

THE CURRENT ROLE OF THE CONTRACT MANAGEMENT UNIT OF JOHANNESBURG MUNICIPAL COUNCIL AND THE NEED FOR SPECIALIZATION

1. INTRODUCTION

1.1. The Recent Reorganization of the City Government

The recent reorganization of city government in Johannesburg resulted in the corporatization of ten former municipal service departments and agencies to form companies under the Companies Act. The goals of the reorganization are to:

- reduce the financial burden to the city of non-performing services,
- develop autonomous service providers that are efficient and effective, financially sound, and meet the needs of, and are responsive to, their customers,
- allow the Council to concentrate on the strategic issues of policy, long-term planning and provision of true public goods,
- capture the value of the services to the Johannesburg Municipal Council (CoJ) either as a shareholder, or in some form of partnering with the private sector.

As a result, the relationship that existed in the past between the services and the CoJ and local councils is being restructured. In the past there were no real boundaries between policy making and service delivery. The regulation of service quality and tariffs was inadequate and confused with policy making. As a result there was little autonomy and accountability on the part of the service providers and decisions were sometimes driven by political considerations rather than principles of sound business management, responsiveness to consumers and economic efficiency. The recent reorganization represents a recognition of the desirability of separating policy making from the management of services and of the need for more explicit and accountable supervision and regulation—though the latter has not yet been completely separated from policy-making. The institutional arrangement that exists now is as follows:

1. CoJ has the triple role of a) sole shareholder of the companies b) municipal policy maker and c) regulator of service quality and user charges for companies that sell directly to users.
2. Ten corporatized companies provide services in accordance with Service Delivery Agreements (SDA)¹ with the CoJ, Business Plans (BPs) and By-laws that are now being prepared.
3. The Contract Management Unit (CMU) of CoJ is charged with drafting the SDAs, BPs, Articles of Association, By-laws and other legal documents, monitoring the implementation of the SDAs and the BPs, and advising CoJ as regards all of its functions: shareholder, policy and regulatory.

¹ Some of the companies are operating under interim SDA's while longer-term SDA's are being drafted.

1.2. The Challenge to Consolidate the Reform

At the current time these actors remain closely linked and they are grappling to better define and understand their new roles, which need further clarification and consolidation. There is a danger that the long-term goals of the reorganization will not be achieved if the parties continue to operate, to all intents and purposes, in their pre-reform roles, ignoring or setting aside the new contractual arrangements and avoiding an evolution into more clearly separate entities with complementary but very distinct roles. There is a particular risk that CoJ may not distinguish sufficiently among its three roles and that as a result, regulation of services will be driven by political considerations or shareholder interests, rather than sound regulatory principles.

Transparency and accountability are enhanced when the three arenas, public policy making, company ownership/management, and regulation, are separated. Conceptually these three arenas might be considered corners of a triangle. At the current time in Johannesburg, the triangle is extremely small and the three corners look a little fuzzy and indistinct from each other. The city has initiated the process of stretching the triangle so that the corners will become distinct and separate from each other, but the lines joining the corners of the triangle are similar to pieces of elastic: as the corners try to separate more clearly from each other, the elastic is trying to pull them back together again. This tension is to be expected, and will even remain in the long term (there will always be constructive tension among the parties), but in the short term the tension will perhaps be greatest. The process is similar to blowing up a balloon – it is very hard to get started but once the initial shape is defined it is much easier to expand to its final size.

Expanding the triangle is a feat which requires:

- Understanding the difference among the different functions and the need to separate them,
- Agreeing who will assume which functions,
- Building confidence & trust between the parties by taking measured steps towards the institutional changes that are desired, and
- Enabling each entity to build the capacity to discharge its new roles and responsibilities.

To promote a constructive dialog about these issues it would be helpful to clarify the difference among shareholder responsibilities, policy making, and regulation, and to explore the regulation questions in more detail: identifying what kind of regulation is needed at the municipal level, for which of the corporatized services, how it can best be carried out and by which entity or entities. The purpose of this paper is to establish a framework for answering these questions and to suggest a way forward.

2. DISTINGUISHING SHAREHOLDER, POLICY MAKING AND REGULATORY ROLES

2.1. The Role of Shareholders

Shareholders expect to receive a return on their investment and/or growth in the value of their equity over the long term. Recognizing that it is very difficult for a political entity to manage business enterprises effectively and without political interference, the City has very wisely contracted out day-to-day business operations of the corporatized services to private firms, and has recruited an impressive group of business leaders, professionals and public figures to serve as members of the Boards of Directors.

Now that these institutional arrangements are in place, it is important that the CoJ give the companies enough autonomy to operate in accord with sound business principles, that it avoid interfering in decisions of the Boards, and that the Boards not micro-manage day-to-day operations. If a company fails to perform, it is the Board's prerogative to penalize or replace management (in accord with its management contract). CoJ has set out its objectives as shareholder of the companies in the Articles of Association and By-laws of each of the companies.

2.2. Policy making

The CoJ as a public authority is interested in social benefits, as well as monetary returns and growth in equity, but it should pursue its interest in social benefits primarily through the policy arena rather than through its role as a shareholder. CoJ exercises its policy-making role with regard to the corporatized companies through the Service Delivery Agreements (and licenses?). The SDAs (licenses?) specify standards and targets for service quality, rules governing interaction with the public and municipal entities, reporting requirements, and—in the case of monopoly services that are sold directly to users—the service area in which the company will operate and users' right to service (the right of access), the setting of user fees, the company's or users' eligibility for subsidies, etc. The companies are also required to observe any other ordinances that CoJ adopts, just like any other entity in the city, unless a special exemption is provided in the SDA. CoJ thus retains a great deal of policy authority over the companies, particularly those that provide essential services that have a direct impact on the growth and development of the city and the welfare of its inhabitants.

2.3. Regulation

Just as political bodies are not particularly well suited to managing and operating businesses, they are also not the most appropriate bodies to enforce regulations and laws. That is why the Constitution of most countries creates a separate judicial system. It is also why many governments create specialized, and relatively autonomous, regulatory and enforcement agencies to monitor and enforce rules and regulations, resolve disputes and protect the rights of concerned parties. Some regulatory and licensing bodies are established to interpret and enforce highly specialized rules governing particular

economic activities that are subject to market failures.² It is usual to regulate activities such as banking, radio and TV broadcasting, subsidize education and health services, limit access to environmentally fragile areas, promote competition, and regulate service quality and tariffs charged by monopoly or semi-monopoly utility services, such as power, telecommunications, water and sanitation.

The need for public intervention and regulation is determined by the nature of the goods and services provided and by the market conditions that are faced by producers. CMU has been established to assist CoJ in supervising the corporatized companies, but whereas some require only supervision of their contracts, others may require more formal regulation. In order to determine what types of supervisory and regulatory functions may need to be established by CoJ and which ones might be entrusted to CMU, it is useful to examine the services provided by the ten corporatized companies and the market conditions in which they operate.

The corporatized companies (UACs), and any other potential service providers, are classified below along two parameters³:

1. Whether they have some features of natural monopolies or are potentially subject to competition, and
2. Whether the services provided are private goods or public goods.

Monopolistic providers of essential services that are primarily private goods but may have some features of public goods:

- Johannesburg Water
- City Power
- Metrobus and other bus companies that are awarded exclusive routes
- Pikitup services for commercial and industrial users
- Other solid waste collectors that are awarded exclusive routes

² Market failure usually occurs due to a lack of competition or the existence of externalities: costs and benefits to the community that are not captured or taken into account by individual users.

³ See Annex 1 for a brief discussion and definition of these parameters.

Providers of public goods that are procured through competitive contract and for which users do not pay directly or do not pay the full cost:

- Pikitup street cleaning services
- Johannesburg Roads Agency
- City Parks
- Johannesburg Zoo
- Propcom?

Providers of private goods that are subject to competition and may have the potential to be financially viable:

- Civic Theater
- Fresh Produce Market

Based on this classification, the regulatory and supervisory needs of each of the services, as well as the need for continued public support, are analyzed in Tables 1, 2 and 3. This analysis shows that two distinct types of regulatory oversight are required:

- Regulation of tariffs and service quality (known as “utility regulation) is needed for essential monopolistic services for which users pay.
- Competitive procurement and monitoring of contractor performance is needed for services that are public goods.

In addition a number of policy matters need to be addressed on an on-going basis:

- Decisions about whether to finance investments
- Decisions about whether to provide subsidies
- Policy decisions to seek private investors or shareholders

2.4 Conclusion

At the current time CMU is advising CoJ on all these functions. This has been an advantage during the critical period of restructuring, but as the reform stage comes to a conclusion, more specialization will be desirable. It is recommended that CoJ establish two specialized agencies to handle the two types of regulatory oversight. In addition it should separate its shareholder functions from its policy making functions by creating a shareholder office within CoJ. This will assist CoJ to consider the tradeoffs between

policy objectives and shareholders interests. The following allocation of roles is recommended:

- CoJ as policy maker
 - Makes policies regarding service quality and long-term development and public investments
 - Makes rules for setting tariffs of monopolistic providers of essential services
 - Determines eligibility criteria for subsidies and their funding
 - Determines level of participation by the private sector
- Clearly identified “shareholder office” within CoJ which:
 - Approves Boards of Directors
 - Approves auditors
 - Receives returns on investment
 - Provides new equity
- An Outsourcing Unit within the Finance Department that would
 - Ensures fair and transparent competition to procure “public good” and municipal support services
 - Awards contracts and negotiates contracts for approval by CoJ
 - Monitors performance of contractors and approves payments
- A Regulator of monopolistic providers of essential services that would
 - Negotiates Business Plans and approves tariffs
 - Monitors and enforces service quality standards and targets
 - Educates and informs the public about services quality and cost
 - Resolves disputes between users and providers and among service providers
 - Advises the CoJ regarding policies and development needs
 - Coordinates with other regulators that have jurisdiction over the services.

The role and functions of the Regulator are discussed in the next section.

3. PROPOSED ROLE OF AN AUTONOMOUS BODY TO REGULATE MONOPOLISTIC ESSENTIAL SERVICES (UTILITY REGULATION)

3.1. Limited Rule Making

Major policies and regulations governing competition, private sector participation, the rights and obligations of the service provider, service quality standards, customer rights and obligations and tariff setting would be established by the CoJ (primarily through the SDAs). The regulator’s rule-making role would be limited to issuing complementary guidelines and procedures that interpret the SDA’s, advising CoJ regarding changes in the SDAs or other related policies and rules, and negotiating and approving the SBPs periodically. SBPs would take into account any policy decisions taken by CoJ as well as the possibility of obtaining additional equity finance or loans from CoJ as shareholder or lending from commercial sources.

3.2. Tariff Setting

Policies governing tariff setting would be established by CoJ in its role as political authority. Rules governing tariff setting would be drafted by the regulator for approval by CoJ. These would be incorporated into or referenced by the SDAs, which would also establish whether tariff revenues should normally cover the full cost of service that the company is expected to provide or whether the company will be subsidized, and if so, how. In recognition of the fact that higher levels and quality of services imply higher costs and may require investment finance, the tariff rules should link tariff revenues to the level and quality of service and an appropriate and financially feasible investment program that is agreed to periodically in the SBP. However, since monopoly service providers experience little or no direct pressure from the market to reduce costs, the tariff framework should not simply allow the company to pass through all its costs. It should provide incentives to reduce costs.

Tariff policies and regulations may be more or less detailed. At one extreme, they could simply take the form of a list of basic principles to be respected, such as full cost recovery and economic efficiency. At the other extreme, they may be very detailed: specifying, for example, formulas for calculating tariffs on the basis of the company's actual audited costs or on the basis of benchmarked costs, how inflation is to be reflected in the tariffs, conditions under which tariffs may be revised, what rate of return is expected, exactly how tariff structure will be established, etc. Tariff policies that fall somewhere in between these two extremes are usually preferable, so that the basic principles and rules are clear, but the regulator has some flexibility to respond to changing circumstances and opportunities. The regulator's role would be to issue complementary regulations to interpret the basic policies and regulations as well as procedures and guidelines necessary to implement the regulations. It should also have the authority to give final approval to tariffs calculated in accordance with the tariff rules.

Since the National Government and CoJ have the power to impose additional obligations on the service providers at any time, in the form of service standards, environmental regulations, social policies etc., it is important to create some mechanism whereby the regulator and the service providers would advise the political authorities on the cost implications of proposed changes in obligations. Once new obligations are effective, the regulator should review and revise tariffs in accord with pre-established procedures, to reflect any justifiable additional costs.

3.3. Monitoring and Enforcement of Performance

If tariffs are limited, the monopoly service providers may try to make up for inefficiency, or increase profits, by reducing service quality, ignoring standards or neglecting the maintenance of assets. One of the key roles of the regulator would be to monitor performance to ensure that it meets acceptable industry and statutory standards and the targets set out in the SBPs. The regulatory framework should provide for regular reporting of information on technical and financial performance by the service providers and procedures for independent verification. When a service provider is not in compliance with its obligations, it should be required to provide an explanation and a

rectification plan for approval by the regulator. In the case of repeated or extremely serious non-compliance with service development and quality obligations, tariff rules or financial performance, and when the company's Board of Directors has not taken adequate measures to improve management performance, the regulator would be empowered to issue warnings and impose penalties and, in the most extreme cases, declare the service provider in breach of its SDA and/or recommend revocation of the service provider's license.

3.4. Consumer Consultation

One of the key roles of a regulator of essential monopoly services is to consult with consumers regarding their needs, concerns and the levels of service for which they are willing to pay. The service provider may be required to carry out surveys of demand and willingness-to-pay as part of the business planning process. However, the regulator should develop its own consultative links with consumers so as to gain their confidence and to obtain input on major regulatory decisions. Consultation can be carried out through a variety of fora and media (user committees, public hearings, telephone hotlines and an interactive website). Different approaches are needed to reach consumers at all income and education levels. It is particularly important that the regulator of an essential services, such as water and sanitation, create special programs to consult with low-income communities, understand the special barriers they face, including regulatory barriers, and promote their access to services.

3.5. Publication of Information

It is also desirable to inform and educate consumers about the cost and benefits of service, their rights, the service provider's obligations, legal tariffs that the service provider may charge, existence of subsidies, as well as the service provider's performance in meeting its obligations. The regulator may require the service provider to provide some this information to users in a regular annual report but, as in the matter of consultation, it is in the regulator's interest to provide some educational and information services so as to gain the respect and confidence of users, promote acceptance of tariffs and advertize the role of the regulator in protecting the rights of all parties.

3.6. Resolution of Disputes

Service providers should be required to establish facilities to receive consumer inquiries and complaints, and to make every reasonable effort to respond in a timely manner and resolve complaints. In the event a user is dissatisfied with the response it receives from the service provider, it should be able to take the matter to the regulator for resolution. The regulator's role is to make an objective decision that respects the rights of all concerned parties. The objectivity of the regulator is essential for establishing the credibility of the regulatory framework and establishing trust. Allowing/requiring the regulator to play this role reduces pressure on political authorities to take sides on the basis of political considerations rather than objective criteria.

3.7. Consultation with CoJ, and Other Policy Makers and Regulators

Because many of the monopolistic essential services are politically sensitive and subject to other types of market failure, such as environmental and health externalities, they are usually regulated by other regulators as well, whether at the National or Municipal level. These regulations and social policies impose costs. Subsidies, especially cross-subsidies, affect demand and thus financial viability and impose some administrative costs. Environmental regulation imposes the investment and operational cost of achieving standards, the cost of collecting and reporting information, and the cost of negotiating interim targets or rectification plans. Since it is the economic regulator's responsibility to protect the financial viability of the services and control tariffs, it would need to develop a cooperative and consultative relationship with other policy makers and regulators. It should have an opportunity to comment on the costs implications of new standards and rules, and contribute to decisions about whether these costs will be borne by consumers through tariff increases or funded by subsidies. In most cases, it is essential to allow a reasonable period of time for introducing the new standards. Ultimately it is the responsibility of the service companies to negotiate compliance schedules with other regulators, but upstream consultation with both the industries and the economic regulator will help to prevent the adoption of unrealistic and unenforceable standards and regulations.

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