PPP UNIT OF THE NATIONAL TREASURY

The Public Private Partnership between
Free State Department of Health

and a consortium comprising
Community Health Management (CHM)
and
Network Healthcare Holdings (Netcare)

at
Universitas Tertiary and Pelonomi Regional Hospitals

Document Comparison
by
Wits Business School

NATIONAL TREASURY
PPP unit

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1. Background

1.1 In 2000 the Free State Health Department (FS DoH) identified Pelonomi and Universitas Hospitals in Bloemfontein as suitable for combining private facilities with those already offered to the public sector.

1.2 This grew from a realisation that the public sector alone could not meet the development challenges facing South Africa, as well as the fact that the private sector had surpassed the public sector in many areas and was able to deliver better and more effective services.

1.3 The objectives of the project, in the case of Pelonomi, were to:

1.3.1 utilise underutilised space and equipment which currently exceeded the needs of the hospital;

1.3.2 provide private hospital facilities in the Bloemfontein areas previously not provided with such facilities; and

1.3.3 improve the appearance of the hospital precinct as well as the public sector facilities.

1.4 The objectives, in the case of Universitas, were to:

1.4.1 utilise excess ward space;

1.4.2 optimise the usage of theatres and other equipment;

1.4.3 provide tertiary and academic healthcare services to private sector patients;

1.4.4 retain professional staff within the public health sector; and

1.4.5 utilise the benefits of the partnership to enhance the capability and reputation of Universitas as a leading academic hospital.

1.5 In exchange for the offer to the bidders of space within and access to facilities at the hospitals, the bidder was expected to complete certain upgrade work for the FS DoH at Pelonomi, and make a payment for the right to use the facilities.

2. Feasibility Study

2.1 There is no feasibility study among the documents which have been supplied to us.

2.2 It is important to note at the outset that the Treasury Regulations introduced during the course of this project were different from those in force in 2004, at the time that the PPP 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.

2.3 No reference is made specifically to Treasury Approvals l, llA and llB, or lll, 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 National Treasury agreement to future budgetary commitments which must be denominated in rands.

2.4 Regulation 16.3.1 required treasury approval in writing prior to initiation of the procurement process. However, such approval was not obtained for this project because the procurement process preceded the issue of the Treasury Regulations in terms of Public Finance Management Act (PFMA) 1999, which took place on 9 April 2000.

3. Request for Qualification (RFQ)

3.1 The RFQ stage of the project also preceded the Treasury Regulations. Consequently it would appear that no RFQ process as prescribed by the regulations was followed, but that a 'registration of capability' process was undertaken whereby interested parties were invited to submit proposals to the FS DoH. The three organisations which pre-qualified in terms of this process were Afrox Healthcare, Mediclinic, and Community Health Management (CHM) comprising Netcare and the Malesela Group.

3.2 In November 2000, after promulgation of the Treasury Regulations, a transaction advisor (TA) was appointed to the project to assist the FS DoH through the process. The TA team comprised the same financial and legal advisors that the Eastern Cape Department of Health used on the Humansdorp project.

4. Request for Proposal (RFP)

4.1 We have been provided with the RFP which runs to 60 pages. This was prepared by the TA and was subject to review by the PPP unit at National Treasury. It was issued on 12 March 2001, with the closing date for submissions being 14 May, which was later extended to 15 June. The RFP appears to comply in nearly all respects with the National Treasury practice manual (although the latter was not published until 2004). More specifically, the RFP provides:

4.1.1 Background information to the bidders in clauses 1 and 2, which enables them to understand the rationale of the project. It gives details of the condition of the facilities, but provides no warranties about these, which is as the manual recommends.

4.1.2 The minimum requirements in respect of both hospitals is detailed in clause 9, setting out financial, legal, technical and BEE requirements.

4.1.3 The standard and services specifications are set out in clause 4.1.3, which deals with output specifications and risk transfer. A compromise is reached whereby the FS DoH retains the risk that the design of the buildings is appropriate for the use for which the facility is constructed, whilst the private partner assumes the risk that the design is practical for construction purposes.

4.1.4 The payment mechanism is described in clause 4. The concessionaire is to pay a concession fee to the FS DoH, made up of a fixed fee (escalating at CPIx), a variable usage fee and a services fee. The details of how each one of these is to be arrived at are included. The bidders are also told that the payment fee will be one of the key criteria for evaluating the proposal, and a draft spreadsheet is attached giving the format which is required (although it is not attached to the document supplied to us). There is no talk about the penalty regime to be applied, which the practice manual says should be included, nor are the FS DoH's affordability limits set out, which the manual recommends should be done.

4.1.5 The legal and regulatory requirements are carefully outlined in clause 6 and a draft concession agreement is attached.

4.1.6 Clause 8 deals with bid formalities and makes it clear where the bidders are expected to be innovative and where variant bids would be considered.

4.1.7 The evaluation criteria are clearly set out in clause 10, but not described in the kind of detail which would enable a bidder to tailor the bid to the evaluation process, which is as the manual recommends.

4.1.8 The RFP doesn't deal with maintenance/replacement obligations which the manual suggests it ought to do, particularly in view of the fact that upgrades will revert to the FS DoH on termination of the concession period.

4.2 We have not been provided with official responses to the RFP.

5. BAFO documents

No BAFO documents were produced in this project.

6. Value-for-Money Report

6.1 This accompanied the application by the FS DoH for Treasury Authorisation 3, although we do not have the actual letter of application on file.

6.2 According to the practice manual, a PPP project may provide value for money, but be unaffordable if the specifications are too high. Thus, although value for money is a necessary condition for PPP procurement, it is not a sufficient one.

6.3 The way to conduct a value assessment, which according to the manual should take place at feasibility study stage, is to construct a base public sector comparator (PSC) model and then a risk-adjusted PSC model. These two models should then be compared with the PPP reference model, as well as the risk-adjusted PPP reference model, to determine whether the project is affordable and whether the PPP option provides value for money. This in turn assists in making the correct procurement choice.

6.4 According to the manual, a risk matrix should be constructed at feasibility study stage, to identify and track risk allocation throughout the procurement process up to financial close.

6.5 In the absence of a feasibility study we are unable to comment on these aspects. However, the value-for-money report does cover a number of these aspects although more superficially and much further down the procurement process line.

The value for money report complies with the practice manual's recommendations in that it:

6.5.1 provides background to the project and the procurement process;

6.5.2 deals with issues of value for money (although it doesn't provide the comparison with PSC as the manual recommends);

6.5.3 provides a risk analysis summary, although it doesn't show risk values, which is advised by the manual. 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 contains four columns, headed "categories, description, mitigation and allocation", which is not unlike the kind of detail which has been included in this report;

6.5.4 deals with affordability under the heading "additional costs for FS DoH;

6.5.5 provides a conclusion and a justification for this conclusion.

6.6 The report does not deal with contingent liabilities and sources and conditions of funding, as suggested by the manual.

6.7 It also doesn't include reference to a legal due diligence or to a management plan, which are recommended by the manual. The reason for this is that the requirement for a management plan was only included in the May 2002 amendments to the Treasury Regulations, while that of the legal due diligence was included in an even more recent amendment. These were not therefore required by the regulations in force at the time.

7. Treasury Authorisation 3

7.1 It is important to note that this Treasury Authorisation is requested in terms of the 2001 regulations.

7.2 The authorisation which we have on file is dated 21 May 2002, which responds to a request for:

7.2.1 approval of the affordability, value for money and risk transfer contained in the value-for-money report attached to the application;

7.2.2 agreement to future budgetary commitments by the Department (as was required by regulation 16.7.1(a) of the 2001 regulations); and

7.2.3 approval by the National Treasury of the final PPP agreement.

7.3 The authorisation granted by the National Treasury notes that acceptance of the procurement documentation was not obtained because this preceded the April 2001 regulations, in terms of which formal approval became a prerequisite for proceeding with the contract. However, Andrew Donaldson, deputy director-general: budget office at National Treasury, notes in his letter that "the close co-operation of your department with the PPP unit in the preparation of the documentation is noted with appreciation," and he grants the necessary approval.

7.4 He also notes in the approval letter that the full risk of implementing the PPP agreement rests with the FS DoH. He goes on to point out that the FS DoH is incurring contingent liabilities in that compensation for termination on provincial government default is payable by FS DoH. He advises that, in the circumstances, the only way of mitigating the risk is by implementing a thorough contract monitoring and management system so as to allow for annual reporting on the project in departmental reports. It is interesting to note that a reporting requirement is one of the amendments incorporated into the regulations by the addition of subsection 16.8.1(e), in May 2002.

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8. Contract Management Plan

Treasury Regulation 16.7.1(b) provides that the institution must provide a 'contract management plan', explaining the capacity of the institution to enforce the agreement effectively, as well as to monitor and regulate its implementation and performance by the parties under the agreement. This requirement was only introduced in the May 2002 amendment to the regulations, which is presumably why no such document was prepared in this case.

9. The Concession Agreement

9.1 A copy of the signed concession agreement, dated 25 November 2002, together with the schedules, has been supplied to us. Our observations on the document are as follows:

9.1.1 Clause 3 cites the purposes and objectives of the agreement as being to combine the strengths of government and the private sector for the more efficient utilisation of government resources, to add on existing resources through private sector investment and to improve maintenance of existing resources through the creation of income-generating activities for the benefit of the concessionaire and the FS DoH.

9.1.2 Clause 7 states that the concession period is 16 years and 6 months. According to the practice manual, an extended concession period such as this provides better opportunities for the FS DoH to yield value for money. A caution, however, is that long concession periods also create more risk, as the status of the concessionaire may change over such a long period, and it may no longer be suitably qualified to perform the services in terms of the agreement.

9.1.3 The FS DoH makes the concession area available to the concessionaire *voetstoots,* in terms of clause 10.8. This means that the concessionaire accepts the concession area 'as it stands', and assumes the risk of any latent defects which may exist in that area. As recommended by the manual, the FS DoH gives no warranties as to the condition of the concession area. 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.

9.1.4 The FS DoH also accepts no responsibility for errors, omissions or inaccuracies in documents, materials or any other information supplied by it to the concessionaire, in accordance with the manual's recommendations.

9.1.5 Clause 10.11 passes the risk and benefit in the new government facilities from the concessionaire to the FS DoH on practical completion, with the latter being responsible for maintenance of these facilities during the concession period.

9.1.6 Clause 11.4 makes the existing project facilities available to the concessionaire *voetstoots* meaning that the concessionaire takes on the risk of any latent defects in these facilities. Once again, the FS DoH gives no warranties as to the condition of these facilities, which is consistent with the manual's recommendations.

9.1.7 The maintenance of the joint use area and project facilities falls to the FS DoH, while that of the exclusive use areas falls to the concessionaire, but each is entitled to carry out these tasks at the other's cost if they are not satisfied that the other party is doing so properly.

9.1.8 Clause 12.2 provides that at the end of the concession period the concessionaire must return the concession area and project facilities to the FS DoH, in the same condition they were in at the completion date, fair wear and tear accepted. The FS DoH therefore assumes the risk that these will be properly maintained, although this is mitigated to some degree by the performance bonds referred to in clause 17, as well as the fact that it is responsible for maintenance of the joint use areas in any event.

9.1.9 Clause 13.1 confers on the concessionaire the obligation to manage, operate and maintain the project facilities and concession area at its own risk, cost and expenditure, in compliance with all relevant laws and otherwise in accordance with Best Industry Practice.

9.1.10 In terms of clause 13.5 the concessionaire is obliged to ensure that the staff are available to carry out the operations, and that they are suitably trained and supervised. This is consistent with the recommendations of the practice manual.

9.1.11 Clause 13.7 deals with radiology, which forms an important aspect of this agreement, as it is a large revenue provider for both parties. The concessionaire is obliged to make use of FS DoH radiology services for private patients, in return for which it guarantees to the FS DoH a minimum revenue, called 'guaranteed radiology fees' (which amounts to approximately R225 million over the concession period). There are further cross-payments to be made in terms of this clause, all of which are important in determining value-for-money.

9.1.12 Clause 14.4 stipulates that the FS DoH shall provide the concessionaire with all pharmaceuticals at the same costs as it receives them. But if this arrangement is terminated or not possible for any reason, the variable concession fee payable to the FS DoH reduces from 2% to 1% of turnover and the fixed concession fee will cease to remain payable.

In addition, the concession period then extends for two months for each remaining full period of six months left of the concession period. Once again this is important from the point of view of value for money.

9.1.13 Clause 14.5 provides that the FS DoH will reconstruct the trauma unit to a level 3 tertiary trauma standard, and that if there is not timeous completion the same penalties will be payable to the concessionaire as will be paid in reverse if the concessionaire fails to complete its construction works timeously. Penalties have a bearing on the transfer of risk, while the construction costs to be incurred by the FS DoH have been taken into account in the affordability considerations.

9.1.14 Clause 14.6 provides that in the case of Pelonomi, the FS DoH makes a one-off contribution to the concessionaire in the sum of R1 693 500 on practical completion of the construction works, and R1 578 000 on final completion of the construction works. In the case of Universitas, FS DoH is to contribute R2 535 500 to the costs on final completion. The FS DoH therefore undertakes to contribute the sum of R8 342 500 to the project in total, which amount, according to the value-for-money report, is paid in order to facilitate the project. To this extent there is no transfer of risk, or a lesser transfer of risk, as if the project fails the FS DoH has lost this 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).

9.1.15 Clauses 14.9 and 15.8 refer to the service level agreement (SLA), and both the FS DoH and the concessionaire undertake to abide by its terms. The SLA is schedule 26 to the agreement and covers mostly the FS DoH's obligations to the concessionaire. The idea is that the parties set up a joint help desk, with reporting of standard, critical and mission critical services, each of which in turn attract different penalties. There are also specific resolve times for the various services to be supplied, varying according to how critical they are. According to the risk matrix, both parties bear the risk of a failure to deliver according to the specified service levels, although we would suggest that the FS DoH will bear the brunt of this risk as the party which carries the most obligations under the SLA.

9.1.16 Clause 16 provides that the FS DoH's architect will issue a certificate of practical completion in respect of the construction works, instead of an independent certifier, which is recommended in the standard provisions. The latter would seem to be the preferable course of action to follow, as the FS DoH'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.

9.1.17 Clause 16.5 passes construction risks to Netcare Construction, which is standard procedure in construction contracts of this nature, and is therefore not unique to the concession agreement or this particular PPP situation. Nor does it necessarily mean that there is a full transfer of risk.

9.1.18 Clause 16.5.2 provides that the FS DoH bears the risk that the designs contained in the existing design documents are fit for the purpose for which they are intended.

9.1.19 Clause 16.7.1 sets out penalties for non-completion of new provincial government facilities by the concessionaire. According to Schedule 15, these run at R2 000 per day for failure to reach practical completion, and R500 per day for failure to reach final completion. The risk matrix correctly allocates this risk to the concessionaire.

9.1.20 Clause 16.7.3 provides that the FS DoH architect certifies penalties for non-completion by the concessionaire. Clause 16.8.2 provides for circumstances where the concessionaire can apply for a postponement of the completion date. Clause 16.8.3 allows the concessionaire to postpone the long stop date and to have the concession period extended where the delay is caused by a change in the design documents, any material adverse government action or any breach of the agreement by the FS DoH. This clause mitigates the concessionaire's risk.

9.1.21 In terms of Clause 16.10 the FS DoH (and in particular its architect) is entitled to monitor the construction works, which is recommended in the standard provisions.

9.1.22 Clause 17.1.1 provides that Netcare Construction will grant to the FS DoH a performance bond, in the form of an on-demand bank guarantee which must be maintained until 90 days after the expiry of the patents defect liability period for the new provincial government facilities.

9.1.23 In terms of clause 17.1.2, the concessionaire will provide a performance bond to the FS DoH on the same terms as those specified above, not later than two years prior to the expiry of the concession period. Together these bonds are intended to secure the performance of both Netcare Construction and the concessionaire under the agreement, thereby mitigating the FS DoH's risk.

9.1.24 In clause 18 the concessionaire indemnifies the FS DoH from any liability, loss or damages to persons or property, arising from the concessionaire's actions. It also indemnifies the FS DoH for loss or damages caused by the ordinary negligence of the FS DoH, but excluding gross negligence. Clause 18.4 limits liability, and excludes claims for consequential losses and loss of profits from the indemnities. It also limits the FS DoH's delictual liability to the concessionaire to instances of gross negligence. All of these are consistent with the manual's recommendations.

9.1.25 Clause 19 deals with warranties. In 19.1.3 the FS DoH warrants that it will use reasonable care in carrying out its obligations under the agreement where failure to do so would materially and adversely affect the concessionaire's ability to perform. The practice manual recommends that the government should give as few and as limited warranties as possible, and this advice has, in the main, been observed.

9.1.26 There are no warranties by the concessionaire as to its share capital (as required by the practice manual), but there are more detailed warranties than those suggested by the manual relating to the skill required by the concessionaire to carry out the operations, and to the fact that it has satisfied itself as to the suitability of the concession area and the project facilities to execute the project.

9.1.27 Clause 20 deals with insurance, and does not contain as much detail as the manual advises. According to schedule 20 of the agreement, insurance risks are shared between the FS DoH and the concessionaire, with the former insuring the joint use areas and facilities, and the latter doing so for the exclusive use areas. This raises the question of how much risk is in fact transferred to the concessionaire, because the obligation to insure usually follows risk.

9.1.28 Clause 20 fails to specify who will carry the risk for uninsurable risks, or for the increase in insurance premiums, or the situation where either party is under-insured. It also does not deal with non-vitiation protection, although 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. It also fails to deal with the control of litigation should this occur, but does provide that one party can take out insurance where the other has failed to do so, and recover these costs from the other party. 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’.

9.1.29 Clause 20 does not provide for proceeds of claims to be paid into a joint account set up for these purposes, as the manual recommends, but once again this may be because the parties are jointly sharing the insurance risks. It does, however, say that the concessionaire cedes all amounts payable under the insurance policies as security for the fulfilment of its obligations in terms of the agreement.

9.1.30 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. In these circumstances the manual recommends that the private party should be excused from liability. This contract does not deal with any of these instances, and ought to do so.

9.1.31 Clause 21 deals with contract management and describes how a liaison committee is to be set up. The liaison committee is to deal with informal dispute resolution, with contract management in general, and with establishing rules and codes of conduct. Since the 2002 amendment to the regulations, these aspects are dealt with in a separate contract management plan. Clause 24 refers to the concessionaire’s BEE credentials, and Schedule 29 to the agreement sets out its empowerment plan.

9.1.32 The manual recommends that the private party should have 40% actively participating black equity. In addition, 40% of management of the private party should be black, and, in turn, 15% of this should comprise 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.

9.1.33 Schedule 29 of the agreement states that CHH, which is a wholly-owned black company, will hold 40% of the beneficial equity in the concessionaire. A further 35% of the equity in the concessionaire has been reserved for local doctors and private investors. 55% of this portion will in turn be offered to PDI doctors and empowerment entities. The schedule also provides that nearly 70% of Netcare and CHH employees are female, and that it has significant capacity to train and transfer skills. It states, furthermore, that all cleaning, catering, security and laundry services will be outsourced to PDI contractors. It will also adopt a legally compliant employment equity plan. The agreement therefore complies in all respects with the BEE requirements set out in the manual.

9.1.34 Payment is dealt with in clause 25 of the agreement. The concessionaire will pay both a fixed and a variable concession fee, and the fixed fee escalates according to CPIx (which is the measure of inflation recommended by the manual). The concessionaire must install metres for electricity and water at its own cost, and pays for these services directly to the suppliers, whereas gases are covered in the fixed fee. All payments are to be made without set-off, which is recommended by the manual, and interest is payable on all outstanding amounts.

9.1.35 Instead of dealing with reinstatement under the insurance section, as the practice manual advises, this agreement has a clause 28 dealing with total or partial destruction. It sets out what will happen in this event, but does not do so in the form and in quite the detail envisaged in the standard provisions. It fails to provide for what will happen in the event of surplus funds from a payout under an insurance policy.

9.1.36 Clause 29 deals with termination and includes most of the standard examples of private party default, such as liquidation, ceasing to carry on business, acts of insolvency, failure to make payments and failure to render services in terms of the service level agreement. According to clause 33.1, in this event the FS DoH shall pay an amount called the concessionaire default termination compensation (for which the formula is provided) to the concessionaire. Examples of institution default are failure to make payment, a breach of a material term of the agreement, a failure to comply with the service level agreement, as well as any material adverse government action. In this case, clause

33.2 states that the FS DoH shall then pay to the concessionaire an amount equal to the provincial government default termination compensation (for which the formula is also provided).

9.1.37 This latter amount is also payable if the contract is voluntarily terminated by the FS DoH, in terms of clause 31.2.

9.1.38 An important test for transfer of risk is whether the amount of money paid out by the institution to the concessionaire in the event of early termination (as envisaged in clause 29), places the concessionaire in the same position as it would have been had it continued with the project. If this amount does place the concessionaire in the same position, then the public institution ultimately bears the risk, but if the concessionaire bears a loss in the process, there is true transfer of risk. The amount of default compensation to be repaid in each of these instances will determine risk allocation. This aspect has not been specifically addressed in the risk matrix included in the value-for-money report, as should have been the case.

9.1.39 Likewise the method by which penalties are calculated determines whether there is transfer or risk. If the penalty regime 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 penalties increase the concessionaire's risk in the event of failure to complete both the public and the private facilities timeously. In the case of the former the concessionaire pays penalties to the FS DoH, whereas in the case of the latter inability to generate revenue while still being responsible for the fixed payment to the FS DoH, constitutes the penalty. The matrix makes no other mention of risks related to penalties, although they would presumably apply in the event of defaults under the SLA.

9.1.40 This agreement does not provide for termination in the event of corrupt acts, which is recommended in the standard provisions. It 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.

10. Project Close-out Report

We have not been provided with a close-out report for this project.

11. Conclusion

11.1 Regulation 16.12 of the regulations in force at the time, states that, "An agreement between an institution and a private party for the latter to perform an institutional function without accepting the significant risks is not a PPP and must be dealt with as a procurement transaction".

11.2 In conclusion, the tentative question to ask is whether this arrangement is, in fact, best suited to a PPP, or whether an outsourcing agreement would have fulfilled the same output objectives at less cost to the parties involved.

11.3 It is apparent from the case study prepared, that this co-location project was initiated at a time when the FS DoH had to find innovative ways of refurbishing its aging infrastructure, of utilising its excess capacity as well as of solving the private sector's need for additional capacity. All these factors no doubt contributed to the decision to choose the PPP procurement option.

11.1 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.