

# **ANALYSIS OF THE UTILISATION OF PUBLIC PRIVATE PARTNERSHIPS IN PUBLIC FINANCIAL MANAGEMENT**

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## **ABSTRACT**

**T**his article explains the role and purpose of Public Private Partnerships (PPP) in relation with public financial management. With the establishment of a PPP it is assumed that the private sector will carry all the risks. In the utilisation of the PPP system government should evaluate, monitor and manage such risks in association with the PPP. In this regard it will depend on the administrative and managerial skills of the public official. Furthermore, in terms of the budgeting systems care should be taken that the project life must be in line with the departmental budget and other financial systems. This approach will ensure that benchmarking and comparisons are possible to determine value-for-money.

## **INTRODUCTION**

**T**he worldwide utilisation of Public Private Partnerships (PPPs) is to deliver certain public services and to turn around for example failing prisons, local educational authorities, housing benefits and health issues. The utilisation of PPPs in the South African context is also applicable where the focus of service delivery outcomes, risk and the three E's (efficiency, effectiveness and economy) are being shared between the public, private and non-governmental sectors. Unfortunately, one finds that the financial controls in government departments encourage managers to think of PPP spending as an addition to their capital programmes. The result of such an approach could lead to a lack of efficiency and effectiveness in budget planning and management.

The purpose is the analysis of the utilisation of PPPs in public financial management and the subsequent impact that PPPs have on the public financial management frameworks and strategies towards service delivery outcomes in all three spheres of government is. The introduction of the *Public Finance Management Act, 1999* (No. 1 of

1999) (PFMA) and the Treasury Regulations issued in terms of the PFMA as a regulatory framework provided a base for PPP's to develop and since PPPs have multiplied and are seen as a method of procuring public services and infrastructure within the national and provincial departments by combining different strengths of the public and private organisations along with the non-profit or third sector. It should also be noted that next to the national and provincial framework lies the Municipal Service Partnerships Policy set out in the *Municipal Finance Management Act, 2003* (No. 56 of 2003), which supports service partnerships in the local government sphere. Through the utilisation of PPPs, the emphasis is placed on affordability, value for money and the appropriate allocation of risk towards delivery of quality public services. However, a fundamental dilemma of PPPs is how to achieve the desired outcomes and true potential while assuring accountability of each project.

## ROLE AND PURPOSE PUBLIC PRIVATE PARTNERSHIPS

The rise in advocacy and the increased influence that non-governmental organisations (NGOs) play in government's policy agendas has resulted in the growth of non-governmental organisations and therefore they will have an impact on government's decision-making processes (Reich, 2002:2). Due to changing perceptions and a broader view towards social responsibility, public private partnerships are placed at the top of many international and national agendas (Ketchum, 2001:7). In this regard partnerships are becoming an integral part of the regulatory framework addressed in policy agendas, nationally and internationally.

Various sources defined PPPs and they are all more or less similar in context. Lund (2004:6) defines PPP in law as:

*"a contract between government institution and private party, where a private party performs an institutional function and/or uses state property in terms of output specifications, where a substantial project risk (financial, technical, operational) is transferred to the private party and where a private party benefits through unitary payments from government budget and/or user fees".*

The above definition specifies the boundaries in which the finance agreements between parties are negotiated and it also provides the framework in which relationships are negotiated. From the definition it is evident that the private entity assumes all risk, while government becomes the monitor and regulator of service delivery but is no longer the administrator of the service (Parliamentary Monitoring Group, 2003). It should also be noted that there are arguments against the reasoning that all risks should be transferred to the private sector and Rodrigues (2002:2) states that the:

*... idea is to establish an appropriate balance, that is not to transfer all risk on to the private sector, but rather an appropriate risk to ensure that all stakeholders benefit, including government, users of services, society and private parties...*

In the South African context the regulatory framework for PPPs is based in the *Constitution of the Republic of South Africa*, 1996 which states:

When an organ of the state in the national, provincial and local sphere of government, or any other institution identified in national legislation, contracts for goods or services, it must do so in accordance with a system which is fair, equitable, transparent competitive and cost-effective.

Until recently, the public, private and NGO sectors working within the health and correctional services arena have viewed each other with antagonism and suspicion. These tensions have been supplanted by positive encouragement for public private partnerships within each sector. It also became evident that multi-member partnerships reflect recognition that some problems require many partners and complex organisational mechanisms to address all the different aspects, thus placing higher demands on the skill levels of management. For example since both health and correctional services are faced by a growing number of PPPs, it became critical to develop sustainable approaches that are effectively incorporated into public bureaucracies and are effectively supported by public funds. Public managers can avoid the pitfalls that could develop from each relationship by utilising managerial skills and effective control and monitoring techniques.

The collaborative efforts between the public, private and non-profit sectors are thus an attempt to change both management and financial control by transferring the financing and management of particular aspects of service delivery to the private sector along with some of the risks. Whether this is effective and will produce better outcomes in service delivery becomes the core question addressed throughout this analysis.

The PFMA regulates the financial management within the national and provincial spheres of government and provides for the responsible persons entrusted with financial management. The PFMA provides the legislative framework in which PPPs are developed. The National Treasury Regulations (Section 16 of 2002) issued in terms of the PFMA, 1999 requires that all PPP projects must first obtain approval from National Treasury.

In order to manage this demand, the PPP Unit came into effect during 2000 with the purpose to regulate national and provincial PPP projects (Lund, 2004:5; Sukazi, 2004:5). The PFMA and the amended National Treasury Regulations (Regulation 16 of 2002) issued in terms of the PFMA gradually evolved as the needs of stakeholders changed and PPP arrangements developed and changed to fit service requirement.

Initially with the introduction of various PPP arrangements, significant gaps and constraints were identified in the legislative framework as PPP projects were implemented and developed (National Treasury, 2001: B8). This became evident in projects such as for example the N3 toll road and projects implemented by correctional services such as the APOPS Prison Contract (National Treasury, 2001: B7 and E21). These gaps in the legislative framework occurred mainly as the majority of the relevant legislation were drafted before PPPs were acknowledged as viable options for service delivery and infrastructure provision (National Treasury, 2001: B8).

The underlying philosophical base of PPPs is focused on the belief that partnership can improve service quality (Dutz, 2003:4). Gaster and Squires (2003:157) argue that local government does this by emphasising the link between people-centred government

and quality services. This argument was emphasised in the address which the Minister of Finance made to the National Assembly when tabling the Medium Term Budget Policy Statement (MTBPS) for 2003 (National Treasury, 2003(a)). National Treasury (2003(a)) views local government as the stepping-stone in delivering infrastructure by utilisation of the consolidated Municipal Infrastructure Grant system. Through these mechanisms, government aims to target the removal of backlogs underscored through sound fiscal policies (National Treasury, 2001:B5 and B7).

The 2003 Growth and Development Summit Agreement further strengthened the call for partnerships between government (public sector), business (private sector) and civil society (NGOs) as part of the strategies tabled in the MTBPS (National Treasury, 2003(a)). By including partnerships as one of the key strategies in the MTBPS and budgeting process it encouraged the formation of PPPs through various types of collaborative networks or partnerships (Reich, 2002:5; National Treasury, 2003(a)).

It has been concluded by authors such as Reich (2002:3) and Dutz (2003:3) that not a single formula exists to construct effective partnerships. This is mainly, as PPPs continue to diversify and are confronted by unique challenges in managing effective organisational integration along the entire route from the producer to the consumer (Reich, 2002). Therefore, each PPP brings with it, its own unique characteristics, different organisational cultures and unique financial resources (Dutz, 2003:3). These differences thus create challenges in the partnerships efforts to collaborate effectively in the achievement their objectives. Coupled to this, there are substantial risks and effort associated with the construction of each partnership. With the construction of these partnership agreements and relationships there will be crossing of the different organisational boundaries. This could emphasise the lack of accountability mechanisms that are supported through control systems. It furthermore places the focus on management's ability to operate outside the classic hierarchical, single organisational setting and highlights their proficiency in managing these collaborations (Guffy, 2003:42).

There is a relationships between the group origin (mandated and voluntary) and the task structure (external and internal). The relationships of the forces and their impact on outcomes are critical points in understanding the PPP project life cycle as described in the Public Private Partnership manual for the national and provincial departments (National Treasury, 2001: G4). Furthermore it also determines how agreements are formulated, the sources of funding agreed on and if the solutions and agreements are workable and thus have a better possibility of success. Managing each type of partnership towards efficient, effective and accountability indeed require well-formulated agreements or contracts as well as defining from the start how the sources of funding are to be shared amongst each party in conducting of feasibility studies.

## **ALIGNMENT OF PPPS AND PROJECT LIFE CYCLE**

In the South African environment the value of PPPs as an instrument in addressing massive infrastructure and service delivery backlogs is in an upward trend and more than R120-billion is invested in PPP projects (Sukazi, 2004:5). From the aforementioned

amount, the health sector has currently R 8 billion invested in PPP projects alone. The construct of partnerships has been for some time been the expected organisational method for securing funding and statutory service plans. The partnership also forms an integral part of government's service improvement strategy and with the spirit of the key decisions taken during June 2003 at the Growth and Development Summit Agreement (Gaster and Squires, 2003:155).

Although government purchases the service or enables the project they still remain the owner of the service because this responsibility cannot be delegated to the private entity. With the introduction of the Standardisation Document (National Treasury – PPP Unit, 2004:2), procedures and guidelines are set out to assist public managers in focusing on the appropriate risk profiles of PPPs and to describe the key issues that are likely to arise in PPP projects regulated by the provisions of Regulation 16 of the National Treasury Regulations of 2002. Unfortunately, this document does not identify whether a PPP is suitable from a strategic and operational need and if in constructing a PPP project, this is the most suitable mechanism for service delivery. The responsibility of this aspect needs to be determined by the accounting officer while the feasibility study is conducted. This is done by demonstrating the affordability of the project and the advantages gained financially from establishing such a service agreement or contract through this partnership over the specified period.

An alignment between the various stages of the project life cycle with the budget cycle and how the project develops from initiation to closure is of critical importance. It is important to keep in mind that each of the stakeholders in the partnerships takes different approaches towards their conceptual view of the project life cycle (Verzuh, 2003:408). The public sector approaches the project life cycle by defining the project, the plan, execution thereof and the finalisation. The private and NGO sectors take it as a business life cycle in which three stages of decision-making occur. During the business cycle the executives evaluate the proposed costs, schedule, scope and risk at each of the predetermined milestones. They can also take a simplified technical development life cycle approach that consist of the following elements: identifying the requirements of the project, constructing the design and operation of the project. Different aspects are emphasised by stakeholders in various stages throughout the project life cycle.

The most critical part of the project life cycle of a PPP project is based in the planning of a project and lies in developing a feasibility study (National Treasury, 2001:G3; Verzuh, 2003:408). Through the feasibility study, costing provides necessary information on the output specifications and indicates when these commitments are drawn from within the department budgets without disrupting other services (National Treasury, 2001:G3). It also ensures the project develops around departmental operational plans, is coordinated and communicated with prospective stakeholders.

A feasibility study should contain the following key sections: a sector needs-assessment, output specification, option analysis, constructing a public sector comparator (PSC), demonstrating affordability and preparing for a benchmark for value-for-money. Through the construction of the PSC the accounting officer is able to apply risk-

adjusted costing and to take an optimistic-pessimistic estimation of particular events into consideration (Wideman, 1992:D-1). National Treasury (2001:G6) also notes that the PSC exercise should use nominal values since these nominal figures are set out in inflated terms and does not reflect the true nature of costs. The nominal figures also allow for easy comparison with the budget, which is expressed in nominal values.

The complexities of PPP projects determine how intricate the PSC model becomes that is constructed to measure the affordability and value-for-money of the options selected (National Treasury, 2001:G6). The effective collaborations between the public, private and non-profit sectors is closely ingrained in the financial management and controls tied to the budgeting system. It should be noted that PPP projects stretch over a considerable longer time frame than the timeframe in which the MTEF operates. Therefore the process of creating a PPP requires careful cash flow projections through feasibility studies to determine the impact that risk factors have on value-for-money and service delivery outcomes (National Treasury, 2001:B5 and J3).

## PPP IN CONTEXT WITHIN BUDGETING PROCESS

PPP arrangements are based on medium and long-term contracts that include well-functioning systems of rule of law, transparency and accountability (Dutz, 2003:4). The technically demanding process for creating PPPs is closely tied to the budgeting and financial system of the national and provincial departments as well as the financial system implemented in local government.

According to Schick (2001:9) the budget process is one of the main components in the machinery of government. Similar to international trends, the South African budget office traditionally functioned as a central command and control post, specifying items of expenditure, monitoring compliance with regulations, ensuring that the inputs are those agreed on in the budget and intervening when deemed necessary. As Schick (2001:9) points out this role cannot coexist with the discretion accorded to managers in the new public administration. With the introduction of the PFMA, the devolution of powers and decentralisation of budget responsibilities to line managers they became primarily responsible for developing their own strategies, which gave them more operational discretion (Schick, 2001:12). The focus within departments changed from managing the inputs to managing the outcomes, meaning that line managers now have to work towards realising a vision (Pauw, *et al.*, 2002:60).

Budgeting is a fundamental part of the organisational planning process and starts with the aim and mission of the organisation and the budget also determines what can be done and how it will be achieved within a set time frame (Pauw, *et al.*, 2002:62). The organisational planning cannot be separated from the feasibility study since both the organisational planning and the feasibility study provide measurable output specifications. The overarching mission of the institution determines the starting point and defines how the service delivery is to be structured towards the vision and outcomes to be achieved (Kaplan and Norton, 2001:72). Only by having well-defined goals and strategic clarity the public sector can rise to the challenge of appropriate

contract design and monitoring of performance (Dutz, 2003:6; National Treasury, 2003(b):57). This means that the emphasis in budget decision-making is placed on strategic and operational planning.

Budget systems have three basic tasks that shape decision-making. These tasks are to maintain aggregate fiscal discipline, to allocate resources in accordance with government priorities and to promote the efficiency of service delivery. Dutz (2003:4) is of the opinion that if PPPs are effectively pursued it will lead directly and indirectly to sound public expenditure accountability. Likewise, PPP arrangements require supportive procedural and institutional mechanisms to ensure success.

In order to evaluate decision-making processes that go hand-in-hand with operational efficiency for PPPs the accounting officer must read in conjunction:

- The regulatory framework for PPPs set out in the *Public Finance Management Act of 1999* (PFMA) and the Treasury Regulations (Section 16 of Treasury dealing with Public Private Partnerships for national and provincial departments and Schedule 3 public entities) issued in terms of the PFMA.
- The Standardised Public Private Partnership Provisions issued by National Treasury in accordance with section 76 (4) (g) of the PFMA of 1999 (National Treasury – PPP Unit, 2004).
- The manual for national and provincial departments towards Public Private Partnerships and the generic PPP project life cycle (National Treasury, 2001).
- The Municipal Service Partnerships Policy as set out in the *Municipal Finance Management Act* (No 56 of 2003), which supports service partnerships in the local government sphere and the Integrated Development Plans (IDP).
- Tender Board Procedures
- The Code of Good Practice for Black Empowerment in Public Private Partnerships (National Treasury – PPP Unit, 2003(c)).
- The Guidelines for Implementing the New Economic Reporting Format (National Treasury, 2003(d)) provides for uniform expenditure reporting (Annual Budget) and increases the quality of compliance with the PFMA.

A major constraint in, for example the PPP Prisons, contract was the difference in itemising and application of terminology between Bloemfontein and Louis Trichardt prison's annual budgets. Benchmarking and comparing services through the creation of effective PSC Models were impossible due to the use of different classification systems (National Treasury, 2003(e):29-30: Parliamentary Monitoring Group, 2003). This impacts negatively on accountability and value-for money decisions.

With the introduction of the PFMA and the MFMA micro budget management system was reduced, even though National Treasury maintained a tight budget oversight and guidance. The national and provincial departments as well as the municipal services became accountable for value-for-money decisions and quality service delivery (Lund, 2004:7). The most important benefit gained from PPPs relative to conventional procurement methods arise from the efficiency gains associated with the collaborative networks tied to the Medium Term Expenditure Framework (MTEF).

## THE EFFECT OF PPPS ON THE PROCESS OF BUDGETING

National Treasury (2003(d):6 and 7) noted the difference in approach between the traditional payment mechanisms and the current PPP payment system. By comparing the traditional payment mechanism against the current PPP payment system a systematic analysis was done, highlighting the differences in approach and how this leads to advantages and benefits for the use of PPPs. The analysis makes use of the building and operation of a hospital and PPP prison in the provincial sphere and clinics in the local sphere of government (Monama, 2002; Parliamentary Monitoring Group, 2003). The examples used in the analysis of PPP projects and payment systems are all involved with the construction of buildings and infrastructure. The management of PPP projects in service delivery show a substantial change in the options available especially in the delivery of municipal services where different financial regulations shape decision-making.

Pauw, *et al.* (2002:88) indicate that poor budgeting directly results in an inability to continue with service delivery. An important part of the budgeting is the ability to combine the working capital management with the Medium Term Expenditure Framework (MTEF) (National Treasury, 2001: J3). The working capital or available cash allows for the day-to-day operations of an organisation (Pauw, *et al.*, 2002:205).

Various forms and options in the use of PPPs exist. The form and option used has a significant impact on the budget planning, which include a mix of *Balance sheet* and *project finance type structures* and determines how PPP agreements are constructed. The PPP Unit (National Treasury – PPP Unit 2003(b): 13) emphasises that before any PPP agreements or contracts are negotiated, financial agreements depend on strong credit ratings such as a contractually stable income stream and proper allocation of risk. Significant weaknesses include high leverage and the single-asset nature of projects. Therefore, it is important that a contracting department should investigate the various forms and types of PPP used and what the financial implications of each option will be for public expenditure.

It is imperative that the financial implications of PPPs on the budget strategies be managed properly as Treasury Regulations require departments to ensure that proposed PPPs are affordable and financial commitments must be available within the department budgets (National Treasury, 2001:J5). The choice of a particular PPP option is tightly interwoven with the type of contract, the form of relationships and coordination arrangements and how administrative processes are developed to enhance the structure and execution of the PPP throughout the project life cycle.

It is evident that most PPP projects are unlikely to have a high investment grade. As indicated by National Treasury PPP Unit (2003(b):14) and National Treasury (2001: E14) innovative and complex construction; overly demanding services; the high reliance on third parties; complex performance related mechanisms; or proportionally low debt service coverage ratio (DSCR) lead to non-investment grade ratings. To obtain sound ratings on projects, especially those that are involved with building of highly capitalised infrastructure and have long and intense construction periods, it is necessary to wait until the construction periods are over and revenues commence that the project becomes less risky. Such PPP projects have to take into consideration that the ratepayers who benefit



from the operation of the asset throughout the projects life cycle are equally involved in repaying the principal (National Treasury, 2001:E14).

## CONCLUSION

PPPs have multiplied over the year and are utilised by the public sector departments to enhance service delivery. In order to manage the PPP arena regulatory frameworks have been introduced such the *Public Financial Management Act, 1999* and the *Municipal Finance Management Act, 2003* and associated legislation and regulations issued by National Treasury. In order to create successful PPPs it is important that strict checks and balances should apply and the accounting officer should take note of the regulatory frameworks. Besides the regulatory frameworks the effectiveness and efficiency of the PPP system mainly depends on the administrative and managerial skills of the government departments and whether they are able to manage PPP projects and the associated risks.

PPPs normally have a longer time frame than the one in which the Medium Term Expenditure Framework operates. In terms of public financial management there should be a clear relationship between the project life cycle and the budgeting process and other financial systems. It is, therefore, important that careful cash flow projections through feasibility studies be undertaken. The purpose is to determine what the impact of the identified risk factors will have on the value-for-money and service delivery outcomes. Budgeting forms the cornerstone of departmental activities and cannot be separated where PPPs will be involved since organisational planning and the feasibility studies provide measurable output specifications and in turn ensures sound public accountability.

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