability levels should be retested during the bid evaluation stage to ensure that the proposals remained affordable.
- 2.1.16 According to a transaction advisor presentation which is among the documents which we have been given, a single vs multi-contract approach was considered, and the single was recommended because of easier negotiation, risk allocations and contract monitoring.

### **3. Request for Qualification (RFQ)**

- 3.1 We have been advised to treat the “Information Memorandum”, dated 10 November 2000, as the RFQ document. According to the Treasury Regulations, the government institution should not commence with the procurement phase until such time as Treasury Approval I has been obtained. However, the information memorandum notes upfront that “a dual process of obtaining approval of the National Treasury and pre-qualification procedures are taking place.” It goes on to state that the required approval from National Treasury has not yet been obtained, but is expected before the pre-qualification process is finalised. According to documents which have been supplied to us, this was granted on 20 December 2000.
- 3.2 The RFQ for this project is very much less formal than the RFP, and appears to lack quite a bit of the information recommended by the manual. More particularly, the RFQ:
  - 3.2.1 does not talk about a bid bond;
  - 3.2.2 does not contain sufficiently detailed disclaimers for government;
  - 3.2.3 fails to set out the KZNDoH’s affordability ceiling;
  - 3.2.4 does not deal with financing requirements in any great detail; and
  - 3.2.5 fails to give detail of how the bids will be evaluated.

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- 3.3 However, the RFQ does comply with the recommendations of the manual in that it:
  - 3.3.1 sets out sufficient background information on the project for potential bidders to understand its purpose;
  - 3.3.2 makes clear the purpose of issuing the RFQ;
  - 3.3.3 covers proposed timelines and makes it clear that the document is to be read together with the advertisement appearing in the Sunday Times on 5 November 2000;
  - 3.3.4 goes into a lot of detail (possibly too much) with regards to the BEE requirements for the bidder;
  - 3.3.5 sets out the type of organisation which the DoH envisages the bidder should be; and
  - 3.3.6 gives the bidder sufficient idea of the nature and services it will be required to perform.

### **4. Treasury Approval I**

- 4.1 It is important to note at the outset that the Treasury Regulations in force at the time of entering into this project were different to those in force in 2004, when the practice manual was prepared. For the sake of clarity those in force at the time of this project will be referred to as the 2001 regulations.
- 4.2 No specific reference is made to Treasury Approvals I, IIA and IIB, or Treasury Approval III, in the 2001 regulations, which simply provide for approval of the Feasibility Study, acceptance of the procurement documents and more particularly the main terms of the PPP agreement, as well as Treasury agreement to future budgetary commitments which must be denominated in rands.
- 4.3 On 20 December 2000, Ismail Momoniat, the chief director: intergovernmental relations at the National Treasury PPP unit, granted approval of the feasibility study to the KZNDoH, saying “We are of the view that sufficient work has been done by the KZNDoH and your department to sign off on the feasibility study, and to permit tender documents to be issued, on the following conditions”. These were:
  - 4.3.1 that the KZNDoH will still bear ultimate responsibility for ensuring that the project is affordable in terms of the budget;
  - 4.3.2 that the use of funds for the up-front purchase of equipment should be dealt with in the contract in such a way as to ensure the security of the purchase;
  - 4.3.3 that the PPP unit will continue to provide technical assistance, to ensure that the RFP documents transfer risk appropriately;
  - 4.3.4 that the project design will include the available budget less a margin of safety, as a specified limit is not to be exceeded; and
  - 4.3.5 that the KZNDoH ensure that the contract with the service provider is signed only after confirmation of all budgetary commitments, which must not deviate significantly from what is contained in the original feasibility study.

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### **5. Treasury Approval II**

Treasury Regulation 16.6.1 (of the 2001 regulations), provides that prior to issuing any procurement documentation, National Treasury must approve such documentation as well as the draft PPP agreement. We have not been supplied with any such approval.

### **6. Request for Proposals (RFP)**

6.1 Four consortia pre-qualified in terms of the RFQ. These were Hospitalia Consortium, Impilo Consortium, Kobimed Consortium and Mkhumbani Consortium. An RFP was issued to these shortlisted bidders on 15 January 2001.

6.2 The RFP which has been supplied to us is dated 15 January 2001, and is a highly detailed and structured document. It meets nearly all of the recommendations set out in the manual, more particularly:

6.2.1 Chapter 1 deals extensively and comprehensively with bid formalities.

6.2.2 Chapter 3 gives comprehensive general background information to the project, which provides the bidders with a clear understanding of what its objectives are.

6.2.3 Clause 3 of chapter 1 details how the bidders should construct their proposals, and sets out the essential minimum requirements (technical, financial and legal) that should be included in the bids.

6.2.4 Chapter 4 deals with the service specifications which are output-based and invites bidders to come up with a performance monitoring system.

6.2.5 Clause 3.3.3 of chapter 1 specifies that FM services must comply with applicable laws of RSA (reiterated in clause 17.4 of chapter 4), and clause 3 of chapter 4 imposes similar standards on medical equipment.

6.2.6 Chapter 5 is headed 'Financial and Legal Proposal', and deals with all financial aspects in great detail. It sets out the KZNDoh's affordability ceiling and invites the bidders to come up with their own payment mechanisms including an unavailability/underperformance deduction regime. It also provides the bidders with extensive detail regarding the financial model which they are expected to produce. Legal aspects are not dealt with in such detail.

6.2.7 Although a draft concession agreement is not attached to the document in our possession we understand that one was included.

6.2.8 The RFP is very detailed and clear about the comments and inputs which it expects from bidders, and the form that their proposals should take. This information is reiterated throughout the document.

6.2.9 The RFP supplied to us does not deal with the evaluation process at all, nor does it set out the evaluation criteria, which the manual says should be included.

6.2.10 We have been supplied with Impilo Consortium's response to the RFP.

### **7. BAFO Documents**

No BAFO procedure was followed in this project.

### **8. Treasury Approval II B**

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- 8.1 According to the Treasury Regulations in force at the time that the practice manual was prepared, Treasury Approval IIB should be obtained after evaluation of the bids but before appointment of the preferred bidder. As pointed out in 4 above, the 2001 regulations were not the same and simply required approval of the procurement documentation.

### **9. Treasury Approval III**

- 9.1 In terms of the regulations in force at the time that the practice manual was prepared, Treasury Approval III should be obtained before signing of the concession agreement. However, the 2001 regulations provide that after the procurement procedure has been concluded but before the signing of the PPP agreement, the institution must obtain relevant Treasury agreement to future budgetary commitments which must be denominated in rands.
- 9.2 We have on file an undated letter from Siphso Shabalala of the KZNDoH, which is headed “National Treasury Authorisation II: IALCH – KwaZulu-Natal DoH” – i.e. application for approval of documents, but which appears actually to be an application for approval of future budgetary commitments.
- 9.3 The letter requests “National Treasury’s approval for the signing of the concession agreement”. It goes on to set out the affordability and value-for-money criteria. The letter explains that the annual fee payable under the PPP has increased from R230.3 million in the feasibility study, to R250 million at the time application is made. It states that this is because certain functions have been moved from the KZNDoH to the private party, which it says improves on risk transfer and accountability, and does not present problems as far as budgetary constraints are concerned, because these are expenses which the KZNDoH had to budget for in any event. The letter also points out that the exchange rate has an important impact on the project because of the significant imported component, and that the exchange rate had weakened by over 20% since preparation of the feasibility study.
- 9.4 Value for money is justified in the letter on the following basis:

PSC per feasibility study (NPV @ 14.43% for 15 yrs)	R4 877.6 million
Risk Adjustment	R 510.8 million
Risk Adjusted PSC (benchmark for VfM calculation)	R5 388.4 million
PPP price	R2 454.3 million
Retained DoH costs (original feasibility study)	R2 564.3 million
<b>Total</b>	<b>R5 018.6 million</b>
Therefore VfM amount	R 369.8 million

- 9.6 We have a letter from Monomiat at National Treasury, dated 25 October 2001, granting National Treasury’s agreement to the KZNDoH’s budgetary commitments, subject to the fact that “this formal concurrence applies only to

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this PPP agreement, that is the medical and IT equipment facilities management PPP for IALCH public private partnership”.

- 9.7 The letter goes on to state that, “This constitutes approval of the PPP agreement in terms of regulation 16.10.1 (b)”. Regulation 16.10.1 provides for Treasury to exempt an institution from any or all of the provisions of Regulation 16 upon written application from that institution, and such approval is often granted as a formality in the proceedings.

### **10. The Concession Agreement**

- 10.1 We have not been provided with a signed version of this agreement, although we are instructed that the draft provided to us is in most respects the same as the version which was signed in December 2001.
- 10.2 The agreement, which is between the KZNDoh, Cowslip Investments (Pty) Ltd, Impilo Consortium (Pty) Ltd and the Member of the Executive Council for Finance for the KZN Provincial Government, is a very carefully drafted document. It differs from the standard provisions contained in the manual in those areas which are necessary because of the nature of the project (bearing in mind that the standardised provisions prepared by the PPP Unit of National Treasury are not tailored to a health sector PPP, but are structured around a typical accommodation project). In this case the treatment of the project assets is extremely important, because a large portion of the value of the project is made up of the initial costs of high-tech medical and IT equipment, as well as the refreshment and replacement costs of such equipment.
- 10.3 More particularly:
- 10.3.1 The agreement refers to Cowslip Investments (Pty) Ltd as Newco, which is defined as such in the definitions clause.
- 10.3.2 The agreement contains suspensive conditions which are not advocated by the standardised provisions, but which are unavoidable and have become standard practice in PPP agreements of this nature.
- 10.3.3 The project term is 15 years, giving the KZNDoh an option to renew this for one further year. The power point presentation on the feasibility study indicates that this period was chosen as most of the equipment lease arrangements were for three- or five-year periods, and multiples of such terms appeared to give the project company the best opportunity of recouping its costs. It was therefore selected as providing the best value-for-money option.
- 10.3.4 Clause 4 dealing with project documents is substantially in the same form as the standardised provisions.
- 10.3.5 Clause 5 headed ‘project operations’ deals with the same issues as those which appear under the heading ‘project deliverables’ in the standardised provisions. The main issue to be addressed here, according to the manual, is that the private party must bear all risks associated with the performance of the project deliverables which are not expressly undertaken by the institution. The catchall clause which they recommend is not included in this agreement, although the obligations which the project company assumes imply that risk has been transferred. The IALCH agreement makes the project company’s

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obligations clear in terms of output specifications, which the standardised provisions say it ought to do, and states that these should be carried out in compliance with all laws and in accordance with best industry practice. Once again, this is as the standard provisions recommend.

- 10.3.6 In terms of clause 5.8, the project company is obliged to provide the KZNDoH with a standby guarantee in the form of an on-demand bank guarantee to the value of R60 million, which is intended to secure the project company's performance under the agreement and is required to remain in force until 90 days after termination of the agreement, 30 days after the compensation date, or 90 days after the project term. It therefore mitigates the KZNDoH's risk on this aspect.
- 10.3.7 The KZNDoH derives further security from the general notarial bond and collateral special notarial bonds to be passed by the project company over all movables installed which exceed R500 000 in value, and any components of the IM&T systems which exceed R10 000 in value. Clause 5.9.3 states that any entity providing loan funding to the project company must acknowledge in writing that its claims against the project company will be subordinate to the claims of the KZNDoH. This is included so as to secure the KZNDoH's contribution, but more importantly to ensure that the KZNDoH will have access to the assets on termination, so that it can continue to run a hospital.
- 10.3.8 The standardised provisions make it clear that the institution should give as limited warranties as possible. Those undertaken by the KZNDoH in clause 6 are essentially those recommended by the manual. The warranties undertaken by the project company also follow the standardised provisions quite closely, although they don't mention warranties to the effect that no litigation is pending or that no insolvency proceedings have been instituted, which the standard provisions advise.
- 10.3.9 The manual states that while the private party will probably push for reciprocal indemnities from the institution, these are not appropriate because of the different roles which the parties play in PPPs. In practice, however, it is not always possible for the institution to avoid giving any indemnities, and in Clause 7.1.1 of this agreement, the parties grant reciprocal indemnities to one another against third party claims arising out of the other party's acts, omission, negligence or breach. The only exception is where the loss is due to the negligence, or wrongful intentional act or omission, of the party seeking to be indemnified.
- 10.3.10 The only other indemnity conceded by the KZNDoH is damage arising out of the use of any project asset by a department employee who is not defined as a 'user' in terms of the agreement, or is not a person training to be such a user. This, however, is qualified by the fact that the onus of proof that such person is not a 'user' rests on the project company. ('User' is defined as a department employee who has been trained to use particular project assets in accordance with Schedule 32 and as set out in the training register from time to time.)

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- 10.3.11 Neither of the parties' claims under these clauses are capped, which is recommended by the manual, because otherwise the claiming party is left residually exposed to the extent of the uncapped liability. The manual does caution, however, that in certain instances capping may be a more affordable option because of the expense for the parties to insure uncapped indemnities. It recommends that bidders should be asked to price for each indemnity on a capped and an uncapped basis.
- 10.3.12 Clause 7.5 excludes consequential or indirect losses or damages, or loss of profits, arising under the agreement, which is consistent with the recommendations of the manual.
- 10.3.13 The project company acknowledges in clause 8 that it has conducted its own analysis of the data disclosed to it by the KZNDoh, and that it cannot make any claims arising out of alleged misunderstandings, inaccuracies or insufficiencies in this information. Once again, the manual advises this course of action.
- 10.3.14 The May 2002 amendments to the Treasury Regulations introduced the requirement of a management plan, which should explain the capacity of the institution to effectively enforce the agreement. In the absence of such a requirement in the 2001 regulations, the details which would have been set out in a management plan are contained in the body of the concession agreement. Clause 9 details the establishment and make-up of a liaison committee, which performs roughly those tasks described by the manual as being included in the management plan, although the contract does not go as far as the practice manual advises. For example it doesn't clarify the key roles and responsibilities of the institution during each stage of the project.
- 10.3.15 Clause 12 of the agreement states that the project company must prepare a schedule of remedial and completion works to be performed on the hospital building (attached as Schedule 22 to the agreement), and that it will monitor the implementation of these works, which will be carried out at no cost to either party by the original contractor. It also specifically excludes the project company from any liability in terms of the agreement to the extent that the contractor fails to execute the remedial works in accordance with Schedule 22.
- 10.3.16 The project company acknowledges in Clause 12.2 that following an audit of the hospital premises, and its certification of the remedial works, and subject to the latent defects exception and excluding the residence building, "the condition of the Hospital premises and the hospital shall be the sole responsibility of project company". The undertakings which follow in this clause are consistent with those specified in the standardised provisions, dealing with project site conditions.
- 10.3.17 The project company contracts out of all liability for latent defects in clause 12.4. The manual states that in projects involving the take-over or refurbishment of an existing building to be utilised by the private party in the provision of services, and where there is no construction guarantee from the building contractor or an insufficient building guarantee, that the institution may be expected to assume the risk of

latent defects in the existing building. It goes on to state that this must be determined on a project-by-project basis, taking into account considerations of value for money. It recommends, however, that the institution should mitigate its risk by giving bidders a reasonable opportunity to inspect the building and to determine the scope of the remediation works, which is what was done in this instance. The manual goes on to state that the institution should appoint an independent expert to monitor the bidder's investigations to ensure that they are sufficiently thorough, and to monitor the implementation of the remediation works. It does not appear that this was done in this project.

- 10.3.18 The project company is not responsible for any claims arising out of land zoning or subsidence issues. As it played no part in the initial construction of the building (which commenced four years previously) this seems a logical approach to take.
- 10.3.19 Clause 14 dealing with project assets complies in all respects with the recommendations of the standardised provisions. The manual cautions against the institution being too prescriptive regarding equipment and materials, as this inhibits the transfer of risk. It advises, therefore, that this should rather be related back to output specifications in the agreement. Likewise, the institution should not be prescriptive about a replacement programme, particularly as the lenders often require this from the private party in any event. What is important for the institution to bear in mind is that it will have no recourse against the private party for non-compliance with the replacement programme. Its remedy will be to levy penalties if the output specifications have not been met.
- 10.3.20 The commissioning programme for the hospital is set out in schedule 31 to the agreement, defining commissioning end dates for each functional unit. Clause 15.3 deals with delays, stating that the KZNDoh may allow an extension of time in certain circumstances. If delays occur which do not fall within the ambit of this clause the project company incurs penalties for late completion, and the agreement specifically excludes any other claims by the KZNDoh against the project company arising out of such delay. The penalties are therefore the means by which risk is transferred to the project company.
- 10.3.21 Clause 15.9.3 states that with effect from the date of commissioning of any functional unit, the project company will be liable for penalties if any areas included in that unit are or become unavailable.
- 10.3.22 According to Clause 16, the project company will provide services to ensure that throughout the project term the equipment and IM&T systems are managed in accordance with its operational method statement, the IM&T output specifications, and best industry practice.
- 10.3.23 Clause 17 goes on to deal with FM services, saying that the project company will provide these according to the FM output specifications and the operational method statement. The output specifications for

each of the FM services to be provided are contained in schedule 30 to the agreement. This is divided into a number of separate documents, each of deals with the output specifications for the particular service to which it relates. Each specification states that it should be read with Schedule 15 (penalties) and that as at the date of signature of the agreement, the criteria for measuring compliance and the method of measurement had not yet been agreed. It acknowledges that the measurement of quality standards is often a subjective measurement, and that the parties will have to develop appropriate objective measurement criteria and methods of measurement.

- 10.3.24 The manual notes that availability of services is one of the most critical elements to be considered. Schedule 15 defines the term 'unavailability'.
- 10.3.25 Clause 18.1 provides that the project company will at its own cost and risk, provide, deliver, commission, manage, maintain and repair project assets and department assets, in such a way that it can meet its output specifications and the KZNDoH can provide clinical services and fulfil its hospital output specifications. The clause is not too prescriptive, which is in accordance with the recommendations of the standardised provisions, so as not to compromise the transfer of risk.
- 10.3.26 In terms of clause 18.2, a joint asset replacement committee, comprising equal numbers of representatives from the KZNDoH and the project company, must be established. The committee is tasked with drawing up a revised asset replacement programme each year, taking into account changes which may be required to enable the project company to meet its output specifications. Failure to replace any equipment in terms of the replacement programme for a critical area means it will be deemed to be unavailable, and the project company will attract penalties. While joint representation on the committee implies sharing of risk, the clause does go on to state that the project company is in no way relieved of any liability or obligation to perform in terms of the contract, ensuring that risk is still transferred.
- 10.3.27 Clause 18.4 obliges the project company to establish an asset replacement account, the funds from which can only be used for replacing or upgrading project assets, for completing the final works, for making payments under the loan agreement and for making payments under the currency swap agreement. (This is surprising as one would expect the use of funds to be limited to replacing or upgrading of project assets.) From the 19<sup>th</sup> contract month, and quarterly thereafter, the amounts paid into this account will be credited as the subscription price payable by Newco for deferred shares.
- 10.3.28 The KZNDoH has protected its interest in the equipment which reverts to it at the end of the project term, by providing for a 'Final Survey' to be conducted by an independent third party no later than 18 months before the end of the project term. The object of the survey is to determine the condition of the equipment, and to provide for final

works to be carried out to put it into the correct state of repair, should this be necessary.

- 10.3.29 Clause 19 deals with monitoring of performance and provides that the project company will monitor its own performance in accordance with the criteria set out in schedule 15 (dealing with the penalty regime). This is consistent with the standardised provisions which recommend that in order to optimise risk transfer, the agreement should specify the performance level through output specifications and not through required inputs. It points out that negotiated performance levels form a key element in the risk transfer mechanism, and while the institution must obviously focus primarily on its requirements, it should also take into account considerations of affordability and value for money.
- 10.3.30 The manual goes on to state that a monitoring methodology should be set out in the agreement. This is dealt with in clause 19.4 which provides for the establishment of a help desk, to which any failures relating to project operations can be reported. According to schedule 17, the help desk is to be run by the project company, which must maintain a complete record of all problems logged and how and when they are resolved. This information will be used in turn to determine penalties under schedule 15.
- 10.3.31 The standardised provisions state that a distinction should be made between the monitoring mechanism implemented by the private party, and that undertaken by the institution as and when it deems necessary. The standard provisions maintain that the private party should have the primary responsibility for monitoring and that the agreement should provide how it will conduct this self-monitoring, which will constitute the basis for the calculation of penalty deductions.
- 10.3.32 The PPP agreement does precisely this, setting out a detailed penalty regime in Schedule 15 which provides exactly how penalties will be calculated, how they will be communicated to the institution, and how they will be paid by one party to the other. Clause 19.3 allows the KZNDoH to “monitor, observe, inspect and satisfy itself as to the adequacy of the performance by Project Company of its obligations hereunder and to review Project Company’s monitoring procedures”. The penalties do not appear to be capped, resulting in greater transfer of risk.
- 10.3.33 Clause 20.2 goes on to provide that the KZNDoH may, in addition to levying penalties, totally or partially suspend the project company from providing one or more aspects of the project operations if its performance is not up to standard.
- 10.3.34 The manual recommends that the private party should have 40% black equity, which participates actively in the management of the company. 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,

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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.

- 10.3.35 Clause 21 of the PPP agreement deals with empowerment, and specifies that throughout the concession period the project company will be at least 40% HDI and HDE owned, and that such owners will participate in the strategic and managerial workings of the company. It also undertakes to ensure that HDIs and HDEs will have an aggregate minimum 40% beneficial interest in sub-contracting vehicles. Schedule 12 Part B specifies that Hospital Services Company, which is to provide facilities management services such as cleaning, catering, crèche portering, transport and security (to name but a few), will be 40% HDE and HDI owned. The project company also undertakes to carry out the necessary skills training, and to provide comprehensive reports to the KZNDoH regarding its empowerment compliance. Failure by the project company to remedy any non-compliance after receipt of a notice to this effect from the KZNDoH, will constitute a material breach of the contract and is therefore regarded in a very serious light.
- 10.3.36 The standardised provisions state that the private party should take responsibility for ensuring that there are the requisite number of trained personnel available at all times to enable it to carry out the project operations. It should also carry the risk for training them and of any damages arising out of failure to do so. Clause 22 of the PPP agreement includes all these provisions, transferring the risk employing and training non-clinical staff to the project company.
- 10.3.37 Clause 23 of the agreement deals with consumables and surgical instruments. According to the summary of the feasibility study which we have, the project company was concerned over the volumes and price risks on consumables, over which they had no control. The obligation to provide these was accordingly divided between the parties. The durable consumables and surgical instruments, both to be supplied by the project company, are subject to capped amounts and anything in excess of these amounts is an expense to be borne by the KZNDoH. Furthermore, the project company's obligations to replace durable consumables due to accidental damage or breakage by KZNDoH employees, is limited to R2 million per annum.
- 10.3.38 Clause 26 provides that the KZNDoH will pay an amount of R360 million towards capital costs of the project. This was necessary in order to bring the project within the affordability ceiling and to expedite the project. The manual 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, and should be for the provision of ring-fenced assets that will revert to the state on termination of the PPP agreement. According to a power point presentation which has been given to us, prepared by the transaction advisor, funding for this

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project comprised R60 million equity (provided by the project company), R360 million KZNDoH contribution, and a R326 million unsecured loan from a financial institution to the project company. The proportion of funding contributed by the department seems t

- 10.3.39 According to the summary of the feasibility study which has been given to us, Cowslip was introduced for security and tax considerations. Through Cowslip, the KZNDoH's contribution was structured as deferred equity. This meant that KZNDoH could have a call option over the equity for early step-in as well as end-of-contract easy takeover.
- 10.3.40 Clause 26.3.1 provides for a service payment payable by the KZNDoH to the project company, as well as payments for a number of other provisions such as utilities and consumables. The standardised provisions state that such payments should always be linked to performance and the availability of services. Clause 26.4 allows the KZNDoH to reduce the monthly payments by the aggregate of any unavailability deductions plus any performance deductions and quality deductions.
- 10.3.41 It is interesting to note that the service payment is not linked to an occupancy rate, although clause 6.2.5 of the RFQ states the service payment will have fixed and variable components, subject to deductions for failures in compliance with availability and service levels. It goes on to state that the variable elements "must recognise the service provider's assumption of throughput or other demand volume related risk". By the time the agreement was signed, this component had disappeared, suggesting that the transfer of risk from the KZNDoH to the project company may have been compromised.
- 10.3.42 One of the conditions, according to the feasibility study, of the project was that the KZNDoH would take no risk for exchange rate fluctuations. The agreement transfers this risk in its entirety to the project company, which mitigates it by taking a 15-year rand Euro hedge.
- 10.3.43 The manual states that set-off should apply to payments from the institution to the private party but not vice versa. Clause 26 of this agreement provides for set-off to apply either way, at the payee's discretion.
- 10.3.44 Clause 27 of the agreement deals with insurance. According to the standardised provisions, the institution should allow the private party to manage its own insurance arrangements as far as possible, in order to optimise risk transfer. Clause 27 provides for the project company to take out its own insurances, and states that it may self-insure up to a maximum loss in any one year of R2 million. It is apparent from Schedule 14 that this option was selected by the project company, presumably because immediately after the events of September 11 2001, insurance through other channels had become too expensive.
- 10.3.45 Clause 27 deals comprehensively with all the issues recommended by the standard provisions, namely how substantial increases in insurance

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premiums should be dealt with, what will happen if certain risks become uninsurable, the control of the defence of any litigation relating to an insured event, how the proceeds of the insurances should be applied and reinstatement.

- 10.3.46 Clause 31 deals with force majeure, providing that the parties' overall objective should be to continue with the project despite the force majeure, if at all possible. The clause provides that if it is not possible for the parties to continue with the project, termination may only take place in accordance with the terms set out in the termination clause.
- 10.3.47 Clause 32 deals with project company events of default and includes most of the standard examples of private party default, such as insolvency, material delay, breach, abandonment, cessation, assignment, failure to make payments or ceasing to provide security to the KZNDoh. According to clause 32.3, the KZNDoh may elect to terminate the contract (if certain specified clauses are breached), or to request the project company to remedy the breach, both of which are in accordance with the standardised provisions.
- 10.3.48 Clause 33 provides for KZNDoh events of default, which are limited to material breach, failure to pay any sum which either singly or in aggregate exceeds R20 million (index linked), failure by Cowslip Investments to pay for any deferred shares, or if the capacity of the hospital increases to over a maximum of 1 100 beds. This is consistent with the manual's recommendation that termination by the private party should be only take place as a last resort. The manual states that it is important to note that there should be no "hair-triggers" which would put the institution at risk.
- 10.3.49 The agreement gives the project company the option to serve notice on KZNDoh requiring it to remedy the default, failing which it may terminate the agreement. Both of these options are recommended by the manual. A third option contained in the agreement, which is not in the manual but which is appropriate to the nature of this contract, is that in the event of default prior to the actual completion date, the project company may suspend delivery of equipment and IM&T systems, and suspend performance of its obligations under the agreement until the fault has been remedied.
- 10.3.50 Clause 34 provides for termination of the agreement as a result of corrupt acts, and follows the wording of the standardised provisions almost exactly. In order to terminate under this section the institution must specify the nature of the prohibited act, the identity of the party it believes to have committed the act, and the date on which the agreement will terminate.
- 10.3.51 Clause 35 sets out instances of non-default termination, including force majeure, termination for convenience, and expiry of the project term.
- 10.3.52 Clause 36 deals with the effect of termination, where the obligations imposed on the project company to hand back equipment, consumables, documents, keys and the like are all consistent with the standardised provisions. In addition, the agreement gives Newco the

option to instruct the project company to repurchase all of the deferred shares, alternatively to ensure that all the shareholders sell all their shares in the project company to Newco. Thus the KZNDoH effectively gains control of the project company, hopefully enabling it to continue to provide clinical services.

- 10.3.53 An important test for transfer of risk applies to the amount of money paid out by the institution to the concessionaire in the event of early termination. According to the manual, “the amount of compensation payable on Private Party Default termination is one of the key commercial issues for all parties concerned”. If the private party 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 private party bears a loss in this process, there is true transfer of risk.
- 10.3.54 The transaction advisor Phase 1 Report quantifies the risks transferred to the project company. It values residual value and condition risk at R13 138 million (at 2000 values), and ‘other project risks’ at R38 588 million. It does not deal specifically with the risks of early termination.
- 10.3.55 According to the transaction advisor power point presentation given to us, compensation on project company default was one of the key issues that arose in negotiation. It says that the matter was resolved by accepting the standardised UK market value clause.
- 10.3.56 The manual argues that a market value approach in determining the compensation due provides a balance between protecting the institution and not unfairly penalising the private party for its default, while also encouraging lenders to step in and rescue the project. It points out that the major criticism of this approach is that the South African market is not mature enough to determine with sufficient accuracy the existence of a liquid market (which is necessary to determine market value). This leads to concerns by the lenders that they may not recover all of the debt.
- 10.3.57 The IALCH PPP provides for the department either to obtain an expert determination of the estimated fair value of the contract, or to elect to retender the carrying out of the project operations.
- 10.3.58 Clause 33, dealing with compensation in the event of KZNDoH default, follows the standardised provisions, providing for repayment of the debt, subcontractor costs, equity compensation and redundancy payments, less any insurance repayments and the book value of all assets in the project company.
- 10.3.59 Compensation for termination for convenience is calculated differently, while that for corrupt acts is the same as for project company default. The agreement also provides for KZNDoH, Newco, or any other party nominated by the KZNDoH, to take over all the project company’s rights and obligations under the currency swap agreement.

## 11. Project Close-out Report

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- 11.1 According to the practice manual, the terms of reference for PPP transaction advisors require that following financial closure they should produce a close-out report for the institution, and a case study for the public. To the best of our knowledge, neither of these were prepared in this instance, although the transaction advisor did compile a very detailed Phase 1 report.
- 11.2 The manual states that the purpose of the close-out report is to provide a comprehensively summarised institutional record, with all project documentation properly annexed, giving the details of the transaction, and including all confidential, negotiated, contracted and financing matters. In view of the difficulties we have had in accessing the correct documents to perform this analysis, we cannot emphasise how important such an exercise is at the end of the project, not only for managing the PPP agreement in the future, but also for preserving the knowledge of parties who may no longer be employed by any of the organisations involved in the project. This is even more important when dealing with long concession periods, as is the case in this instance.
- 11.3 We have been provided with a five-page document, headed “Province of KZNDoH, The Inkosi Albert Luthuli Central Hospital PPP”, which we have been instructed to regard as a close-out report. It is not clear who prepared this document, nor does it follow the guidelines set out in the manual. While it summarises the process followed in very broad terms, it does not include recommendations or set out lessons learnt during the course of the project.