# Case Studies on the Public Private Partnerships at

***Humansdorp District Hospital***
***Universitas and Pelonomi Hospitals***
**and**
***Inkosi Albert Luthuli Central Hospital***

**for the**

**PPP UNIT OF THE NATIONAL TREASURY**

## Overall Findings and Recommendations

NATIONAL TREASURY

PPP unit

**Bid no: 010/06** Wits Business School November 2007

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# 1 INTRODUCTION

This document draws together the findings, conclusions and recommendations of those who have researched the public private partnerships (PPPs) at Humansdorp District Hospital, Universitas and Pelonomi Hospitals and Inkosi Albert Luthuli Central Hospital (IALCH). It seeks to identify the best practice highlights as well as recommendations for ensuring that these PPPs – and other PPPs which the government enters into – operate as effectively as possible and deliver the best possible value for money.

# 2 BEST PRACTICE HIGHLIGHTS

These PPPs demonstrate a number of best practice highlights which should be replicated in other PPPs. Firstly, they were all conceived by committed decision-makers and the procurement process was driven by them. In each instance, they had the full support and involvement of people in the highest positions within both the public and private organisations. This is important because PPPs are complex processes to drive and to manage, requiring perseverance and commitment.

In addition, all of the PPPs made use of international expertise and case studies, because local expertise was thin at the time. This meant that the local parties could learn from international experiences and incorporate this learning into their processes. This was important in all instances because the PPP Manual had not been put in place yet. Indeed, in the cases of Humansdorp and Universitas-Pelonomi, the relevant treasury regulations were also not yet in place when the projects were initiated, and the PPP process at Humansdorp was put on hold until the regulations were in place.

In this regard, the IALCH PPP definitely seems to have benefited from having commenced when the treasury regulations were in place, and therefore from adhering to these regulations from the beginning. The particular benefit of this can be seen in the quality of the feasibility study (even though the study conducted does not compare with that laid down in the PPP Manual currently). Moreover, following this process forced the public partner to define exactly what it wanted from the PPP, and this has been critical in guiding the entire process – including the management of the contract since financial closure.

The Humansdorp PPP may have suffered from the fact that the initial ‘feasibility study’ was no more than a wish list, and the subsequent feasibility study was really an attempt to formalise the wish list. Moreover, possibly because the objectives were less clearly defined, the implementation process thus far has led to ambiguity and relaxation on compliance to the agreement.

Although the project at IALCH commenced before the current PPP approval process was in place, it appears that many of the principles laid down in the manual were followed anyway, and may even have informed the formulation of this manual. It is clear that the procurement process of this PPP was far more streamlined and took less time than the other two. Had these processes been in place when the other two were conceived and procured, they too might have taken less time to reach financial closure.

As it is, one of the things that helped to facilitate the process at IALCH was that the team set tough but not unrealistic deadlines and did its best to meet them. In the end, deadlines were overrun, but the process was still completed in a record time. We believe that the setting of these deadlines, the commitment to achieving them and that the fact that a rigorous process was followed, all worked together to bring procurement to a relatively speedy conclusion. The experiences at Humansdorp lend support to this, because once negotiation commenced, the team adhered to deadlines, and the negotiations were completed quickly.

These case studies also show that the choice of transaction advisor is very important, and that the transaction advice team should contain experts in all of the areas to be covered by the PPP. Asking transaction advisors to draw up PSC and public sector reference models is a tall order, because it assumes that they have the same expertise as the private party which will eventually implement the contract. This is why the composition of the team is so important, and the benefits of a well constituted transaction advice team were seen in the IALCH procurement process.

At the same time, we believe that it is important that the transaction advisors look not only to the interests of the public sector (from which they receive payment), but also to the interests of the private sector. This is because, ultimately, public and private sector interests overlap in this sort of partnership. Thus, the transaction advisors should investigate value for money and sustainability for both the private and the public partner – otherwise they do the public partner a disservice.

Another highlight of best practice that our research on these case studies has shown is the importance of thinking creatively about how to finance the deal. This is particularly evident in the IALCH PPP, where the transaction advisors recommended an alternative method of upfront funding from the government to the private sector, which has made the PPP more affordable on a number of fronts.

# 3 RECOMMENDATIONS

Having noted some best practice highlights, we wish to make a number of recommendations, based on the results of this research.

## 3.1 Systemic Impact

The first of these relates to the importance of taking systemic or contextual factors into consideration in the conception and management of a PPP. This is for two main reasons. Firstly, systemic factors impact on how the PPP itself is able to operate. Secondly, perceptions about PPPs may be negatively influenced by systemic factors, even if these systemic factors have nothing to do with the actual PPP. A PPP is not an island. It takes place in a socio-political, economic and geographic context which has a profound impact on how the PPP evolves, how it is perceived, how it is managed and how it should be managed.

Thus, for example, the problem of staff shortages is something with which all hospitals have to deal, whether they have entered into a PPP or not. The problem of doctor 'cartels' and doctor unwillingness to refer patients outside of their accustomed domain is widespread. Changes to legislation are outside of the control of the PPP. Yet, as the case studies have demonstrated, these factors are having an important effect on the PPPs at these hospitals – impacting on their sustainability and on the value for money that they can deliver.

We therefore believe that the feasibility studies of PPPs should look at systemic factors which could have an impact on the value that the PPP will actually be able to deliver in practice. Doing this may also provide some cautions for contract and hospital management in the future – pointing to issues that might have to be managed to ensure the continued success of the PPP.

Two systemic factors which we believe are particularly worth mentioning relate to staffing issues. The first is that of attracting, training and retaining medical staff. All three hospitals noted that this has been a problem, and we believe that the public sector should be looking to more innovative approaches to addressing these problems. This is something which has an indirect, but significant effect on how effectively the PPPs function, because if the public partner does not function as effectively as it could, neither does the PPP.

So, for example, it may be necessary to build greater flexibility into the recruitment process. One of the things that is hampering recruitment of medical staff to Humansdorp – which because of its location should be an attractive place to work – is the constraint of having to follow public sector recruitment and advertising procedures and formats. This means that the hospital cannot promote the particular advantages of working there over any other public sector hospital. It may also be necessary to investigate the way in which nursing staff are managed to ensure that there are no push-factors that drive them out of the public sector, or to look for positions in other public sector hospitals. These are just two suggestions, and are not meant to address all the problems of attracting and retaining medical staff that we identified. The point is that this challenge needs to be addressed if the PPPs are to function to their fullest potential.

The second issue relating to public sector staffing is that of the turnover of key staff. The case studies have shown that such staff turnover had negatively influenced the ability of the public sector to manage the PPPs at Universitas-Pelonomi and IALCH. The converse – that of the benefits of stability – are evident at Humansdorp. This is because of two major factors: knowledge and understanding of the contract, and the development of a relationship of trust between the public and private partners.

This impact is not only on the management of the PPP. The difficulties that our team had in obtaining information for these case studies related in some measure to the fact that the people who were involved at crucial stages in the contracts' evolution are not there now. Added to this is the fact that we found record-keeping to be poor, which means that documentary records have been lost or are difficult to get hold of. The effects of this are not only on the potential usefulness of these case studies, but also on anyone else in the public sector wanting to learn from the experience gained from the parties to these projects.

We would recommend processes be put in place to retain key staff and to ensure continuity of staff on these projects. But, given that staff turnover is unavoidable (and often useful because it brings in new blood), it is important also to put in place knowledge management structures that will ensure the transfer of knowledge to the people who will be involved in managing the contracts in the future. This will make sure that institutional memory does not get lost and that the new people have the knowledge that they need to manage the contracts effectively.

### 3.2 Risk Transfer

The second point that we want to make relates to risk transfer. One of the primary motivators for entering into PPPs is the transfer of risk from the public sector to the private sector, and it is often here where value for money is derived as well. For example, it was the risk adjustment to the IALCH public sector comparator which showed the value that the PPP could deliver. Without adjusting for risk, a PPP did not appear to deliver much value.

We would like to caution, however, that the transfer of risk should not be to the extent that it prejudices the sustainability of the private partner, because any threat to the sustainability of the private partner is a threat to the sustainability of the PPP. It could be argued that the private partner should make sure that the sums add up for them, and should not enter into the agreement if they do not. However, in two of the projects that we researched, namely Humansdorp and Universitas-Pelonomi, it is clear that the public sector used a certain amount of coercion to get private sector buy-in for the projects, by making obtaining a licence to operate a private hospital conditional on entering into the PPP. In both instances, the private partners are battling to make money. They may also have battled if they had had to build a hospital from scratch. Nevertheless, the threat of not being able to obtain a license without entering into a PPP may have caused the private partners to take on more risk than they would normally have. This may impact sustainability in the longer term.

Furthermore, we would argue that room should be made for evaluating risk transfer during the course of the concession. Here we think particularly of the impact of the changes to the Road Accident Fund on the private partner at Universitas-Pelonomi. This was an unanticipated event which substantially impacts on the potential income of the private partner and which has increased its risk in the partnership. In the interests of ensuring sustainability, we think that there should be provision for renegotiating contracts in light of events like this, to ensure that the risk burden on the private sector is not too great.

Similarly, we do not believe that it is sustainable for the public sector to demand a super-profits share if it is not also prepared to take a share of the losses. If there is a cap on the income that the private sector may earn, there must also be a collar to limit their losses: an unprofitable private partner is in no-one's interests, because this makes them unsustainable.

### 3.3 Public Sector Management

The third point relates to the importance of good public sector management in ensuring the success of a PPP. By this we mean more than just good contract management, but public sector management in general. Because these agreements are partnerships, their full success depends on both parties being as effectively managed as possible.

In many instances, if the public sector does not deliver, neither can the private partner. For example late payment of bills and a lack of public sector appreciation of the needs of the private sector hamper the private partner's ability to deliver at Humansdorp.

In addition, some of the systemic issues mentioned above might be mitigated by better public sector management. It might result in a greater ability to attract, train and retain staff. It might also have meant that the professors in KZN would be more willing to change their current practices and adopt the new patient referral system, through effective change management processes. In turn this may have increased occupancy levels at IALCH and meant that the hospital is better able to deliver value. Better succession management practices may lessen the impact of the turnover of key staff.

A further observation relates to the fact that, by its own admission, the public sector is not managing to address the weaknesses that it sees in its system with sufficient speed. At the same time, and also by its own admission, these weaknesses are one of the reasons that the public sector wants to enter into PPPs. This has implications not only for the present management of PPP contracts, but also for management of the projects when the PPPs end. Unless the idea is to renegotiate new PPPs when the current PPPs have run their course – a kind of de facto privatisation – the life of a PPP is finite. Thus, if the public sector does not improve the way in which it operates and its ability to deliver services effectively, embarking on PPPs only defers the problem until a later date. It is therefore important to ensure that public sector skills are improved in the interim, so that when the concessions revert to this sector, it is able to manage them effectively.

One of the ways of doing this, we would suggest, is to build a process of skills transfer from the private partner to the public sector into the concession agreement. In this way, skills that are essential to the management of the project will not remain with the private partner when the contract has come to an end.

This brings us to our final observation relating to management of the public sector. Although it is often the case that the public sector does not operate as effectively or efficiently as the private sector, this is not universally true, and it does not have to remain this way. If the private partner – operating at a fee that is being paid by the public sector and therefore within public sector affordability – is able to attract and retain the necessary skilled staff (especially non-medical staff), it should be possible for the public sector to do so. Thus, while acknowledging the fact that private sector efficiency and effectiveness may generally be better, all in the public sector should nevertheless strive to achieve comparable performance. In turn, this would enable the public sector to negotiate and operate from a position of greater strength when entering into PPPs in the future.

### 3.4 Contract Management

The more obvious aspect of public sector management as it relates to a PPP is that of the management of the actual contract. This is perhaps the most crucial factor for the success of a PPP and its ability to continue to deliver affordability, value for money and risk transfer. This is for a number of reasons:

- contract management is at the coalface of the relationship between the private and public partner;
- PPPs bring together partners from very different spheres with different motivations and ways of operating, creating an environment in which distrust can develop very easily;
- a relationship of trust between the two parties is very important, by virtue of the fact that this is a partnership, and not merely an agreement; and
- contracts such as these need actively to be managed if they are to deliver the value that is anticipated and if all parties are to play the role to which they have committed themselves.

In regard to the second point above, our research for these case studies has shown that while the public sector wants to take advantage of the private sector efficiencies to achieve value for money, it is important to acknowledge that profit has to be the outcome of the PPP for the private party. If there is this understanding, some of the difficulties in the relationship between the two parties could be avoided.

We would recommend that all PPPs should be managed by a competent contract manager or contract management team and that the PPP Unit needs to support this manager or team on an ongoing basis. Furthermore, there should be a workable succession plan in place for contract managers.

The manager or team should have the following characteristics (in no particular order of priority):

- a thorough understanding of PPPs and their critical success factors;
- a thorough understanding of the contract;
- an understanding of the nature and demands of the private sector;
- sufficient status and credibility in the public sector and with the private sector to have de facto and designated authority;
- strong interpersonal skills;
- strong analytical skills;
- a commitment to ensuring that the PPP is sustainable and that it continues to deliver value for money to both the public sector and the private sector; and
- a willingness to advocate for the PPP to ensure that it does not garner a poor reputation amongst stakeholders and to rectify problems that might be causing a poor reputation.

In addition, we believe that the contract manager or leader of the contract management team would need to be politically astute and able to work effectively with a range of different stakeholders.

The PPP Unit’s support could include training of contract managers, advice on how to handle difficult issues (by virtue of the fact that it has been exposed to other PPPs and can learn from them), workshopping the management of PPP contracts with various contract managers so that they can learn from each other's experience, and advising responsible departments on the choice of and succession planning for contract managers.

Succession planning is important of the issues of turnover mentioned in public sector management above and because administrations come and go, while PPPs often last for a long time. This means that those who were involved in conceiving it, and had the passion to drive it through the preparation phase, may not be there for implementation. As a consequence, institutional memory can be lost, and along with it the deep understanding of the driving factors behind the PPP as well as of the contract that governs it. It would be advisable for future PPP endeavours to give serious thought to how the PPP will be managed in years to come where priorities amongst those in power may change.

### 3.5 Value for Money

Delivery of financial value for money is very difficult to evaluate in practice. This is for a number of reasons. First of all, there have to be questions about the validity of any PSC that the transaction advisors draw up, no matter how diligently they do their job. Some of the figures that the transaction advisors rely on to do their calculations come from the public sector, where record-keeping is sometimes poor and figures are unavailable or unreliable. Moreover, PPPs are often treading new ground (this was definitely the case at IALCH) and it is therefore difficult to find anything comparable in the public sector upon which to base the PSC calculations.

In addition, PPP contracts cover a long term – sometimes up to 21 years. Calculations which look that far into the future can only be an educated best guess, because it is very difficult to take all possible eventualities into consideration, and the environment may undergo a radical change, which could alter the actual cost to the public sector substantially. Thus, the assumptions that are used as the basis for the PSC may prove to be incorrect in practice, and therefore the PSC becomes invalid.

Furthermore, in our opinion, the methodology for drawing up a PSC in terms of the PPP Manual may be flawed. Where possible, it says that discounted cash flow techniques are to be used to evaluate the models and the National Treasury proposes that the PSC and PPP reference models are developed in nominal terms and discounted at a nominal discount rate without adjusting for inflation. In terms of current financial theory this is a major flaw in the analysis, particularly where income tax has to be taken into account, as it ignores the impact of inflation on income tax allowances. Furthermore the underlying assumption is that inflation is the same for all income and cost elements of the budget or cash flow. This is patently incorrect and must impact on the validity of the PSC.

At the very least, however, the exercise of drawing up a PSC forces the public sector to consider costs and to think about the project and its costs in a planned and systematic way. A well thought-through PSC which bears no resemblance to how things would actually have worked in reality is better than no PSC at all, or a hastily drawn together PSC where no attempt has been made to consider all relevant factors. Thus, we think the exercise is valuable, if somewhat theoretical.

The second factor that makes delivery of financial value for money difficult to evaluate in practice relates to the fact that public sector record keeping is such that it has been difficult to obtain information that allows for evaluation of value for money at these hospitals. Moreover, PSCs were not drawn up at for two of these PPPs, because they were initiated before the treasury regulations were promulgated. This in itself indicates the usefulness of a PSC, because, given that public sector records are available, a PSC will at least gives a base figure against which to compare current expenditure and make some kind of evaluation.

We would argue, however, that value for money cannot only be measured in terms of whether the PPP is affordable, whether the public sector could deliver the same service at the same or a lesser cost, or even whether the extent of the risk transferred to the private sector is significant or not.

Instead, we would argue that at least some of the measure of value for money should come from questioning whether the nature of the project is in and of itself value-for-money (whether delivered using a PPP or not). For example, in the context of the other demands on the health budget of the country and the province, can a hospital such as IALCH deliver value for money, regardless of whether a PPP agreement is entered into? Would a different kind of hospital not have left more in the overall health budget to allocate to other health needs in the province? This is not to say that the concept of a state-of-the-art hospital is flawed, because excellence in everything is of great value and sets the benchmark for others to follow. But it does come at a cost.

Furthermore, we believe that value for money can also be measured through the intangibles that a project is able to deliver. So, for example, at Humansdorp, one of the benefits to the community of the PPP is that confidence in the health system has improved, and the surrounding population has the security of accessibility to good health care. This kind of value cannot be reduced to monetary terms, but it is also something against which value for money should be assessed. Insofar as the hospitals are delivering a service that was not delivered before and/or are doing so at levels that were not being achieved before, all of the PPPs that we studied are delivering this kind of intangible value.

Finally, the issue of evaluating whether PPPs are delivering of value for money is influenced by another factor – that of what the public sector could do in theory, in relation to what it would do in practice. This is perhaps well illustrated by the PPP at IALCH. There is a widespread belief amongst public sector health professionals who do not work at IALCH, and in the KZN DoH itself, that the hospital (and hence the PPP, because the two are seen as synonymous) is expensive. The view is that given the same amount of money, the public sector could definitely deliver the same level of service – and perhaps do so for less money. This may well be true, but evaluating how true would take another study.

Yet, the question is less about whether the public sector could do the same, and more about whether it would. It is widely accepted that public health facilities worldwide tend to replace equipment only when it is broken. This is no less true in South Africa. As it must be assumed that no-one embarks on a project with the intention of not replacing equipment or replacing it too late, the fact that this happens must be because of a tendency not to live up to initial intentions.

However, the value of a PPP is that, if well managed, it locks both the private and the public sector into delivering and paying for the service levels that were initially intended. Thus the value that a well-managed PPP can deliver is to ensure that the best intentions of the initial specifications get delivered throughout the life of the project.

### 3.6 Comment on PPP Manual Financial Model

Based on the research for these case studies and our analysis of the PPP Manual, we have some observations about the National Treasury's requirements regarding financial models drawn up in the preparation phase. The conversion of the base PSC model to a risk adjusted model is an extremely onerous and difficult exercise. It requires the identification of risks and their impacts, an estimation of the likelihood of risks occurring, an estimation of the cost of each risk, strategies for mitigating the risks, the allocation of risk and the construction of a risk matrix. This risk matrix would include the cash flow costs to be added to the base PSC model, which would again be analysed.

An alternative methodology would be that of using real options. In current financial theory and practice, real options are providing an alternative means of project evaluation, to take into account the benefit of management's ability to make decisions to mitigate risk or alternatively to expand, contract or abandon operations. This would be an interesting alternative or adjunct to the risk identification process above.

Finally, bidders are expected to submit financial models that will allow the institution to thoroughly interrogate the proposal. The criteria of the model are laid out in the PPP Manual. It should be observed that, if risk is supposed to pass from the public to the private partner, how the project operates financially should be a matter of choice for the private partner, although the private partner should still make its evaluation model available.

# 4 SUMMARY

In summary then, our research into the PPPs at Humansdorp, IALCH and Universitas-Pelonomi has revealed the following practices that should be emulated in other PPPs:

- involvement and commitment of key decision-makers;
- involvement of experts (international if necessary) to avoid making unnecessary mistakes;
- choice of competent transaction advisors with relevant expertise;
- setting of tough but achievable deadlines and commitment to stick to them;
- defining clearly in the beginning what the project should achieve;
- ensuring that the agreement itself is well-structured and sound; and
- creative thought about how to finance the deal.

We would also make the following recommendations based on our observations:

- improve public sector management to take into account systemic issues that may impact the PPP;
- ensure that such systemic issues are examined in the feasibility study to that they can be planned for appropriately;
- put in place effective knowledge management and succession plans to ensure transfer of knowledge from the key project staff who leave;
- put strategies in place to retain key staff for longer periods;
- ensure that there is a suitably skilled contract manager to manage each PPP contract;
- develop structures to provide training and ongoing support to contract managers;
- develop an understanding and appreciation of the private sector motivation to make a profit, and ensure that PPP contracts are able to achieve this for the private partner;
- ensure that the transfer of risk to the private party does not make the partnership unsustainable;
- make provision for renegotiating the terms of the agreement when the PPP has been in process for a while, so that practical experience can be brought to bear on the contract;
- improve public sector record keeping to facilitate evaluation of value for money; and
- consider revising the financial model requirements so that the PSC and public sector reference models are less onerous to compile and potentially more accurate.

# 5 CONCLUSION

In conclusion, we believe that PPPs are a viable alternative service delivery option for the public sector, particularly in the health sector where the budget for refurbishment and new hospitals is limited. Our research has shown that PPPs can and do deliver value for money, risk transfer for the public sector and improved service to the public. These PPPs have laid the groundwork for future, highly successful PPPs if best practice and recommendations are followed.