

Service delivery agreements

Renegotiations and amendments

Contract renegotiations and amendments are a relatively common feature of long-term service delivery agreements and public-private partnerships (PPPs). The legislature has recognised this in existing and newly promulgated legislation which clearly aims to limit the risks associated with contract amendments.

Introduction

Section 81(4) of the Municipal Systems Act 56 of 2003 (the Systems Act) obliges a municipality to give the community reasonable notice of its intention to amend a service delivery agreement and to allow public representations on the proposed amendment. This applies to service delivery agreements entered into after a competitive bidding process and so will typically mean agreements with the private sector.

The recently promulgated Municipal Public-Private Partnership Regulations to the Municipal Finance Management Act (1 April 2005) likewise contains provisions regarding the amendment of PPP agreements. The regulations, however, go much further than the Systems Act provisions. The new PPP regulations also require a public commenting process but widen this to include an obligation to solicit the views of both the National Treasury and the relevant provincial treasury. Any amendment must also be consistent with the basic essentials of PPPs as set out earlier in the regulations.

International trends

What lies behind this apparent concern to strictly control any proposed contract amendments?

It is useful to have a look at some of the statistics on contract renegotiations (and cancellations) for PPPs internationally to get an idea of the prevalence and impact of this practice.

PPPs in the developing world have become somewhat controversial as a result of the

perceived prevalence of contract renegotiations and cancellations. A World Bank report on renegotiations of concession contracts in Latin America (2002) noted that renegotiation is not an unusual occurrence and that during the 1990s, an estimated 74% of transport concessions and 55% of water concessions in Latin America were renegotiated. A 2004 International Monetary Fund study on PPPs also noted the relatively high number of contract renegotiations and referred to a study that found that project budgets in Chile increased on average by 15% after contract renegotiation. In South Africa, the first two flagship water concessions in Nelspruit and Dolphin Coast likewise underwent contract renegotiations relatively early into the contract. Both these contracts were entered into just prior to the promulgation of the Systems Act.

In recognition of the renegotiation problem, Chile has attempted to limit the associated risks by placing a statutory prohibition on any renegotiation altering the 'financial balance' of a contract. Not surprisingly, this has proved rather difficult to enforce. Another method of attempting to head off contract renegotiations has been to improve project specifications and tender procedures to ensure that amendments to the scope of work do not become necessary during the contract term.

Risks and dangers

One of the obvious problems with allowing a culture of contract renegotiation is that this threatens to render the detailed cost/benefit

key points

- **Contract renegotiation threatens to render cost/benefit analyses and feasibility studies in PPPs meaningless.**
- **This may threaten one of the prime objectives of PPPs, which is to achieve value for money.**
- **It is critical for municipalities that are party to long-term outsourcing agreements to be alive to the risks of contract renegotiation and material contract amendments.**

analyses and feasibility studies meaningless, as the ‘financial balance’ of a contract will almost invariably be affected after a renegotiation process. This may threaten one of the prime objectives of a PPP, which is to achieve value for money.

A further threat is that bidders may start to rely on the ‘certainty’ of being able to renegotiate terms and so bid low, knowing they can increase their charges later. The World Bank has identified this as a real risk and has referred to the problem as “strategic bidding”.

Another important factor is that in some sectors, such as the water sector, there are very few big players in the global arena. Any water concession is thus likely to involve the participation of one of the four or five large international companies. In any contract renegotiation, a municipality will therefore face a company with a wealth of international experience and expertise. One has to ask how balanced the negotiating process will be and how effectively the municipality will be able to protect its interests under these circumstances.

communities, from unfair or unbalanced contract renegotiations.

But do they go far enough? In the Systems Act, perhaps a distinction should be made between material and non-material contract amendments? After all, any large concession contract or long-term PPP is going to require tweaking here and there throughout the contract period. That is to be expected. But where the danger lies is in renegotiations which impact on affordability, risk transfer and value for money objectives. Also, the municipal PPP regulations only cover PPPs. The protections contained in the regulations should be mirrored in the Systems Act to apply to all long-term or large-scale service delivery agreements. Further, the Systems Act provisions on contract amendment only apply to service delivery agreements entered into after a competitive bidding process. This should possibly be extended to service delivery agreements with public entities, too, as it is quite possible that the ‘financial balance’ of the contract or value for money considerations may be negatively affected after an amendment or contract renegotiation in these circumstances.

In the interim, however, it is important for municipalities that are party to long-term outsourcing agreements to be alive to the risks of contract renegotiations and material contract amendments. Municipalities must be diligent in taking what steps they can to mitigate the risks of renegotiation and this should be over and above any statutory provisions.



Victoria Johnson
**Senior Associate: Corporate and
Commercial Law**
Sonnenberg Hoffmann Galombik
